
International Finance and Trade

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Detailed Curriculum

SECTION I: INTERNATIONAL FINANCE

Part I: International Economics

Introduction to International Finance: Increasing Interdependence in the Global Economy, Trends in International Trade and Cross-Border Financial Flows, India in the Global Economy, Recent Developments in Global Financial Markets, Liberalization, Integration and Innovation, Challenges of International Financial Management, Gains from International Trade and Investment.

Theories of International Trade: Theory of Absolute Advantage, Theory of Comparative Advantage, Heckscher-Ohlin Model, Imitation-Gap Theory, International Product Life Cycle Theory.

International Trade Finance in India: Import Financing, Letters of Credit, Export Financing, EXIM Bank, Exchange Control Regulations Related to Merchant Transactions.

Balance of Payments: Concept of Economic Transactions, Resident, General Government Institutions, Principles of Accounting, Components of the BoP Account, Factors Affecting the Components of the BoP Account, Balance of Payments Compilation, BoP – The Indian Perspective, Importance and Limitations of BoP Statistics.

Part II: Global Financial System

International Monetary System: Exchange Rate Mechanisms, History of Monetary Systems – Gold Standard, Gold Exchange Standard, Bretton Woods System, Post Bretton Woods System, European Monetary System, Recent Developments.

The Foreign Exchange Market : Structure and the Participants, Types of Transactions, Mechanics of Currency Dealing, Exchange Rate Quotations, Arbitrage, Forward Rates, Evolution of Exchange Control and the Foreign Exchange Market in India, Exchange Rate Computations. The Links between the Forex Market and the Money Market, Covered Interest Arbitrage, Covered Interest Parity Theorem, Swap Margins and Interest Rate Differentials, Option Forwards, Cancellation of Forward Contracts, Forward-Forward Swaps, Short Dated and Broken Date Contracts.

Exchange Rate Determination: Purchasing Power Parity (PPP), Law of One Price, Forms of PPP – Absolute Form, Relative Form and Expectations Form, Empirical Evidence Regarding PPP, Interest Rate Parity (IRP), Covered Interest Arbitrage, Relationship between PPP and IRP, Reasons for Departure from IRP.

Exchange Rate Forecasting: Forward Rate as a Predictor of Future Spot Rates, The Demand-Supply Approach, The Monetary Approach, The Asset Approach, Portfolio Balance Approach, News as a Determinant, Technical Analysis.

Part III: Exchange Risk Management

Introduction to Exchange Risk: Macroeconomic Risks and Corporate Performance, Defining Foreign Exchange Exposure, Measuring Foreign Exchange Exposure, Conceptual Approach, Classification of Foreign Exchange Exposure, Transactions Exposure, Translation Exposure, Operating Exposure, Exposure and risk, Risk as variability of Cash Flows.

Management of Exchange Risk: The Hedging Decision, Automatic vs. Discretionary Hedging, Cost of forward hedge, Choice of currency of invoicing, Internal Hedging Strategies: Leads, Lags, Netting, Offsetting, External Hedging: Forwards, Money market hedge, Futures and Options, Hedging Contingent Exposures and Exposures with Uncertain Timing. Operating Exposure, Purchasing Power Parity and Real Exchange Rates, Determinants of Operating Exposure, Operating Exposure for Exporters and Importers, Assessing and Coping with Operating Exposure.

Part IV: International Projects

International Project Appraisal: The Difficulties in Appraising a Foreign Project, Issues in Cost of Capital, The Adjusted Present Value (APV) Approach, The APV Approach for a Foreign Project, Choice of Discount Rates.

International Financial Markets and Instruments: The Costs and Risks of Foreign Currency Borrowing, Syndicated Loans, Bond Issues, MTNs, NIFS and Related Instruments, Project Finance, Country Risk Assessment.

International Equity Investment: Comparing Domestic Versus Foreign Equity Investment, Gains from Cross-border Diversification, International CAPM, The Depository Receipts Mechanism.

Short-term Financial Management: Short-term Funding and Investment, Centralized vs. Decentralized Cash Management, Netting, Pooling, Exposure Management, Offshore Invoicing Centers.

International Accounting and Taxation: Accounting for Forex Transactions and Derivatives, Transfer Pricing, Consolidation of MNCs Accounts, International Taxation.

SECTION II: INTERNATIONAL TRADE

Trade Blocks: Formation of Trade Blocks, Conditions for Success, OPEC, Its objectives, Functions of European Community (EC) Functioning of EC India and EC of the North America Free Trade Agreement (NAFTA), its Objectives, UNCTAD, Its Functions.

WTO: History, Functions, Structure of WTO Agreements, Trade Related Aspects of Intellectual Property Rights (TRIPS), Trade Related Aspects of Investment Measures (TRIMS), General Agreement on Trade in Services (GATS)

GATT: Trade Negotiations under GATT, Uruguay Round, Important Aspects of Market Access in the Uruguay Round, Subsequent Developments.

EXIM Policy: Historical Perspective, Objectives, Highlights of the Current Policy, Imports, Classification-Import Licences, Exports-Export Promotion Capital Goods Scheme (EPCG), Other Guidelines.

Uniform Customs and Practice for Documentary Credits 1993 Revision-Rules: Description of Articles, Applications of Articles, Collection Rules, Role of Drawer, Collecting Banker, Paying Banker.

Export Finance and Exchange Regulations: Incentives Available to Exporters-Preshipment Finance, Post Shipment Finance-Rediscounting of Export Bills Abroad - Preshipment Credit in Foreign Currency (PCFC), Other Exchange Control Regulations, Declaration Forms-GR/PP Procedure, Export Letters of Credit, Documents to be Presented under an Export Letter of Credit, Guidelines for Scrutiny of Documents Presented under Letter of Credit, Reporting System, Role of ECGC and its Functions.

Import Finance and Exchange Regulations: Classification, Imports under Foreign Credits/Loans-Postal Imports-Other Exchange Control Regulations-Merchanting Trade, Forward Exchange Contracts for Imports, Types of L/Cs, Mechanics of an L/C, Import Letters of Credit-Requirements for Opening an Import Letter of Credit, Operational Features of an Import L/C, Documentation Formalities, Scrutiny of Documents Required under an Import L/C, Other Relevant Guidelines, Role of Customs/C&F agents, Reporting System.

Section I: International Finance

Part I – International Economics

Chapter I

Introduction to International Finance

After reading this chapter, you will be conversant with:

- Need to Study International Finance
- Meaning and Implications of Globalization
- Integration of Financial Markets – Reasons, Benefits, Costs and Effects.

NEED TO STUDY INTERNATIONAL FINANCE

Financial management of a company is a complex process, involving its own methods and procedures. It is made even more complex because of the globalization taking place, which is making the world's financial and commodity markets more and more integrated. The integration is both across countries as well as markets. Not only the markets, but even the companies are becoming international in their operations and approach. This changing scenario makes it imperative for a student of finance to study international finance.

When a firm operates only in the domestic market, both for procuring inputs as well as selling its output, it needs to deal only in the domestic currency. As companies try to increase their international presence, either by undertaking international trade or by establishing operations in foreign countries, they start dealing with people and firms in various nations. Since different countries have different domestic currencies, the question arises as to which currency should the trade be settled in. The settlement currency may either be the domestic currency of one of the parties to the trade, or may be an internationally accepted currency. This gives rise to the problem of dealing with a number of currencies. The mechanism by which the exchange rate between these currencies (i.e., the value of one currency in terms of another) is determined, along with the level and the variability of the exchange rates, can have a profound effect on the sales, costs and profits of a firm. Globalization of the financial markets also results in increased opportunities and risks on account of the possibility of overseas borrowing and investments by the firm. Again, the exchange rates have a great impact on the various financial decisions and their movements can alter the profitability of these decisions.

MEANING AND IMPLICATIONS OF GLOBALIZATION

In this increasingly globalized scenario, companies need to be globally competitive in order to survive. Knowledge and understanding of different countries' economies and their markets is a must for establishing oneself as a global player. Studying international finance helps a finance manager to understand the complexities of the various economies. It can help him understand as to how the various events taking place the world over are going to affect the operations of his firm. It also helps him to identify and exploit opportunities, while preventing the harmful effects of international events. A thorough understanding of international finance will also assist the finance manager in anticipating international events and analyzing their possible effects on his firm. He would thus get a chance to maximize profits from opportunities and minimize losses from events which are likely to affect his firm's operations adversely.

Companies having international operations are not the only ones which need to be aware of the complexities of international finance. Even companies operating domestically need to understand the issues involved. Though they may be operating domestically, some of their inputs (raw materials, machinery, technological know-how, capital, etc.) may be imported from other countries, thus exposing them to the risks involved in dealing with foreign currencies. Even if they do not source anything from outside their own country, they may have foreign companies competing with them in the domestic market. In order to understand their competitors' strengths and weaknesses, awareness and understanding of international events again gains importance.

What about the companies operating only in the domestic markets, using only domestically available inputs and neither having, nor expecting to have any foreign competitors in the foreseeable future? Do they need to understand international finance? The answer is in the affirmative. Globalization and deregulation have resulted in the various markets becoming interlinked. Any event

occurring in, say Japan, is likely to affect not only the Japanese stock markets, but also the stock markets and money markets the world over. For example, the forex and money markets in India have become totally interlinked now. As market players try to profit from the arbitrage opportunities arising in these markets, the events affecting one market also end up affecting the other market indirectly. Thus, in case of occurrence of an event which has a direct effect on the forex markets only, the above mentioned domestic firm would also feel its indirect effects through the money markets. The same holds good for international events, thus, the need for studying international finance.

INTEGRATION OF FINANCIAL MARKETS

We have stated that globalization is taking place. What exactly do we mean by globalization? It essentially involves the various markets getting integrated across geographical boundaries. We will discuss the integration of the commodities market in a later chapter. Let us discuss the integration of financial markets first. What does it involve? Integration of financial markets involves the freedom and opportunity to raise funds from and to invest anywhere in the world, through any type of instrument. Though the degree of freedom differs from country to country, the trend is towards having a reducing control over these markets. As a result of this freedom, anything affecting the financial markets in one part of the world automatically and quickly affects the rest of the world also. This is what we may call the Transmission Effect. Higher the integration, greater is the transmission effect. Let us look at the reasons for this integration.

Reasons

Financial markets were not always as integrated as they are today. A number of factors are behind this change. The most important reason is the remarkable development of technology for transfer of money and information, making the same possible at an extremely fast speed and at considerably reduced cost. This has made possible the co-ordination of activities in various centers, even across national boundaries. Another significant development was the sudden increase in the inflation levels of various industrial countries which resulted in the price of various financial assets changing widely in response to the changes in the domestic inflation rates and the interest rates in different countries. These developments led to some others, which contributed all the more to the process of globalization. They are:

- i. **The development of new financial instruments:** For example, instruments of the euro-dollar market, interest rate swap, currency swap, futures contracts, forward contracts, options, etc.
- ii. **Liberalization of regulations governing the financial markets:** Though the extent and direction of liberalization has been different in different countries, based on the domestic compulsions and the local perspective, it has been substantial enough to make operations in foreign markets a lucrative affair.
- iii. **Increased cross penetration of foreign ownership:** This has helped in the countries developing an international perspective while deciding on various factors influencing the process of globalization.

Benefits

The function of the financial system is to efficiently transfer resources from the surplus units to the deficit units. Greater integration of the financial markets helps in performing this function in a better manner. Just like natural resources are distributed unequally among various countries, some countries are capital-rich, while others are capital-poor. Capital-rich countries generally enjoy a lower return on capital than the capital-poor countries. Let us imagine the scenario where there are no capital flows between these two sets of countries. In the absence of

adequate capital, the capital-poor countries will have to either forego or postpone some of the high-yielding investments. On the other hand, capital-rich countries will be investing in some of the low-yielding investments due to lack of better opportunities. When capital flows are allowed to take place, investors from the capital-rich countries would invest in the high-yielding projects available in the capital-poor countries. This would benefit both the countries. The residents of the capital-rich country will benefit by earning a higher return on their investments, and the cash-poor country will benefit by earning profits on the project which they would otherwise have had to forego. Integration of financial markets thus results in a more efficient allocation of capital and a better working financial system.

The other benefit of an integrated financial system is smoother consumption patterns enjoyed by all the countries over a period of time. The national income of a country is not constant from one year to the next. Besides the upward or the downward trend, there may be temporary jumps or slumps in a country's income due to various reasons. In these periods, if the country is not willing (or able) to make a corresponding change in its investments, it will have to reduce its consumption or will face a sudden surge in it, depending on the situation. Cross-border capital flows provide a solution to this problem. In times of a temporary slump in the income, a nation can borrow abroad and maintain its consumption at the normal level, paying back later when the income stabilizes. Similarly, a country having a temporary increase in income can invest it abroad in order to draw on these investments in times of need, and thus maintain its consumption at the normal levels.

Yet another benefit arising out of this integration is the possibility of enjoying the benefits of diversification. Just as diversification across various securities makes higher returns at the same risk-level (or same returns at a reduced risk-level) possible, diversification across borders also gives investors the same opportunity, by providing additional securities as well as an economic environment different from the one within the country. Of course, just like diversification across securities is possible only when the securities are not perfectly positively correlated, diversification across borders is possible only when the economic conditions of the countries involved are not perfectly positively correlated with each other.

Costs

It is a well known fact that risks and rewards go hand-in-hand. Accordingly, integration of the financial markets also involves taking some additional risks – currency risks and country risks.

Currency risk denotes the risk of the value of an investment denominated in some other country's currency, coming down in terms of the domestic currency. It also denotes the risk of the value of a foreign liability increasing in terms of the domestic currency. These could happen due to a change in the exchange rates.

Country risk is the risk of not being able to disinvest at will due to countries suddenly changing their attitude towards foreign investment, or due to some other factors like war, revolution, etc. Governments may suddenly change their policies regarding allowing non-residents to invest in certain areas, or repatriating their profits, or some other factor affecting the returns of the foreign investors.

One additional risk that integration of the financial markets has brought to the fore is that while the markets grow together, they usually also go down together in times of a downturn in an economy or in case of any panic among the investors. This trend has been quite visible in the various crises we have faced in the last few decades like the stock market crash of 1987, or the recent South-East Asian currency crisis, which got reflected in the stock markets worldwide.

Effects

The most important and visible effect of globalization and integration of financial markets is the increase in volatility. Whether it be interest rates, exchange rates or prices of financial assets, all of them change quite frequently in response to various changes taking place in different segments of the financial markets all over the world. Such change gets reflected in exchange rates before getting reflected in interest rates. Further, with the deregulation of the financial markets the world over, the control of the authorities on these variables has reduced to a great extent, thus exposing a firm to a number of risks, hitherto unknown to it. In this changed scenario, learning international finance (of which exchange risk management and interest risk management are an integral part) becomes essential for a finance manager.

SUMMARY

- Globalization is a continuous process and its pace is increasing with the passage of time. While it brings along a lot of opportunities, it is also accompanied by a number of problems and risks, which we will have to learn to handle.
- The developments of the last few years have made the study of international finance extremely important.

Chapter II

Theories of International Trade

After reading this chapter, you will be conversant with:

- Introduction to Theories of International Trade
- Developments on the International Trade Front
- Trade Barriers

INTRODUCTION TO THEORIES OF INTERNATIONAL TRADE

In the previous chapter, the various reasons and benefits of the integration of the financial markets were discussed. One important stimulant for this development was the increase in trade among different countries. A well-developed global financial system is essential for supporting increased international trade. The international payment system, the availability of international credit and credit guarantees (all forming a part of the international financial system), form the backbone of international trade. There are some fundamental issues which still need to be addressed. Why does international trade take place? What makes two entities in two different countries buy from or sell to each other? How is it decided as to which country should export a particular good and which country should import it? Who gains from such trade? A number of theories have been propounded in an effort to answer these questions. Some of the major theories will be explained in the following sections. The theories that will be covered are given below:

- Theory of Absolute Advantage
- Theory of Comparative Advantage
- Heckscher-Ohlin Model
- Imitation-Gap Theory
- International Product Life Cycle Theory.

Theory of Absolute Advantage

In 1776, **Adam Smith** proposed the theory that international trade takes place because one country may be more efficient in producing a particular good than another country, and that other country may be capable of producing some other good more efficiently than the first one. This provides an incentive to trade as both the countries can benefit from specialization and the resultant increase in productivity. Let us elaborate with an example. Suppose there are two countries – Angelland and Babel. Angelland can produce a supercomputer by using 10 units of labor, while Babel uses 15 units of labor for the same. On the other hand, to produce an aircraft Angelland requires 20 units of labor and Babel requires only 10 units of labor. All other factors are used in equal amounts by both the countries. Here, Angelland enjoys an absolute advantage in producing supercomputers and Babel in producing aircrafts. According to Adam Smith, in such a scenario, Angelland will restrict itself to producing supercomputers, and Babel to aircrafts. These goods will then be traded among these two countries. Let us assume that the countries exchange 1 supercomputer for 1 aircraft. Angelland will then be able to produce a supercomputer using 10 units of labor, exchange it for one aircraft and use the remaining 10 units of labor to produce a supercomputer for its own consumption. This way it will be able to derive the satisfaction of using a supercomputer as well as an aircraft by exhausting only 20 units of labor, which would otherwise have yielded only an aircraft. Babel can also benefit in a similar fashion. Thus, international trade results in increasing the rate of economic growth of both the countries by utilizing the resources of both the countries more productively. If increasing returns to scale are experienced, the benefits are further increased.

There are certain limitations to this theory. Firstly, it explains the causes of trade between two countries only in those situations, where both the countries enjoy absolute advantage in the production of at least one product. Secondly, it assumes that the transportation costs involved in selling a commodity in a country other than the one in which it was produced, are either non-existent or insignificant when compared to the degree of comparative advantage. This may not always hold good. Another assumption of the model is that prices are comparable across countries, implying stability of exchange rates. These assumptions may again not

hold good. Lastly, the theory assumes mobility of labor between products. As a country starts concentrating on producing the commodity in which it enjoys a comparative advantage, the labor is assumed to shift from other sectors to that sector. Labor may be mobile, but only to an extent. The kind of adaptability required for labor to be perfectly mobile cannot actually exist.

Theory of Comparative Advantage

According to the absolute advantage theory, two countries enter into trade when both of them hold an absolute advantage in the production of at least one product. The question which arises here is whether two countries can benefit by trading with each other even if one of them has an absolute advantage in all the commodities. Yes, they can. According to the theory of comparative advantage, propounded by the English economist **David Ricardo** in 1817, trade is possible as long as the country experiencing the disadvantage is not equally less efficient in producing all the products, i.e., both the countries enjoy comparative advantage in at least one of the products. Let us take an example to understand what this means.

Continuing with our example of countries Angelland and Babel, let us assume that their respective efficiencies in producing steel and cement to be as given in the Table 1.

Table 1: Efficiencies of Countries as Reflected by the Labor-Hours Used

	Labor-hours required	
	1 unit of steel	1 unit of cement
Angelland	5	10
Babel	15	20

As we see, Angelland enjoys an absolute advantage in producing both steel and cement, as the number of labor-hours required to produce one unit of each commodity is lesser than that required by Babel. Let us further assume that both the countries have 600 units of labor-hours at their disposal. These labor units can be used for producing either steel or cement. If Angelland utilizes these units for exclusively producing steel, then it will be able to produce 120 ($600/5$) steel-units. In case it goes for producing only cement, its capacity would be 60 ($600/10$) units of cement. Similarly, Babel can produce either 40 units of steel or 30 units of cement. As we see, for producing each unit of steel, the production of a particular number of units of cement has to be foregone, and vice-versa. The quantity of cement thus foregone in order to produce one additional unit of steel is called the **opportunity cost** of steel. As Angelland can either produce 120 units of steel or 60 units of cement with the available resources, the opportunity cost of steel for Angelland would be 0.5 ($60/120$). The opportunity costs of producing steel and cement for the two countries can be similarly calculated. This calculation is shown in Table 2.

Table 2: Opportunity Costs Involved in the Production of Steel and Cement

	Opportunity cost	
	Steel	Cement
Angelland	$60/120 = 0.50$	$120/60 = 2.00$
Babel	$30/40 = 0.75$	$40/30 = 1.33$

Enjoying comparative advantage for a country means having a lesser opportunity cost in producing a commodity than the other country. As we can see from Table 2, Angelland has a lower opportunity cost and hence enjoys a comparative advantage in producing steel, while Babel enjoys it in producing cement. According to the theory of comparative advantage, each country should produce that good, in which it has a comparative advantage. Hence, Angelland should

produce steel and Babel should produce cement. This result can be arrived at by one more method. As we see from Table 1, Angelland is comparatively more efficient in producing steel than in producing cement. It consumes only one-third the units of labor that Babel needs to produce a unit of steel, while in the case of cement it needs half the labor-units required by Babel. Thus, Angelland should produce steel since it is comparatively more efficient in steel production. This gives us the same result as given by the measurement of comparative advantage.

The analysis of comparative advantages, thus tells us as to which country should produce which commodity. Now we have to understand how this specialization in production and the consequent trade will help the two countries in increasing their standard of living. Assume the state of *autarky*, i.e., the state where no cross-border trade takes place. Angelland foregoes 0.5 units of cement for every one unit of steel it produces. At the same time, Babel foregoes 1.33 units of steel for every unit of cement that it manufactures. Introducing international trade in the picture, if Angelland could get more than 0.5 units of cement in exchange for one unit of steel, it will gain. Similarly, if Babel could sell a unit of cement for more than 1.33 units of steel, it will also benefit from trade. In other words, Babel would benefit if it could get a unit of steel for less than $0.75 (=1/1.33)$ units of cement. Hence, both the countries can benefit if a unit of steel can be traded in the international market for anywhere between 0.5 and 0.75 units of cement. According to the theory of comparative advantage, Angelland should produce only steel and Babel only cement and they should trade these in the international markets for mutual benefit. Let us say, the international terms of trade are 0.65 units of cement per unit of steel. If Angelland produces one unit of steel using 5 units of labor in the process, and trades it for 0.65 units of cement, it will save 1.5 units of labor ($0.65 \times 10 - 5$). These labor-units can be used to produce additional units of steel for consumption at home or to be exchanged for more units of cement. Similarly, Babel can save 2 units of labor by producing 0.65 units of cement and trading it for a unit of steel ($15 - 0.65 \times 20$). These units can also be used for further production of cement, either for home consumption or for further trade. These gains are referred to as *gains from trade*. Thus, we see that international trade benefits, irrespective of whether a country enjoys absolute advantage in the production of any product or not.

In explaining the theory of comparative advantage, David Ricardo made certain implicit assumptions. They are

- i. **Perfect competition:** Perfect competition with flexible prices and wages prevails in both the countries. This results in the prices of steel and cement being different in Angelland and Babel due to a difference in the labor-hours used and hence the production costs.
- ii. **Productivity of labor:** Labor is the only factor of production and the average product of labor is constant for producing both the products in both the countries. This means that the marginal product of labor is constant, implying constant returns to scale.
- iii. **Full employment:** There is full employment in both the countries. This assumption is necessary for calculating the opportunity costs of the goods by making a choice between the production of the two goods compulsory.
- iv. **Mobility:** Labor is perfectly mobile between various sectors, but perfectly immobile between countries.
- v. **Technology:** No technological innovation takes place in any of the economies. This assumption is also necessary for keeping the marginal product of labor, and hence the comparative advantages, constant.

As the two countries start trading, the conditions in the domestic markets will change. As demand for steel in Angelland increases due to export demand, price of steel in that country will rise. Similarly, the price of cement in Babel will also rise. Meanwhile, the increase in supply due to import of cement in Angelland and steel in Babel will reduce the prices of these goods in the respective countries. The

change in the domestic prices will result in a change in the profitability involved in the production of these goods. As production of steel becomes more profitable and that of cement becomes less profitable in Angelland, there will be a shift in production in that country from cement to steel. There will be a similar shift in production in Babel from steel to cement. As a result of the shift in production, the labor also moves from one sector to the other. This process will continue till the relative prices in the countries involved are equalized for both the commodities.

This theory is also not free from limitations. What if labor is not able to shift from one sector to the other in response to the shift in production? Will the theory still hold good? In such a case, unemployment in the economy will rise and the country will end up even less efficient than it was under the state of autarky. So, when the economy is in the grip of a recession or malfunctions, the theory of comparative advantage may not work. The reason world trade order broke down during the Great Depression of 1930s, can easily be traced to the soaring unemployment and falling outputs all over the world. International trade again picked up after the Second World War when the manifold increase in trade among the industrialized nations led to unprecedented economic growth. Thus, we can say that the theory of comparative advantage works properly when the economy is generally in an equilibrium and the various economic indicators like the exchange rate, prices and wages are at their appropriate levels. A disequilibrium in the economy like the declining part of an economic cycle make it go haywire. Similarly, some other assumptions of the theory like perfect competition and absence of technological innovation are very rigorous. The theory also leaves the reasons giving rise to comparative advantage untouched. In addition, it suffers from all the drawbacks of the theory of absolute advantage. Yet, despite the drawbacks, this theory is one of the closest explanations of international trade and the benefits derived from it. No nation desirous of prospering and achieving high levels of economic growth can afford to ignore it.

Heckscher-Ohlin Model

The theory of comparative advantage assumes a single factor of production – labor – and describes the situation where trade takes place between countries having different technologies, i.e., the countries operating at different levels of efficiency giving rise to comparative advantages. The **Heckscher-Ohlin model** developed by Eli Heckscher and Bertil Ohlin in the 1920s, explores the possibility of two nations operating at the same level of efficiency, benefiting by trading with each other. Following are the assumptions of the model:

- i. No obstructions to trade (for e.g., trade controls, transport costs) are there.
- ii. Both commodity and factor markets are perfectly competitive.
- iii. There are constant or decreasing returns to scale.
- iv. Both the countries have the same technology and hence operate at the same level of efficiency.
- v. There are two factors of production – labor and capital. Both are perfectly immobile for inter-country transfers, but perfectly mobile for inter-sector transfers.

According to this theory, there are two types of products – labor-intensive and capital-intensive. The model further says that the reason two countries operating at the same level of efficiency can, and do benefit from trade can be traced to the differences in their factor endowments. The labor-rich country is more likely to produce labor-intensive goods and the country rich in capital will most probably produce capital-intensive goods. The two countries will then trade these goods and reap the benefits of international trade.

Just as having a higher per capita income, rather than having a higher national income should be the criteria for judging as to which country is richer; for judging as to which country is capital-rich, the criteria should be greater physical amount

of capital *per unit of labor* rather than abundance of capital. There is another way of categorizing a country as capital-rich or labor-rich. The country where capital is cheaper than in the other country under the condition of autarky can be called as capital-rich. The theory always holds good if we categorize the countries on the basis of factor prices. If the amount of factor is used as the basis of categorization, then to make the theory valid, we have to make the additional assumption that the tastes of the consumers are identical and homothetic in both the countries. This is so, because a bias in consumer tastes towards consumption of labor-intensive goods in an economy which is physically capital-rich, or vice-versa, can distort the factor prices so as to make the relative price of a capital-intensive good higher in the physically capital-rich country. This would result in a contradiction between the categorizations made on the basis of the two different interpretations of factor abundance. The assumption of identical tastes removes this obstacle.

The Heckscher-Ohlin model is also not free from drawbacks. Firstly, it assumes that factor endowments are given, whereas they can also be developed through innovation. Secondly, due to minimum wage laws existing in some countries, the factor prices may change to such an extent, that an otherwise labor-rich country may find it cheaper to import labor intensive goods than to produce them locally. Finally, the findings of an empirical study by economist **Wassily Leontief** pointed out that despite being a capital-rich country, US exports are more labor-intensive than capital-intensive. All these factors highlight the fact that there is more to international trade than just factor endowments. In case of US exports, as Leontief found out, it was the availability of highly skilled and educated labor that prompted the US to export labor intensive goods.

Imitation-Gap Theory

This theory, given by Posner, considers the possibility of trade between two countries having similar factor endowments and consumer tastes. According to this theory, improvement in technology is a continuous process and the resulting inventions and innovations in existing products give rise to trade between such countries.

The degree of trade between such countries will depend upon the difference between the demand lag and the imitation lag. **Demand lag** is the difference between the time a new or an improved product is introduced in one country and the time when consumers in the other country start demanding it. **Imitation lag** is the difference between the time of introduction of the product in one country, and the time when the producers in the other country start producing it. Imitation lag depends on a number of factors including the readiness of the producers in the second country to adopt new technology, availability of patent protection to the original producer, time taken by the second country producers to learn the new process and to adapt the existing plant and machinery to it, the simplicity or otherwise of the innovation, and the likelihood of the second country producers developing the technology on their own due to a constant process of research and development. Demand lag depends to a large extent on the speed and effectiveness of flow of information, the readiness of the consumers in the second country to use innovative products, the speed with which they react to changes in technology, and their ability to convert their desires into demand (i.e., their financial ability to purchase the products). If due to any of the above factors, the imitation lag is shorter than the demand lag, no trade will take place between the two countries. However, normally demand lag can be expected to be shorter than imitation lag. In such a case, the country coming out with the innovation will be able to start exporting to the second country as the consumers there become aware of its product, and the exports will keep growing as more and more consumers become aware. These exports will continue to increase till the demand lag is over, i.e., till all the consumers react to the innovation. If the local producers can start producing the same product before this time period, they can arrest the growth of these

imports into their country, otherwise the exports will continue and will stabilize at a particular level. At the end of the imitation lag, the trade will start coming down and will be finally eliminated. If due to further technological innovations in the first country, it is able to come out with a still better product before the elimination of these exports, the second cycle would start even before the first one has ended. On the other hand, if there are no further innovations in the first country and the second country producers are able to come out with another new product due to the stimulation received by research in their country, the whole cycle will reverse.

International Product Life Cycle Theory

The International Product Life Cycle (IPLC) theory, given by Vernon, explains the various stages in the life of a new product and the resultant international trade. Two important factors considered by this theory (and generally ignored by the other theories) are technological innovation and market structure. The important principles of this theory are:

- New products are developed as a result of technological innovations.
- Trade patterns are determined by the market structure and the phase in a new product's life.

According to this theory, innovations are generally concentrated in the richer, more developed countries. In the early stages of a new product, it is produced and exported by the country which introduced the innovation. In the second stage of the life of the product, production may shift to other developed countries where the factors required are in abundance and thus offer a cost advantage. In the third and the final stage, production shifts to lesser developed countries. This process results in the originally exporting country becoming the importer.

There are two major reasons for innovations to be concentrated in the capital-rich countries. The first reason is that the environment in the capital-rich countries happens to be more conducive to research and development, which forms the backbone of innovations. This is so because the patent regulations are more effective there, along with a favorable tax structure. R&D generally requires a lot of money and skilled labor, which are available aplenty in capital-rich countries. The second incentive for such countries to create new innovation is that the consumers there generally have high incomes and are ready to try new products.

Once new products are developed, they are first produced in the country that develops them. The reasons are quite similar to the ones which promote R&D to take place in such countries. Since the production of a new product is generally very risky (as it is highly priced because of it being an improvement over the existing products), the producers will feel more comfortable if the consumers it is directed at, are having relatively high incomes. The production of such goods also requires flexibility on the production side, which is made possible by the availability of skilled labor in such economies. When a product is in its initial stages, it is much more beneficial, even essential, to be at a close proximity to the ultimate consumer. This again favors production to take place in these countries, rather than some far off country which may be endowed with better suited factors of production. Initially, these goods are produced for local consumption and due to price inelasticity, high profits are enjoyed by the producers. These high profits encourage increased production, and as supply starts outstripping demand, the country starts exporting to the rest of the world.

As the product enters the maturity stage and the factor requirement changes, the center of production also shifts from the country which initially introduced the innovation, to other developed countries which may offer a cost advantage due to a more suitable pattern of factor prices. The factor requirements may change due to standardization of the product and its manufacturing process taking place after some time of the introduction of the product in the markets. The entry of other countries in the production scene may also be facilitated by the expiry of the patent

granted at the time of the innovation or the development of substitutes in other countries. As the production process may still require highly skilled labor and the product may be expensive enough to need high-income consumers, production may shift only to other developed countries. Also, the substitutes are likely to first come up in other developed countries. The exports from the country which came out with the innovation would decline in this phase, and those from these other developed countries will register an increase.

After passage of some more time, the production process would become totally standardized and it would become possible to produce the good with relatively unskilled labor. Also, as the technology would become easily available, producers in relatively less developed countries would become interested in producing the good. By this time, the country introducing the innovation could also be reasonably expected to come out with still newer technology, making the earlier product cheaper and affordable by the residents of these lesser developed countries. All these factors would result in the shifting of production to the latter. Thus, in the last phase of the product life cycle, these countries would start exporting the standardized product and the countries earlier engaged in its production and export would face a decline in their exports, some of them even becoming importers of the same product. It is important to remember here that since different versions of the same product may be at different stages of their life cycle at the same time, a country may be exporting as well as importing the same product, albeit different versions, at any given point of time.

DEVELOPMENTS ON THE INTERNATIONAL TRADE FRONT

Intra-Industry Trade

The theories discussed in the previous section explain why one country exports some products to a few countries, while importing other products. Another interesting phenomenon observed is that of a particular country simultaneously importing and exporting the same product. This is referred to as intra-industry trade. Why does intra-industry trade take place? A number of reasons can be attributed to the popularity of such trade. A few of them are given below:

- One reason which promotes intra-industry trade is transportation costs. The distance (and hence the transportation costs involved) may be lesser between city X in Angelland and a city in Babel, than between city X and city Y in the same country (i.e., Angelland). This would encourage consumers staying in city X to import from Babel rather than buy from within their own country. If Angelland is involved in exporting the same good to other countries, it will effectively end up being engaged in intra-industry trade.
- Seasonal differences provide another reason for intra-industry trade. A country may import a particular foodstuff when it is not in season in that part of the world and may export it when it comes in season.
- Product differentiation also promotes such trade. It is generally observed that capital-rich countries export superior quality varieties of the capital-intensive products, while the labor-rich countries export both the labor-intensive products and the lower quality varieties of the capital-intensive products. If demand for both lower and higher quality goods exist in both types of countries, it would again result in intra-industry trade. However, international trade due to product differentiation need not necessarily be a result of difference in qualities. Trade may also take place due to the existence of different brands. For example, the US exports one brand of automobiles while importing another.

In addition to the above theories, there are a few more factors affecting international trade. These are

- **High Re-entry Costs:** A firm temporarily facing a slump in international demand and/or price for its product may have to continue its supply, even if it is not economically justifiable, due to high re-entry costs. In such a situation, international trade will take place despite a comparative disadvantage being faced by the firm.
- **Economies of Scale:** Economies of scale may encourage a firm to produce more in order to attain lower per unit cost. This additional output would then be unloaded in the foreign markets. Thus, a firm may be able to export even without enjoying comparative advantage, as a result of scale economies.
- **Currency Value:** Exchange rates, i.e., value of one currency in terms of another currency may increase or decrease the competitiveness of a product in the international markets. This may result in a change in the trading pattern among nations.
- **Consumer Tastes and Imperfect Competition:** Consumer tastes are an important factor governing international tastes. Due to a perceived difference in quality, brand image of a particular product, or some other psychological reason, consumers may be ready to purchase a more expensive product despite a similar product being available for a lesser price. This may also happen in case of imperfect competition prevailing where information about the availability of the cheaper product may not be held by a section of the consumers. These factors would distort the trade patterns.

Growth of International Trade

As we have seen, trade among nations induces countries to specialize in particular products or in particular varieties of some products. This results in a more efficient allocation and utilization of world resources. As the producers benefit from specialization and economies of scale and the consumers get a wider range of products to choose from, the economic activity increases, thus giving a push to economic growth the world over. Countries have been trading with each other for several centuries, but as countries began to appreciate the above-mentioned fact, international trade started growing by leaps and bounds. There have been times when countries showed a reduced interest in such trade and adopted various measures to protect their domestic industries which resulted in a drawback to the growth, but such times have had their roots in the underlying weak economic variables. These protectionist measures were introduced for tiding over temporary difficulties such as the Great Depression of 1930s, rather than out of any general disinclination towards trade. In fact, during the last half-a-century, international trade has grown at a rate faster than that of the GDPs of the countries involved. As a result, exports as a percentage of GDP has increased dramatically for a number of countries.

Risks Involved in International Trade

Risks and rewards always go hand-in-hand. True to this maxim, the advantages of international trade are not unaccompanied by additional risk. There are two types of additional risks that have to be taken care of while trading across nations – exchange risk and country risk. Exchange risk is the uncertainty of returns induced by unexpected changes in exchange rates. As exchange rates change unexpectedly, they may have an unfavorable effect on sales, prices, costs and profits of exporters and importers. Country risk refers to the risk of an exporter not receiving his payment from the importer due to some country specific reasons. These reasons may be political (like war), social (civil war), or economic (extreme liquidity crunch in the economy). Even when the capacity of the importer to pay is not impaired by any of these reasons, the payment may not come through due to some currency exchange restriction suddenly imposed by the importing country. Despite these additional risks, international trade has proved to be an attractive proposition.

TRADE BARRIERS

Despite all the obvious benefits of international trade, governments have an inclination to put up trade barriers in order to discourage imports. There are two kinds of barriers: Tariff and non-tariff.

Tariff Barriers

Tariff is a tax levied on goods traded internationally. When imposed on goods being brought into the country, it is referred to as an import duty. Import duty is levied to increase the effective cost of imported goods in order to increase the demand for domestically produced goods. Another type of tariff, less frequently imposed, is the export duty which is levied on goods being taken out of the country, to discourage the export of those goods. This may be done if the country is facing a shortage of that particular commodity or if the government wants to promote the export of that good in some other form, for example, a processed form rather than in raw material form. It may also be done to discourage exporting of natural resources. When imposed on goods passing through the country, the tariff is called transit duty.

Tariff can be imposed on three different bases. A specific duty is a flat duty based on the number of units regardless of the value of the goods. For example, there may be a duty of Rs.5,000 per computer imported into India. In this case, a person importing, say, 20 computers would have to pay a duty of (5,000 x 20 = Rs.1,00,000). An ad valorem duty is expressed as a percentage of the value of the good. So a person importing a walkman worth Rs.2,000 carrying an import duty of 10% would have to pay Rs.200 towards duty charges. A compound duty is a combination of a specific and an ad valorem duty. For example, a book worth Rs.500 carrying a specific duty of Rs.25 and an ad valorem duty of 2% would in effect be carrying a compound duty of Rs.35.

Over the last few decades, tariffs have been losing their importance as barriers to trade, their place being taken by non-tariff barriers.

TECHNICAL BARRIERS

Countries generally specify some quality standards to be met by imported goods for various health, welfare and safety reasons. This facility can be misused for blocking the import of certain goods from specific countries by setting up of such standards which deliberately exclude these products. The process is further complicated by the requirement that testing and certification of the products regarding their meeting the set standards be done only in the importing country. These testing procedures being expensive, time consuming and cumbersome to the exporters, act as a trade barrier. Under the new system of international trade, trading partners are required to consult each other before fixing such standards. It also requires that the domestic and imported goods be treated equally as far as testing and certification procedures are concerned and that there should be no disparity between the quality standards required to be fulfilled by these two. The importing country is now expected to accept testing done in the exporting country.

PROCUREMENT POLICIES

Governments quite often follow the policy of procuring their requirements (including that of government-owned companies) only from local producers, or at least extend some price advantage to them. This closes a big prospective market to the foreign producers.

INTERNATIONAL PRICE FIXING

Some commodities are produced by a limited number of producers scattered around the world. In such cases, these producers may come together to form a cartel and limit the production or price of the commodity so as to protect their profits. OPEC (Organization of Petroleum Exporting Countries) is an example of such cartel formation. This artificial limitation on the production and price of the commodity makes international trade less efficient than it could have been.

EXCHANGE CONTROLS

Controlling the amount of foreign exchange available to residents for purchasing foreign goods domestically or while travelling abroad is another way of restricting imports.

DIRECT AND INDIRECT RESTRICTIONS ON FOREIGN INVESTMENTS

A country may directly restrict foreign investment to some specific sectors or up to a certain percentage of equity. Indirect restrictions may come in the form of limits on profits that can be repatriated or prohibition of payment of royalty to a foreign parent company. These restrictions serve to discourage foreign producers from setting up domestic operations. Foreign companies are generally interested in setting up local operations if they foresee increased sales or reduced costs as a consequence. Restrictions against foreign investment, thus, act as an impediment to international trade by giving rise to inefficiencies.

CUSTOMS VALUATION

There is a widely held view that the invoice values of goods traded internationally do not reflect their real cost. This gave rise to a very subjective system of valuation of imports and exports for levy of duty. If the value attributed to a particular product would turn out to be substantially higher than its real cost, it could result in affecting its competitiveness by increasing the total cost to the importer due to the excess duty. This would again act as a barrier to international trade. This problem has now been considerably reduced due to an agreement between various countries regarding the valuation of goods involved in cross-border trade.

TRANSPORTATION COSTS

These costs act as another trade barrier. The cost of moving goods from one market to another has the same effect as tariffs. While tariffs are imposed by governments, transportation costs act as natural barriers to trade.

Non-tariff Barriers

Non-Tariff Barriers (NTBs) include all the rules, regulations and bureaucratic delays which help in keeping foreign goods out of the domestic markets. There are different types of NTBs:

QUOTA

A quota is a limit on the number of units that can be imported or the market share that can be held by foreign producers. For example, the US has imposed a quota on textiles imported from India and other countries. Deliberate slow processing of import permits under a quota system acts as a further barrier to trade.

EMBARGO

When imports from a particular country are totally banned, it is called an embargo. It is mostly put in place due to political reasons. For example, the United Nations imposed an embargo on trade with Iraq as a part of economic sanctions in 1990.

VOLUNTARY EXPORT RESTRAINT (VER)

A country facing a persistent, huge trade deficit against another country may pressurize it to adhere to a self-imposed limit on the exports to the deficit facing country. This act of limiting exports is referred to as voluntary export restraint. After facing consistent trade deficits over a number of years with Japan, the US persuaded it to impose such limits on itself.

SUBSIDIES TO LOCAL GOODS

Governments may directly or indirectly subsidize local production in an effort to make it more competitive in the domestic and foreign markets. For example, tax benefits may be extended to a firm producing in a certain part of the country to reduce regional imbalances, or duty drawbacks may be allowed for exported goods, or, as an extreme case, local firms may be given direct subsidies to enable them to sell their goods at a lower price than foreign firms.

LOCAL CONTENT REQUIREMENT

A foreign company may find it more cost effective or otherwise attractive to assemble its goods in the market in which it expects to sell its product, rather than exporting the assembled product itself. In such a case, the company may be forced to produce a minimum percentage of the value added locally. This benefits the importing country in two ways – it reduces its imports and it increases the employment opportunities in the local market.

Comparison Between Quotas and Tariffs

Any kind of trade barrier reduces the efficient allocation of world resources and the achievable level of standard of living. Both quotas and tariffs cause this to happen. Yet, there are some differences between the two. The imposition of a tariff generates revenue for the government, which could be used to reduce other taxes or for other welfare activities and thus negate the harmful effect of tariffs on consumers to some extent. In the case of a quota being imposed, the only beneficiaries would be the importers who are able to get hold of an import license. Secondly, quotas are enforced by allowing imports only against import licenses, which are issued on a selective basis. Since the basis of selection for the grant of import licenses is rarely clear, it leaves scope for manipulation. In this aspect, a tariff is better than a quota as it is a more transparent mechanism. Otherwise also, importers would prefer facing a tariff rather than a quota, since a tariff would make the availability of the commodity (though at a higher price) a certainty and eliminate the ambiguity involved in a quota system. On the other hand, the local producers for whose benefit the barrier is being put up, would rather have a quota in place since it helps them in planning for their future production levels if they can project the future domestic demand. In case of a tariff being in place, the future movements in the world prices and the elasticity of demand for imported goods would also have to be estimated, which would prove to be a much more difficult exercise.

Reasons for Imposition of Trade Barriers

Various arguments have been forwarded to justify the imposition of trade barriers. Some of them may be valid in certain conditions, but most of them are based on a fundamental misunderstanding of the basic principles underlying international trade. In some cases they only serve to protect the interest of some specific groups in the economy. The various reasons given are as follows:

- Tariffs are a source of revenue for the government.
- Sometimes compromising on economic welfare becomes essential due to some important national goals. For example, national security cannot be compromised by opening up the defense sector. There may be other national concerns that have to be taken care of, for example, preservation of cultural traditions or environment protection.
- The fallacy that a country's economic condition can be improved only if the country enjoys a trade surplus, tempts governments to put up trade barriers. This line of thinking stems from the period when a nation's wealth used to be measured by the amount of gold it held and any trade surplus or deficit was settled by transfer of gold. This system, called the gold standard, no longer works and hence cannot be taken as a reasonable excuse to put up trade barriers. (The system of gold standard is explained in detail in a later chapter.)
- Free international trade has a few major implications. The first one is factor price equalization. As international demand for a commodity produced in a particular country grows, the price of the factor of production which is used intensively for that product, increases in that particular country. At the same time, demand for the same product produced in other countries reduces, which lowers down the price of that factor in those countries. Hence, the

factors of production which are comparatively inefficient suffer in terms of reduced compensation. Another implication is that in the event of an increase in the productivity of one of the factors of production, there is a reduction in the production of goods which intensively use the other factor. These implications give rise to a demand from those sectors for protection – of domestic industries, local jobs and the levels of factor prices. These sectors serve as very powerful lobbying groups for putting up trade barriers.

- Tariffs are a popular means of retaliation for other countries putting up barriers against domestic goods.
- When some foreign producer is found to be dumping some particular good, i.e. selling it at a price that does not even cover his costs (this may be done to secure a foothold in the market), anti-dumping duty may be levied.
- When some foreign country subsidizes its exports (may be to avoid balance of payments problem), the importing country may impose a *countervailing duty*.
- A nation which is large enough to be able to affect world prices may be able to change the terms of trade in its favor by levying tariffs. Imposition of tariffs would increase the domestic prices beyond the international prices, thus reducing domestic demand. If the domestic demand is large enough, then this fall would induce the world price of that commodity to come down, thus improving the terms of trade for the large country. In this situation, imposition of tariffs could prove to be an attractive proposition for the large country, at least in the short-term. In the long-term, other big countries may also decide to act in the same manner, resulting in a decline in the economic welfare of all the countries.
- Trade barriers may be needed to protect an infant industry with tremendous growth potential, if it is believed that in the long run it would be able to stand on its own and face international competition. A new industry may not be able to withstand the intense competition from well-developed industries of other countries. However, if it is provided an initial period of shelter, it may be able to develop the economies of scale, the skilled labor force, the technological efficiencies and the product adaptation in accordance with consumer tastes, which are required for turning the comparative advantage in its favor. This fact encourages countries to put up trade barriers in that initial period.
- Barriers can be used to increase the demand for domestic products (by increasing the price of foreign goods by imposing a tariff or by restricting their availability with the help of quotas), in order to increase the domestic employment opportunities, especially during periods of recession. This method of generating employment may, however, involve a huge economic cost. The same result may be achieved by following appropriate monetary and fiscal policies. Besides, international trade would cause labor to shift from industries which suffer from comparative disadvantage to those enjoying comparative advantage. This would also result in an improvement in the productivity of labor, thus providing a long-term solution to the problem of unemployment. Restrictive barriers can only provide a short-term solution to the said problem.
- Restrictions may be put in place to reduce expenditure in foreign currency by the citizens in order to improve the balance of payments situation.
- Helping the exporters build-up world markets can be another reason for putting up of trade barriers.
- Providing encouragement to local production in order to reduce reliance on foreign producers serves as a justification for trade barriers.

- Certain Non-Tariff Barriers (NTBs) like tax breaks for firms producing in certain backward areas of the country (i.e. local production) may be put in place in an attempt to reduce regional income disparities.
- Free trade may not be allowed because of the drawbacks of international trade, for example, the unequal distribution of the benefits of international trade among the various sections of the society, short-term unemployment during the transition period from the production of the goods in which the economy is relatively inefficient to those in which it is relatively efficient.
- Though a particular industry may not be under any direct threat from advancements in technology in other countries, barriers may still be put in place due to externalities and spillover effects. These terms refer to the phenomenon where a change in technology in a related industry or an outside event changes the comparative advantage of another industry.
- Governments may not allow trade with another country due to ideological differences, international sanctions or other political reasons (for example, the US has not traded with Cuba for a long time). Economic sanctions can take a number of forms – from embargo (a complete ban on transactions) to restriction on some particular types of transactions. For example, while in 1990, an embargo was imposed against Iraq due to UN sanctions; in 1998, US banned American entities from entering into some particular transactions with India as a part of sanctions.

Costs of Trade Barriers

Trade barriers have three effects on the economy. First, by increasing the cost of foreign goods and shifting the domestic demand towards domestically produced goods (which are not competitive, implying a higher cost of production), barriers encourage inefficient production by local producers. Secondly, faced with a higher price, consumers reduce the consumption of that good. Lastly, tariffs generate revenue for the government. The first two effects have an economic cost involved. Though the third effect does not involve any economic cost, this benefit together with the benefit to the domestic producers cannot offset the economic costs of inefficient production coupled with the reduced consumption and higher prices to be borne by the consumers. So, there is a net loss caused by discouragement to international trade by way of putting up trade barriers.

SUMMARY

- World trade has grown rapidly in the last few decades. These latest developments can be reasonably expected to make it grow at an even faster rate. Whether the benefits of this growth are being equally distributed among the various nations or are being usurped by a few developed nations due to the political and economic power enjoyed by them, is a hotly debated topic which is unlikely to be settled in the near future.
- The only thing which is certain is that the world as a whole is going to tremendously benefit by this coming together of nations in an attempt to sort out their differences and to find a mutually benefiting solution to the various problems facing them.

Chapter III

International Trade Finance in India

After reading this chapter, you will be conversant with:

- Role of EXIM Bank in Trade Finance
- Exchange Control Regulations Related to Merchant Transactions

THE ROLE OF EXPORT-IMPORT BANK OF INDIA (EXIM) IN TRADE FINANCE

The EXIM bank was set-up to finance and promote foreign trade. EXIM bank extends finance to exporters of capital and manufactured goods, exporters of software and consultancy services and to overseas joint ventures and turnkey/construction projects abroad. Term loans are also extended to projects located in export zones.

EXIM bank financing can, if required, supplement working capital finance extended by commercial banks at pre-shipment stage. The functions of the EXIM bank are lending, guaranteeing, promotional services and advisory services.

Lending

I. To Indian Companies	II. To Foreign Govt., Foreign Companies	III. To Indian Banks
1. Direct Assistance	1. Buyers' Credit	1. Bill Rediscounting
2. Consultancy and Technology Services	2. Lines of Credit	2. Refinance
3. Overseas Investment Finance	3. Relending Facility	
4. Pre-shipment Credit		
5. Deemed Exports		
6. 100% Export Oriented Units and Free Trade Zones		
7. Forfaiting		

Lending to Indian Companies

Direct Assistance

Funds are provided on deferred payment terms to Indian exporters of plant, equipment and related services, which enable them to extend deferred credit to the overseas buyer. Credit is provided by EXIM bank in participation with commercial banks. Banks provide the credit and they can avail of refinance from the EXIM bank. The exporter is expected to obtain an advance and a down payment of at least 15 percent of the contract value.

Consultancy and Technology Services

Indian companies executing overseas contract involving consultancy and technology services, can avail of EXIM's financing program, to offer deferred payment terms to their clients. The credit may be extended to the Indian company either by EXIM bank in participation with commercial banks, or directly by commercial banks who could in turn seek refinance from EXIM bank. The Indian company in turn would offer deferred payment terms to their clients.

The credit normally given in Indian rupees is repayable in half-yearly installments over a period not exceeding five years. Guarantee of foreign government or a guarantee/irrevocable LC of an acceptable bank would need to be obtained. The Indian company also has to obtain ECGC insurance cover and assign it in favor of the bank.

Overseas Investment Finance

The EXIM bank provides export credits to Indian promoters for their equity contribution to overseas joint ventures. The funds are in the form of long-term credit not exceeding ten years. EXIM bank's finance will be made available to Indian promoters by way of

- i. Rupee term loans for financing equity contribution.
- ii. Foreign currency loans/guarantees, where the equity contribution is allowed by the Government of India out of foreign currency loan to be raised by the Indian promoter.

Equity contribution by Indian promoters can be in various forms such as

- a. Capitalization of proceeds of exports in the form of plant and machinery.
- b. Technical know-how.
- c. Capitalization of earnings such as royalty and management fees.
- d. Cash remittances.

Where cash remittances are allowed, Indian promoters are granted approvals to remit foreign exchange from India or raise foreign currency loans for the purpose of equity contribution.

The quantum of finance will be determined with reference to the Indian promoters' share in the equity structure of overseas joint ventures, subject to a maximum of 80 percent of the Indian promoters' equity contribution. Commercial banks may also opt to take up risk participation in term loans and guarantees extended by EXIM bank.

Pre-shipment Credit

If the requirement of pre-shipment credit by exporters is for periods in excess of 180 days, EXIM bank participates in the credit.

Financing Deemed Exports

Deemed exports occur in case of specified transactions within India, which result in foreign exchange earnings or savings as given below:

- i. Supplies made in India to World Bank/IDA-aided projects against international competitive bidding
- ii. Supplies to free-trade zones/100 percent export oriented units
- iii. Sales to foreign shipping companies and
- iv. Supplies to ONGC and Oil India Ltd., for offshore and onshore drilling operations.

Deemed exports can avail of EXIM bank's deferred credit facility. EXIM bank may participate with commercial banks in extending rupee loans for bridging cash flow deficits of projects/supply contracts; EXIM bank also issues guarantees and provides bridge finance in foreign currency.

Capital and producer goods are eligible for medium-term credits. Long-term credits up to ten years are provided in exceptional cases. Credit is normally secured by a bank guarantee.

Assistance to Export-Oriented Units

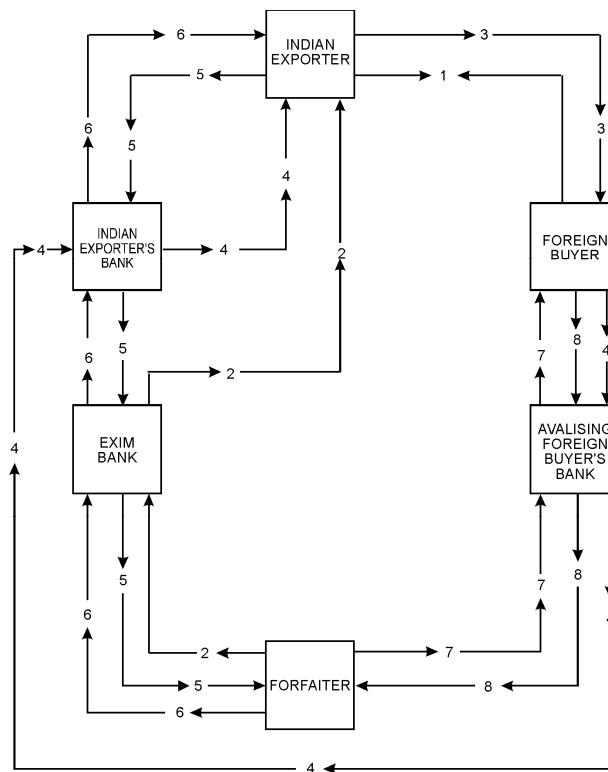
Free-trade zones and export-oriented units are given finance for acquisition of land, building, plant and machinery, preliminary and pre-operative expenses and working capital (as margin money). EXIM bank's assistance will be in the form of direct assistance given as rupee term loans or deferred payment guarantees or indirect assistance as refinance to commercial banks.

The export-oriented units seeking EXIM's finance will have to establish the technical, economic and financial feasibility of their projects.

Forfaiting

Forfaiting is a common form of financing export related receivables. It is similar to Bill Rediscounting Scheme. EXIM Bank has introduced this scheme for the Indian exporters. Under this scheme, the exporter after finalization of the sale (or contract) with a prospective buyer furnishes all the necessary details regarding the contract to the EXIM Bank through which a contract of forfaiting is finalized by the exporter with the overseas forfaiting agency. The exporters draw a series of bills of exchange on the overseas buyers' which will be sent along with the shipping documents to the buyer's bank for overseas buyers' acceptance. Overseas buyers' bankers will hand over to the exporter the documents against the acceptance of the buyer and signature of 'aval' or the guaranteeing bank. The exporter will submit to his bank to be forwarded to EXIM Bank which passes the documents to the forfaiting agency. Proceeds of the bills are passed from the overseas forfaiting agency to the exporter through the EXIM Bank. From October 1997, the authorized dealers are allowed to undertake forfaiting of medium-term export receivables.

Figure 1: A Flow Chart of a Forfaiting Transaction



1. Commercial contract between the foreign buyer and the Indian exporter.
2. Commitment to forfait bills of exchange/promissory notes (debt instruments).
3. Delivery of goods by the Indian exporter to the foreign buyer.
4. Delivery of debt instruments.
5. Endorsement of debt instruments without recourse in favor of the forfaiter.
6. Cash payment of discounted debt instruments.
7. Presentation of debt instruments on maturity.
8. Payment of debt instruments on maturity.

Lending to Foreign Governments and Foreign Companies

Buyers' Credit

Credit is given to buyers abroad to enable them to import engineering goods from India on deferred payment terms. The loan facility is to be secured by a letter of credit or a bank guarantee.

Lines of Credit

EXIM bank also extends lines of credit to overseas governments or agencies nominated by them, to enable buyers in these countries to import capital/engineering goods from India on deferred payment terms. The exporters can obtain payment from EXIM bank against negotiation of shipping documents.

Relending

An overseas bank can enter into a credit line agreement with EXIM bank. The overseas bank would relend the funds to importers of capital goods, consumer durables and services from India. The borrowing bank may be a commercial bank, a central bank, an investment/merchant bank with a good credit standing.

Figure 2: Specimen Copy of a Promissory Note

Per Aval WELLINGTON BANK, MANCHESTER, UNITED KINGDOM	MANCHESTER 31 MARCH, 1992	US\$ 850,000
	On 1 APRIL, 1993	for value received pay against this promissory note
	to the order of MACHINERY EXPORTS (INDIA) LTD.	the sum of
	EIGHT HUNDRED FIFTY THOUSAND US DOLLARS	
	effective payment to be made in UNITED STATES DOLLARS	without deduction for
	and free of any taxes, impost, levies or duties present or future of any nature	
	This promissory note is payable at WELLINGTON BANK, MANCHESTER, UNITED KINGDOM	
	Drawn on JOHN SMITH IMPORTS (UK) LIMITED	
	OXFORD HOUSE, RUE DE LA VIE	
	MANCHESTER, UNITED KINGDOM	

Figure 3: Specimen Copy of a Bill of Exchange

Per Aval for account of the drawee WELLINGTON BANK, MANCHESTER, UNITED KINGDOM	For Acceptance JOHN SMITH IMPORTS (UK) LIMITED OXFORD HOUSE, RUE DE LA VIE, MANCHESTER, UNITED KINGDOM	MANCHESTER 31 MARCH, 1992	US\$ 850,000
		On 1 APRIL, 1993	for value received pay against this Bill of Exchange
		to the order of MACHINERY EXPORTS (INDIA) LTD.	the sum of
		EIGHT HUNDRED FIFTY THOUSAND US DOLLARS	
		effective payment to be made in UNITED STATES DOLLARS	without deduction for
		and free of any taxes, impost, levies or duties present or future of any nature	
		This Bill of exchange is payable at WELLINGTON BANK, MANCHESTER, UNITED KINGDOM	
		Drawn on JOHN SMITH IMPORTS (UK) LIMITED	PP MACHINERY EXPORTS (INDIA) LTD.
		OXFORD HOUSE, RUE DE LA VIE	
		MANCHESTER, UNITED KINGDOM	DIRECTOR

Loans will be denominated in US dollars and repayment will also be in the same currency. Short-term loans extending from 180 days to one year are repayable by quarterly/half-yearly installments. Medium-term loans are also given.

The relending facility will operate as follows:

- a. The borrowing bank, upon its approval of a sub-loan to an importer, opens irrevocable letters of credit in favor of the Indian exporter through EXIM bank or banks designated by the latter.
- b. The Indian exporter ships goods and presents shipping documents to EXIM bank or banks designated by the latter.
- c. EXIM bank pays to the Indian exporter the rupee equivalent.
- d. EXIM bank or the negotiating bank in India forwards shipping documents to the borrowing bank, together with the advice of having made disbursement to the supplier.

Lending to Indian Banks

Rediscounting of Export Bills

Commercial banks that are authorized dealers can rediscount their short-term usance export bills with EXIM bank.

Refinance for Deferred Payment Exports

Deferred payment exports arise when export proceeds are to be received after six months from the date of shipment. EXIM bank offers hundred percent refinance facility to banks, which enables a bank to extend deferred credit to an Indian exporter against supplier's credit offered by the exporter to the overseas buyer. Capital goods, consumer durables and industrial manufactures can be considered for deferred credit.

Guarantees

Overseas Construction Projects

Guarantees are issued by the EXIM bank on behalf of exports of turnkey projects and construction contracts. Such guarantees include:

- i. Bid bond guarantee
- ii. Advance payment guarantee
- iii. Performance guarantee
- iv. Retention money guarantee and
- v. Guarantee for borrowing abroad.

Bid bond guarantee is issued for a maximum period of six months. For advance payment guarantee, exporters are expected to secure mobilization advance of 10-20 percent of contract value. Performance guarantee for 5 to 10 percent of contract is issued and is valid up to one year after completion of the contract. Guarantee for release of retention money enables the exporter to obtain the release of full payments.

Bridge finance may be needed at the earlier phases of the contract. Up to 10 percent of the contract value may be raised in foreign currency from a foreign bank against the EXIM bank's guarantee for borrowing abroad.

Syndication of Export Credit Risks

EXIM bank and other banks participating in the funding of a loan would syndicate the respective credit risks to other eligible commercial banks, who would assume part of the total risk. Proposals valued at more than Rs.1 crore, entailing deferred credit exports of engineering goods and services, are forwarded by the sponsoring bank for consideration by an inter-institutional working group which meets at Mumbai, with EXIM bank as the focal point. While clearing the proposal, the participation arrangement for the funding of export credit is also determined.

Software Exports

The new policy of the government on computer software exports and development has rationalized the system of facilities and incentives for exports. Under the new policy, EXIM bank has been designated as an agency for facilitating speedy clearances and meeting foreign exchange requirements towards imports for computer software export where export obligation of 350 percent of foreign exchange used is undertaken. EXIM bank will undertake financial and technical analysis of Software export proposals and monitor the progress.

EXIM bank extends advisory services to exporters in several areas and undertakes promotional activities like techno-economic surveys collecting and disseminating market information.

EXIM bank offers an integrated package covering foreign currency and rupee term finance for acquisition of imported and indigenous computer/computer-based systems for export purposes. EXIM bank welcomes the association of commercial banks for providing working capital finance for software export projects assisted by it. A rebate of 50 percent on customs duty payable on import of computer system is available to software exporters opting for 350 percent export obligation.

Export and import transactions are governed by the EXIM policy and the RBI exchange control regulations. While the EXIM policy regulates the movements of goods and services by prescribing the permissible exports and imports, the RBI regulations regulate the corresponding payments for these international transactions. While extending credit for any such trade, the banks need to make sure that the respective guidelines have been followed by the concerned parties. The RBI regulations are given below.

EXCHANGE CONTROL REGULATIONS RELATED TO MERCHANT TRANSACTIONS

Exchange controls were introduced in India in 1939, during the World War II, to conserve foreign exchange, particularly the US dollar, for meeting essential defence expenditure. The main purpose of exchange controls is to conserve foreign exchange and ensure its effective utilization.

After the World War II, the exchange control regulations framed under the Defence of India Rules were replaced by the Foreign Exchange Regulation Act, 1947, which was revised and replaced by the Foreign Exchange Regulation Act, 1973. With a view to create conducive climate for attracting foreign direct investment to increase production and promote exports, FERA 1973, has been substantially amended by FERA [Amendment] Act, 1993. FERA was replaced with Foreign Exchange Management Act (FEMA), 1999 to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India.

Exchange controls also cover foreign capital and activities financed by it. The administrative authority of foreign exchange regulation is vested with the Reserve Bank of India (RBI) and the routine work of exchange control is delegated to banks authorized to deal in foreign exchange. Exchange controls and procedures are set out in the Exchange Control Manual published by the RBI.

Transactions Subject to Control

- a. Purchase, sale, and other dealings in foreign exchange and maintenance of balance at foreign centers.
- b. Realization of export proceeds and payment for imports.
- c. Payments to non-residents or to their accounts in India.
- d. Transfer of securities between residents and non-residents and acquisition and holding of foreign securities.

- e. Foreign travel with foreign exchange.
- f. Export and import of currency, cheques, travellers cheques, securities, etc.
- g. Activities in India of foreign nationals and branches of foreign firms and companies.
- h. Foreign direct investment and portfolio investment in India including investment by non-resident Indians, persons of Indian origin and corporate bodies predominantly owned by such persons.
- i. Appointment of non-residents and foreign nationals and foreign companies, etc., as agents in India.
- j. Setting up of joint ventures/subsidiaries outside India by Indian companies.
- k. Acquisition, holding and disposal of immovable property in India by foreign nationals/companies.
- l. Acquisition, holding and disposal of immovable property outside India by residents in India.

SUMMARY

- The Exim Bank was set-up to finance and promote foreign trade.
- It extends finance to exporters of capital and manufactured goods, exporters of software and consultancy services, and to overseas joint ventures and turn-key/construction projects abroad.
- Exim Bank precisely lends to the Indian companies, Indian banks, Foreign governments, and Foreign companies.
- Exim Bank also issues various guarantees.
- Certain regulations are issued by the RBI for exporters.

Chapter IV

Balance of Payments

After reading this chapter, you will be conversant with:

- Concept of Economic Transactions
- Principles of BoP Accounting
- Balance of Payments Factors Affecting the Components of BoP Account
- BoP Compilation
- BoP Account – The Indian Perspective
- Importance and Limitations of BoP
- Relationship between BoP Variables and Other Economic Variables

The determination of a country's exchange rate depends upon the exchange rate system followed by it. The exchange rate of a currency is its value (or price) in terms of another currency. Like all other commodities, the price of a currency also depends on its supply and demand factors. When the exchange rates are truly flexible, the demand and supply arise only from the market forces. In the case of fixed exchange rates, in addition to the supply and demand arising from the market, the Central Bank/regulatory authority ensures an official demand or supply, which keeps the overall forces balanced in order to maintain the exchange rate at an equilibrium level which is considered desirable by the Central Bank. (The various exchange rate systems are discussed in the next chapter.)

To forecast the level of exchange rate, we need to know the factors that affect the demand for and supply of a currency. Any factor increasing the supply of a currency reduces its price, i.e., causes it to depreciate and vice versa. Similarly, any factor increasing the demand for a currency, increases the price of that currency, i.e., causes it to appreciate and vice versa. All these factors are reflected in the Balance of Payments (BoP) account. The BoP account is the summary of the flow of economic transactions between the residents of a country and the Rest of the World (ROW) during a given time period. The BoP is for a country what a statement of sources and uses of funds is for a company. It measures the flow of international payments and receipts. As it measures flows and not stocks, it records only the *changes* in the levels (and not the absolute level) of international assets and liabilities.

Balance of Payments is described by the IMF in its Balance of Payments Manual as a statistical statement for a given period showing –

- a. Transactions in goods, services and income between an economy and the rest of the world;
- b. Changes of ownership and other changes in the economy's monetary gold, Special Drawing Rights (SDRs), and claims and liabilities to the rest of the world; and
- c. Unrequited transfers and counterpart entries that are needed to balance, in the accounting sense, any entries for the foregoing transactions and changes which are not mutually offsetting.

These components of the BoP are discussed in a subsequent section.

The Balance of Payments Manual prescribes certain principles and concepts to be followed by countries while compiling their BoP data, in order to ensure that recording of transactions is systematic and consistent. The principles refer to adoption of the double-entry bookkeeping system, distinction between entities to be treated as residents and those to be treated as non-residents, scope of economic transactions to be included in the BoP statistics, valuation of such transactions and the time when these transactions are to be recorded.

CONCEPT OF ECONOMIC TRANSACTIONS

IMF prescribes that all economic transactions between residents and non-residents be recorded in the BoP. For this purpose, economic transactions include all those activities whereby two entities exchange something of economic value. There are at least two parties involved, either in reality, or by implication. An example of the latter is the transfer of a non-resident's funds to the country to which he is migrating. Though there is only one party involved in reality, the transfer is assumed to be from a non-resident (as the migrant is before migration) to a resident (as he is after migration). By implication, there are two entities involved and hence the transaction appears in the BoP account.

Generally, those transactions are recorded which take place between a resident and a non-resident. Yet, there are a few transactions which are recorded even if they take place between two residents or two non-residents. Let us look at an example. The BoP account records various transactions like exports/imports of goods and

services, payment of dividend/interest, investments in assets etc. These transactions are broadly classified into current account and capital account. Suppose X has a FCNR deposit in US\$ with SBI which he now proposes to transfer to Bank of India. Then the amount of FCNR will be paid by SBI to Bank of India. While this does not affect the BoP as a whole, the transactions will be recorded in the BoP. Similarly, a transaction like deemed exports (where supplies are made by a resident to another resident but such sale is treated as if it is an export) are also recorded in the BoP even though the BoP position itself may not change. Thus, certain transactions which do not affect the BoP position may also be recorded.

Another exception to the general principle is the recording of those transactions where the transfer of a thing having economic value is only one-sided, i.e., the transferor does not receive anything of economic value in return. These are called transfer payments. Examples of such payments are aids, grants, taxes and gifts etc. Since there is no corresponding payment to make the double entry possible, the offsetting entry is put under the head "Transfer Payments".

Concept of Resident

According to the IMF manual, an entity is said to be a resident of that economy to whose territory it has closer links than with any other economy. For this purpose, territory is defined as including the areas falling within the political boundaries of a country, or its territorial seas, or those parts of international waters over which it has exclusive jurisdiction. All entities other than those which qualify as residents in accordance with the above-mentioned definition are considered as non-residents. The IMF manual classifies entities into four categories:

- i. General Government Institutions
- ii. Individuals
- iii. Private Non-profit Bodies
- iv. Enterprises.

The following rules are given by the manual for determining the economy to which an entity has closer links.

GENERAL GOVERNMENT INSTITUTIONS

All the departments, establishments and bodies of the Central, State and Local Governments that are located in the territory of a particular economy, are considered its residents. The embassies, consulates and other entities representing an economy's government are also considered as the residents of that particular economy, although they are located abroad.

INDIVIDUALS

According to the manual, "all persons who may be expected to consume goods and services, participate in production, or engage in other economic activities in the territory of a given economy on other than a temporary basis, and whose center of interest lies in that economy" are to be considered as the residents of that economy. The criteria for recognizing permanence is a stay in that economy for a minimum period of one year.

As an exception to the above rule, an economy's government's diplomats, consular representatives and other representatives are considered as that economy's residents, irrespective of the length of their stay abroad. This is so because their country is expected to continue to be their "center of interest".

PRIVATE NON-PROFIT BODIES

Under this category, those bodies are included which provide services to the society either free of cost or at subsidized rates. They are considered the residents of that economy in which they are located and provide their services.

ENTERPRISES

This category includes those entities which produce and sell goods or services on a commercial basis. These are considered to be the residents of that economy on whose territory they conduct their operations. According to this definition, the foreign branches of a resident enterprise are viewed as the residents of that economy in which they are operating instead of residents of their domestic economy, despite the fact that the enterprise and its branches would be a single legal entity (having been incorporated in the domestic economy). A company's foreign subsidiary would also be considered a resident of that foreign economy in which it is incorporated and operating.

Principles for Valuation of Transactions

Every year, a large number of transactions enter the BoP account of each country. To make the data comparable across countries and over a period of time, it is essential that a uniform system be adopted for valuing these transactions. The IMF manual recommends the following principles to be followed for valuation of transactions entering the BoP account:

- a. The transactions should be valued at market prices. For this purpose, the manual describes market price as "the amount of money that a willing buyer pays to acquire something from a willing seller, when such an exchange is one between independent parties into which nothing but commercial considerations enter".
- b. Both imports and exports should be valued at f.o.b. basis (i.e. free on board basis). This means that the price paid for the insurance and shipment of goods should not be included as a part of the value of goods either by the importer or the exporter, but should be recorded separately as a payment for services (wherever paid to a foreign agency).
- c. Any transaction denominated in a foreign currency should be converted into the domestic currency at the exchange rates prevailing in the market at the time the transaction took place.

PRINCIPLES OF BOP ACCOUNTING

The foremost principle of BoP accounting is the use of the double entry bookkeeping system, i.e., every transaction has two aspects and hence enters the BoP account twice, once as a credit and once as a debit. Since for every credit there is a corresponding debit, the balance of payments account always balances. The logic underlying every transaction being entered twice is that whenever there is a transaction, whether purchase or sale, there would be a corresponding payment – either immediate or deferred, giving rise to two entries. Since there is no compensation involved in the case of transfer payments, they are treated as trade in goodwill to satisfy the principle of double-entry. An outflow on account of transfer payment is regarded as a purchase of goodwill, while an inflow is regarded as a sale.

There is a clear rule for determining the side of a BoP account on which a particular transaction should be entered. The rule is that any transaction which creates demand for the domestic currency in the forex markets enters the BoP account on the credit side, and any transaction increasing its supply enters the debit side. Another way of understanding the rule is through sources and uses of foreign currency. Any transaction which is a source of foreign currency is a credit

entry, and any transaction which is a use is a debit entry. In accordance with these definitions, credit transactions are recorded with a plus sign, and debit transactions with a minus sign.

Let us consider a few examples. As a country exports goods to another country, the demand for the domestic currency goes up as the foreign importer would need to buy the domestic currency to pay for the imports. This would appear as a credit item in the BoP account as it is a source of foreign currency. On the other hand, imports increase the supply of the domestic currency, as foreign currency would need to be bought in exchange for the domestic currency in order to pay for the imports. Since it is a use of the foreign currency, it would appear as a debit item.

BALANCE OF PAYMENTS

The Balance of Payments (BoP) is a systematic record of all economic transactions between the 'residents' of a given country and the residents of other countries – the rest of the world – carried out in a specific period of time, usually a year. It represents a classified statement of all receipts on account of goods exported, services rendered and capital received by residents, and payments made by them on account of goods imported, services received from and capital transferred to non-residents or foreigners. Thus, BoP is a much wider term in its coverage as compared to balance of trade. Whereas the balance of trade refers to merchandise imports and exports (visible trade), the BoP refers to all economic transactions – including 'invisible transactions' like banking, insurance, transport services, etc., with the rest of the world.

Balance of payments account is based on the 'standard double entry system' of bookkeeping. Thus, every entry is entered twice, once as a credit item and once as a debit item. A transaction which increases the external purchasing power of a country is recorded as a credit entry. It represents a source of foreign exchange. Examples of such transactions are,

- i. Export of goods or merchandise exports;
- ii. Export of services like travel, insurance, etc., or invisibles;
- iii. A capital inflow into the country, i.e. borrowing abroad;
- iv. Decrease in foreign exchange reserves and gold reserves of the monetary authority.

A transaction which reduces the external purchasing power of the country is recorded as a debit entry. It represents the use of foreign exchange reserves. Such transactions are,

- i. Merchandise imports and invisible imports;
- ii. A capital outflow or lending abroad;
- iii. Increase in foreign exchange reserves and gold reserves of the monetary authority.

Apart from the statistical discrepancies on account of different data sources, the offsetting credit and debit entries are, in principle, always in balance. What then do we mean by BoP deficits and surpluses? The answer is that we can select a sub-group of transactions and see whether the net balance on these is negative (deficit) or positive (surplus). Depending upon the particular sub-group chosen, there can be a variety of concepts of BoP deficits and surpluses as discussed.

Components of Balance of Payments

The BoP statement is usually divided into three major groups of accounts. The construction of the accounts can best be appreciated by examining Table 1 given below.

Table 1: India's Overall Balance of Payments

	Credit	Debit	Net
A. CURRENT ACCOUNT			
1. MERCHANDISE			
a. Exports (on f.o.b. basis)			
b. Imports (on c.i.f. basis)			
2. INVISIBLES (a + b + c)			
a. Services			
i. Travel			
ii. Transportation			
iii. Insurance			
iv. G.n.i.e			
v. Miscellaneous			
b. Transfers			
vi. Official			
vii. Private			
c. Investment Income			
Total Current Account (1 + 2)			
B. CAPITAL ACCOUNT			
1. FOREIGN INVESTMENT (a + b)			
a. In India			
i. Direct			
ii. Portfolio			
b. Abroad			
2. LOANS (a + b + c)			
a. External Assistance			
i. By India			
ii. To India			
b. Commercial Borrowings (MT and LT)			
i. By India			
ii. To India			
c. Short-term			
To India			
3. BANKING CAPITAL (a + b)			
a. Commercial Banks			
i. Assets			
ii. Liabilities			
iii. Non-Resident Deposits			
b. Others			
4. RUPEE DEBT SERVICE			
5. OTHER CAPITAL			
Total Capital Account (1 + 2 + 3 + 4 + 5)			
C. ERRORS AND OMISSIONS			
D. OVERALL BALANCE (A + B + C)			
E. MONETARY MOVEMENTS (i + ii)			
i. I.M.F.			
ii. Foreign Exchange Reserves			
(Increase – / Decrease +)			

CURRENT ACCOUNT

The Current Account records the transactions in merchandise and invisibles with the rest of the world. Merchandise covers exports and imports of all movable goods, where the ownership of goods changes from residents to non-residents and *vice versa*. Therefore, Current Account captures the effect of trade link between the economy and rest of the world.

The merchandise trade values exports on f.o.b. (free on board) basis and are shown as credit items and the imports valued on c.i.f. (cost insurance and freight) basis are the debit items. However, the IMF Balance of Payments manual provides guidelines for compilation of the BoP statistics prescribing the valuation of both exports and imports on f.o.b. basis.

The item Invisibles includes travel, transportation, insurance, investment income, and other miscellaneous items. The credit under the Invisibles comprises the value of services rendered by residents to non-residents. The income earned by residents on ownership of financial assets (investment income), use of non-financial assets (property income) and other receipts in cash or kind without a quid pro quo (transfer payments) are all recorded as credits. Similar remittances made by residents to non-residents are recorded as debits.

G.n.i.e. implies government not included elsewhere. A credit entry of the G.n.i.e. includes items like: Funds received from a foreign government for the maintenance of their embassy, consulates, etc., in India. Under the heading 'Miscellaneous', payment to a foreign technical consultant for professional services rendered by him will appear as a debit item.

Transfers may be of two types: Official and private. A debit entry under the heading Official Transfers constitute items like revenue contributions by the Government of India to international institutions or any transfer (even in the form of gifts) of commodities by the government to non-residents. Private transfers include items like cash remittances by non-resident Indians for their family maintenance in India. With effect from 1996-97, private transfer receipts include redemption in rupees of both principal and interest under Non-Resident External (Rupee) Accounts and Non-Resident Non-repatriable Rupee Deposit schemes.

CAPITAL ACCOUNT

In the case of the Capital Account an increase (decrease) in the country's foreign financial assets are debits (credits) whereas any increase (decrease) in the country's foreign financial liabilities are credits (debits).

All transactions of financial nature are entered in the Capital Account of the BoP statement. The transactions under this heading are classified into five heads: (1) Foreign Investment, (2) Loans, (3) Banking Capital, (4) Rupee Debt Service and (5) Other Capital.

Any investment made by foreign residents (individuals, companies, financial institutions or even a foreign government) in the acquisition of physical assets in India is a Foreign Direct Investment. It is depicted by an inflow of foreign capital and is a credit item in the BoP Statement. When a foreign country portfolio investor directly purchases financial assets in the Indian securities market it is termed as Foreign Portfolio Investment.

Loans include concessional loans received by the government or public sector bodies, long-term and medium-term borrowings from the commercial capital market in the form of loans, bond issues, etc., and short-term credits. Disbursements received by Indian resident entities are credit items while repayments and loans made by Indians are debit items.

Banking capital covers the changes in the foreign assets and liabilities of commercial banks whether privately owned or government owned and co-operative banks which are authorized to deal in foreign exchange. An increase in assets (or decrease in liabilities) is a debit item while a decrease in assets (or increase in liabilities) is a credit item.

The item 'Rupee Debt Service' is defined as the cost of meeting interest payments and regular contractual repayments of principal of a loan along with any administration charges in rupees by India.

Though recording of transactions in the BoP statement is made according to the principle of double entry, certain discrepancies in estimation and timing may result in a situation where debits are not exactly equal to the credits. The item 'Errors and Omissions' indicates the value of such discrepancies. A negative value indicates that receipts are overstated or payments are understated, or both, and *vice versa*. Persistently, large errors with the same sign are indicative of serious weaknesses in the recording of transactions or flows.

MONETARY MOVEMENTS

The monetary movements keep record of (a) India's transactions with the International Monetary Fund (IMF), and, (b) India's foreign exchange reserves which basically consist of RBI holdings of gold and foreign currency assets. Drawings (essentially a type of borrowing) from the IMF or drawing down of reserves are credit items, whereas, repayments made to IMF or additions made to existing reserves are debit items.

BALANCE IN THE BOP STATEMENT

The Balance of Payments statement is prepared on the basis of the double entry system. Therefore, the statement as a whole would fully balance without any surplus or deficit. However, analysis of the BoP is not done for the statement as a whole, but only for debit and credit for certain groups of items whose balance has certain significant implications.

TRADE BALANCE

The trade balance is the difference between merchandise exports and imports. By the end of year 2003 there was a visible trade deficit, as commodity imports exceeded exports by US \$13984 million. By the end of year 2004, this deficit raised to \$28356 million. Trade balance would be an important indicator of income and outgo, if the imports and exports of services are not significant.

Changes in trade balance indicate changes in the efficiency of the country in producing and exporting goods in which it enjoys comparative advantage. The demand for the products of a country, other things remaining equal, depends on its relative efficiency in producing goods. However, shifts in demand as evident from the trade balances, occur slowly, over time. Japan and West Germany have been exceptions, and have witnessed rapid growth in trade balances after the World War II.

Another factor affecting the trade balance of the country is its 'terms of trade'. Terms of Trade is the ratio of a country's export prices to import prices. It is constructed by taking an index of prices of exports and an index of prices of imports and dividing the first by the second.

Illustration 1

Year	2001	2004
Index of Export Prices	100	150
Index of Import Prices	100	125
Terms of Trade Index	100	120

An improvement in a country's terms of trade indicates a faster rise in the prices of its exports than its imports.

What is the effect of an improvement in terms of trade on the trade balance?

Solution

At first instance this may look beneficial: in foreign exchange terms, a given amount of exports will now finance the purchase of a greater amount of imports or a given amount of imports can now be financed with a lower amount of exports. This will improve the trade balance. In the same way, when the terms of trade deteriorate for a country, its trade balance will worsen. This is true when the export/import demands are price-inelastic. For instance, when oil prices increased in 1973, the terms of trade for India worsened. The demand for oil being price-inelastic, trade deficit increased substantially. When export/import demand functions are price-elastic, an improvement in terms of trade will result in worsening trade deficit.

CURRENT ACCOUNT BALANCE

In most cases, where transactions in invisibles are not significant, a study of the trade balance explains the current account balance. An important implication of current account balance, viewed from the national income accounting approach, is that it represents the difference between domestic saving and domestic investments in a given year. A deficit on current account means that domestic saving is insufficient to fund domestic investment, resulting in import of savings from abroad. If domestic savings exceed domestic investments a surplus on current account will result and would make our BoP situation more comfortable. The current account balance indicates the country's stock of net international assets.

While reading the balance in both current account and trade account, one has to study the rate of growth in exports and imports. Growth in exports, particularly accompanied by high rates of investment, indicates that economic growth is exported, and is a positive sign. On the other hand, high deficits in the current account, accompanied by high growth rate in imports is undesirable.

CAPITAL ACCOUNT BALANCE

The balance in the capital account indicates how the balance in the current account has been financed. If one can distinguish between long-and short-term sources, one can comment upon the financing methods adopted by the country. Similarly, distinction has to be made between finances obtained on commercial terms and on soft terms. The larger the former component, the greater the vulnerability of the country to volatility in interest rates.

When the BoP is in deficit or surplus, we separate the official reserve account from others. If the balance on current and capital accounts taken together is negative, then it is a case of BoP deficit. This has to be balanced by a matching surplus on the official reserve account i.e., a reduction to foreign exchange and gold reserves. However, this practice is based on the assumption that transactions in the current and capital accounts are autonomous transactions responding to the economic situation, both domestic and external, while official reserve transactions are of a compensating nature.

The Balance of Payments always Balances

On the whole, the balance of payments always balances. Let us consider a simple analogy which will make this clear. Suppose a household cannot spend more than it receives in any one year without financing its overexpenditure by drawing on its savings or borrowing from the bank or some other creditor. The amount dissaved or borrowed, plus the household income must equal the household's outgoings. In the same way, a country's total outgoings must equal its total receipts. A current account surplus must be matched by a rise in net external assets and a current account deficit by a fall. Because of the double entry concept underlying the recording of transactions, BoP account must always be in balance. Therefore, the following identity must hold:

Balance in Current Account + Balance in Capital Account + Change in Monetary Movements = Zero.

The change in Monetary Movements account reflects the overall BoP position. That is, an increase in Foreign Exchange Reserves or net repurchase from IMF indicates the position of BoP surplus and a decrease in the Foreign Exchange Reserves or net purchase from IMF indicates a BoP deficit. Therefore, when there is no change in the Monetary Movements account:

Surplus/Deficit in Current Account = Deficit/Surplus in Capital Account

What is the situation, if a country does not have any Monetary Movements account and it can neither borrow from nor lend abroad?

As mentioned earlier, in reality, the two sides of the account are seldom balanced because of different data sources and imperfect nature of data collection. For this reason a balancing item represented by 'E&O' is inserted. The item 'Errors and Omissions' indicates the value of such discrepancies due to different exchange rates applied to receipts and payments.

The balance of payments is widely used in evaluating a country's economic programs and its relative strength in global markets. It is analyzed for the value of various components, their rates of growth and the interrelationships that exist between them.

Principles for Timing the Recording of Transactions

Every transaction is recorded by the two countries involved. To avoid discrepancies, it is necessary that both the countries record it in the same period in their BoP accounts. Also, as the two aspects of a transaction are generally recorded using different sources, it is essential that both the sources record the transaction in the same time period to make the BoP statement balance. For the above mentioned reasons, the IMF manual prescribes some rules as to when a transaction should be recorded in the BoP account. The rules are as follows:

- a. **Current Account:** Merchandise trade should be recorded when the change in ownership takes place. This is said to happen when the corresponding payment is made. Trade in services is to be recorded when the services are actually rendered. Interest, dividends and other like payments are to be recorded when they are due for payment. The rule for transfer payments is that they should be recorded when the ownership of the underlying assets changes.
- b. **Capital Account:** Capital account transactions are also recorded when the change in ownership takes place. For these transactions, the change in ownership is assumed to have taken place when the transaction goes through the banking channels. International loan drawings are recorded at the time of the actual disbursement of the loan and not when the lender commits to lend or sanctions the loan.

FACTORS AFFECTING THE COMPONENTS OF BoP ACCOUNT

Exports of Goods and Services

Exports of goods and services are affected by the following factors:

- **The Prevailing Exchange Rate of the Domestic Currency:** A lower value of the domestic currency results in the domestic price getting translated into a lower international price. This increases the demand for domestic goods and services and hence their export. This is likely to result in a higher demand for the domestic currency. A higher exchange rate would have an exactly opposite effect.
- **Inflation Rate:** The inflation rate in an economy vis-à-vis other economies affects the international competitiveness of the domestic goods and hence their demand. Higher the inflation, lower the competitiveness and lower the demand for domestic goods. Yet, a lower demand for domestic goods and services need not necessarily mean a lower demand for the domestic currency. If the demand for domestic goods is relatively inelastic, then the fall in demand

may not offset the rise in price completely, resulting in an increase in the value of exports. This would end up increasing the demand for the local currency. For example, suppose India exports 100 quintals of wheat to the US at a price of Rs.500 per quintal. Further, assume that due to domestic inflation, the price increases to Rs.530 per quintal and there is a resultant fall in the quantity demanded to 96 quintals. The exports would increase from Rs.50,000 to Rs.52,800 instead of falling.

- **World Prices of a Commodity:** If the price of a commodity increases in the world market, the value of exports for that particular product shows a corresponding increase. This would result in an increase in the demand for the domestic currency. A fall in the demand for domestic currency would be experienced in case of a reduction in the international price of a commodity. This impact is different from the previous one. The previous example considered an increase in the domestic prices of all goods produced in an economy simultaneously, while this one considers a change in the international price of a single commodity due to some exogenous reasons.
- **Incomes of Foreigners:** There is a positive correlation between the incomes of the residents of an economy to which the domestic goods are exported, and exports. Hence, other things remaining the same, an increase in the standard of living (and hence, an increase in the incomes of the residents) of such an economy will result in an increase in the exports of the domestic economy. Once again, this would increase the demand for the local currency.
- **Trade Barriers:** Higher the trade barriers erected by other economies against the exports from a country, lower will be the demand for its exports and hence, for its currency.

Imports of Goods and Services

Imports of goods and services are affected by the same factors that affect their exports. While some factors have the same effect on imports as on exports, some of them have an exactly opposite effect. Let us analyze these factors and their effects.

- **Value of the Domestic Currency:** An appreciation of the domestic currency results in making imported goods and services cheaper in terms of the domestic currency, hence increasing their demand. The increased demand for imports results in an increased supply of the domestic currency. A depreciation of the domestic currency has an opposite effect.
- **Level of Domestic Income:** An increase in the level of domestic income increases the demand for all goods and services, including imports. This again results in an increased supply of the domestic currency.
- **International Prices:** The international demand and supply positions determine the international price of a commodity. A higher international price would get translated into a higher domestic price. If the demand for imported goods is inelastic, this would result in a higher domestic currency value of imports, increasing the supply of the domestic currency. In case of the demand being elastic, the effect on the supply of the domestic currency would depend on the effect on the domestic currency value of imports.
- **Inflation Rate:** A domestic inflation rate that is higher than the inflation rate of other economies, would result in imported goods and services becoming relatively cheaper than domestically produced goods and services. This would increase the demand for the former, and hence, the supply of the domestic currency.
- **Trade Barriers:** Trade barriers have the same effect on imports as on exports – higher the barriers, lower the imports, and hence, lower the supply of the domestic currency.

Income on Investments

Both payments and receipts on account of interest, dividends, profits etc., depend on the level of past investments and the current rates of return that can be earned in an economy. For payments, it is the level of past foreign investments and the current domestic rates of return; while for the receipts it is the past domestic investments in foreign economies and the current foreign rates of return which are relevant.

Transfer Payments

Transfer payments are broadly affected by two factors. One is the number of migrants to or from a country, who may receive money from or send money to relatives. The second is the desire of a country to generate goodwill by granting aids to other countries along with the economic capability to do so, or its need to take aids and grants from other countries to tide over difficulties.

Capital Account Transactions

Four major factors affect international capital transactions. The foremost is the rate of return which can be earned on the investments as compared to the returns that can be earned on domestic investments. The higher the differential returns offered by a country, the higher will be the capital inflows. Another factor is the additional risk that accompanies these returns. More the risk, lower the capital inflows. Diversification across countries may offer some extra benefit in addition to the returns offered by a particular investment. This benefit arises from the fact that different economies may be at different stages of economic cycle at a given time, thus making their performance unrelated. Higher the diversification benefits, higher the inflows. One more factor which has a very significant affect on these transactions is the expected movement in the exchange rates. If the exchange rates are quite stable, or the movement is expected to be in the investors' favor, the capital inflows will be higher.

BALANCE OF PAYMENTS COMPILATION

The BoP account is compiled using various sources of information. The most important source is the R>Returns which the Authorised Dealers are required to submit to the RBI every fortnight. These R>Returns provide the details of all foreign exchange transactions entered into by the ADs, including the transactions passing through the rupee accounts of non-resident banks. Other sources of information are the Government of India (the Department of Economic Affairs under the Ministry of Finance, and other government agencies located abroad) and surveys conducted specifically to facilitate BoP compilation, etc.

Theoretically, each of these transactions recorded through the various sources have an impact on the BoP account of the country. In practice, however, these transactions are not recorded individually in the BoP account. The transactions falling under different headings and sub-headings of the BoP account are aggregated, and then the BoP account is prepared on the basis of these net figures. Yet, it is important to understand the impact of these individual transactions on the BoP account. Here are a few illustrations which explain this impact.

Illustration 2

An Indian resident exports goods to an American resident and his payment is settled by a bill of exchange denominated in US dollars, having a maturity of 90 days. From India's point of view, two things have happened – export of goods has taken place and a foreign asset has been acquired (a short-term claim on a foreign resident). This transaction will, hence, have the following impact on India's BoP:

Holdings of foreign asset (Bill of exchange)	Dr.
Merchandise export	Cr.

While the first term will form a part of the capital account, the second will come under the current account.

Illustration 3

The bill of exchange mentioned in illustration 4.1 is presented for payment by the Indian exporter on maturity. He gets paid in US dollars which he retains in an account in a US bank. On one hand, this reduces the holdings of foreign assets (in the form of the bill of exchange), and on the other hand, it increases the same (in the form of the deposit). The impact will be

Holdings of foreign assets (Deposit)	Dr.
Holdings of foreign assets (Bill of exchange)	Cr.

The net effect on the BoP would be nil.

Illustration 4

The exporter then converts the dollars into rupees by selling the dollars to his local clearing bank. The effect of this transaction would be to reduce the exporter's holding of foreign assets and increase that of the clearing bank to the same extent. Since the foreign asset holdings of Indian residents in totality remain the same, there will be no effect on the BoP account.

Illustration 5

The clearing bank then sells the dollars to the central bank for the domestic currency. This results in the holdings of foreign assets going down and the official reserves going up (because a foreign currency held by a central bank is classified as a reserve asset rather than holding of a foreign asset). Hence, its impact on the BoP will be

Official reserves	Dr.
Holdings of foreign assets	Cr.

If the clearing bank sells the foreign currency to another bank, there will be no impact.

Illustration 6

An Indian resident imports goods from Germany and signs a usance bill of exchange denominated in German marks for the amount due. It will result in an increase in imports and an increase in liabilities to foreign residents (from the point of view of the Indian BoP). The impact will be

Merchandise imports	Dr.
Liabilities to foreign residents	Cr.

On maturity of the bill, the Indian importer would buy German marks from a bank and settle the payment. This will reduce the liabilities to foreign residents, as also the holdings of foreign assets (in the form of German marks – a foreign currency – held by the bank). The impact would be

Liabilities to foreign residents	Dr.
Holdings of foreign assets	Cr.

When the bank purchases German marks from the central bank to offset its earlier deal with the importer, the result will be an increase in the holdings of German marks by the bank (a foreign asset) and a reduction in the official reserves. It will have the following effect on the BoP:

Holdings of foreign assets (German marks)	Dr.
Official reserves	Cr.

Illustration 7

An Indian resident takes medical treatment in America and pays for it in US dollars. This is a purchase of service. For making the payment, the resident would need to buy dollars from a bank. The effect will be:

Trade in services	Dr.
Holdings of foreign assets (bank's holdings of dollars)	Cr.

If the bank buys dollars from the central bank to cover the sale, it will again have the following effect:

Holdings of foreign assets (bank's holdings of dollars)	Dr.
Official reserves	Cr.

Illustration 8

X, an NRI, decides to come back to India. He sells off all his assets and converts the resultant dollars into rupees. He would do this by selling the dollars to some bank. The effect would be

Holdings of foreign assets (dollars)	Dr.
Transfer payments	Cr.

In accordance with the principles of BoP accounting, even that part of X's property which does not accompany him has to be accounted for. The impact will be similar to the one mentioned above. The debit would be on account of the increase in the holdings of foreign assets (which X would now hold as a resident) and the credit as an offsetting entry.

Illustration 9

An Indian company issues ECBs denominated in French francs. This involves buying of an Indian asset (in the form of debt instruments) by foreign residents. There would be a simultaneous increase in the foreign asset holding of the bank to which the Indian company sells the francs. The impact would be

Holdings of foreign assets	Dr.
Liabilities to foreigners	Cr.

Illustration 10

IMF allocates SDRs to member countries from time to time. The allocation results in an increase in the official reserves of the country receiving the SDRs. The effect is

Official reserves	Dr.
Allocation of SDRs	Cr.

Till now, there has been no incident of cancellation of SDRs. Cancellation would have a reverse effect on the BoP.

Illustration 11

Suppose that some non-residents hold a part of the equity of a resident enterprise. The part of their share of earnings of the company which is paid out as dividends would be recorded in the BoP as an import of services. According to the BoP accounting principles, even that part of their share in the earnings which is retained in the company has to be recorded in the BoP account. Such retained earnings are considered as income paid out and reinvested by the non-residents. The effect is

Trade in services	Dr.
Holdings of foreign assets	Cr.
(for the notional payment of earnings in foreign currency)	

Holdings of foreign assets Dr.

Liability to foreigners Cr.

(for the notional reinvestment of earnings and the resultant increase in the amount of foreign currency held).

BALANCE OF PAYMENTS ACCOUNT – THE INDIAN PERSPECTIVE

The Indian BoP broadly follows the principles laid down by the IMF manual for preparation of the statement. The concepts of ‘economic transaction’ and ‘resident’, as well as the principle of double-entry system are adopted totally in accordance with the recommendations of the manual. The Income Tax Act and Foreign Exchange Regulation Act give different definitions for the term ‘resident’. However, for BoP purposes, the definition given in the IMF manual is followed.

There is a little deviation from the manual’s suggestions for valuation of transactions. In India’s BoP statement, the principle of recording transactions at market price is not always applied because of the practical difficulties involved. For example, if a company pays for some machinery or for technical know-how by allotting shares to the seller, ascertaining the market value of the transaction becomes difficult. Similarly, if a company buys from or sells to its subsidiary operating in another country, it becomes difficult to find out whether the price at which the transfer has taken place, reflects the market value or not. All transactions other than merchandise trade are recorded in the Indian BoP at the actual price paid through the banking channel. In these circumstances, transactions might not get recorded at their actual market value. The second significant deviation from the principles of valuation is that while exports are recorded at their f.o.b. value, imports are recorded in the Indian BoP statement at the c.i.f. value (i.e., cost, insurance, freight value). When the insurance and shipment costs are borne by the Indian importer, they are included in the cost of goods imported. Also, the transactions denominated in foreign currencies are converted into Indian rupees on the basis of the average exchange rate for that month, instead of the exchange rate applicable to the specific transactions.

Table 2: India’s Overall Balance of Payments

India’s Balance of Payments: April-December, 2004 (in US\$ million)		
	April-December, 2004	April-December, 2003
Exports	57485	44394
Imports	85841	58378
Trade Balance	(–)28356	(–)13984
Invisible, Net	21005	18790
Current Account	(–)7351	4806
Balance		
Capital Account	20835	16544
Change in Reserves	(–)13484	(–)21350
(–) Indicates increase		

Source: Reserve Bank of India

Table 3: India's Balance of Payments: April-December 2003-2004

Item	(In Rs. crore)			(in US\$ million)		
	2001-02	2002-03	2003-04	2001-02	2002-03	2003-04
A. Current account						
i. Merchandise	(-60427)	(-62428)	(-76872)	(-12703)	(-12910)	(-12703)
ii. Invisibles (a+b+c)	64161	82415	116510	13485	17047	25425
a. Services	21960	32671	48878	4577	6765	10684
b. Transfers	59668	73615	89308	12509	15217	19444
c. Income	(-17467)	(-23871)	(-21676)	(-3601)	(-4935)	(-4703)
Total Current Account (i+ii)	3734	19987	39638	782	4137	8719
B. Capital Account						
1. Foreign Investment (a+b)	31877	21918	66299	6692	4555	14492
a. Foreign Direct Investment	22588	17412	14404	4741	3611	3137
i. In India	29192	22575	21463	6131	4660	4675
ii. Abroad	(-6604)	(-5163)	(-7059)	(-1390)	(-1049)	(-1538)
b. Portfolio Investment	9289	4506	51895	1951	944	11355
i. In India	9617	4679	51998	2020	979	11377
ii. Abroad	328	173	103	-69	(-35)	(-22)
2. External Assistance, Net	5418	11745	12179	1117	(-2460)	(-2661)
3. Commercial Borrowings	7476	11370	8439	(-1567)	(-2344)	(-1576)
4. Short term to India	4236	4715	7318	-891	979	1560
5. Banking Capital	26671	40612	28491	5592	8412	6197
6. Rupee Debt Service	2458	2303	1758	(-519)	(-474)	(-376)
7. Other Capital, Net	793	16679	21881	158	3455	4763
8. Total Capital Account (1-5)	50589	58506	101613	10573	12113	22122
C. ERRORS & OMISSIONS	2269	3523	2674	402	730	580
D. Overall Balance [A(5)+B(8)+C]	56592	82016	143925	11757	16980	31421
E. Monetary Movement (i+ii)	56592	82016	143925	11757	(-16980)	(-31421)
i. I.M.F	0	0	0	0	0	0
ii. Foreign Exchange Reserve (-/+)	56592	82016	143925	11757	(-16980)	(-31421)

* Provisional

Source: Reserve Bank of India

The recommendations of the IMF manual regarding timing of the transactions being recorded are followed totally for capital account transactions, transportation and insurance services, transfer payments and for undistributed income. For other transactions, the conventions differ. Exports are recorded when the customs authorities clear them for shipment and imports are recorded when they are paid for. Due to this method of recording imports, those imports fail to get fully reflected in the period in which they occur, for which the Indian importer obtains trade credit from the foreign supplier. Services other than transport and insurance are recorded when the payment takes place. Similarly, interest and dividends are recorded when they are actually paid, not when they are due.

In India, foreign exchange transactions are regulated by the provisions of the Foreign Exchange Regulation Act (FEMA). According to this Act, only Authorised Dealers are permitted to deal in foreign exchange and no one is permitted to buy or sell any currency except through the authorised dealers.

The Statement

The Indian Balance of Payments for the financial year 2003-04 is shown in Table 3.

Table 4 gives a few ratios indicating the trend in the various components of BoP. These ratios help in evaluating the BoP position and estimating its future movements.

Table 4: Balance of Payments: Key Indicators

(US\$ million)

Item/Indicator	2003-04	2002-03	2001-02	2000-01
1	2	3	4	5
i. Trade Balance	(-15454	(-10690	(-11574	(-12460
ii. Invisibles, net	26015	17035	14974	9794
iii. Current Account Balances	10561	6345	3400	2666
iv. Capital Account	20860	8535	8357	10018
v. Overall balance#	31421	16985	11757	5868
vi. Foreign Exchange Reserves (Increase-, Decrease+) (Excluding Valuation Charges)	(-31421	(-16985	(-11757	(-5868
Indicators (In Percent)				
1. Trade				
a. Exports/GDP	10.7	10.5	9.3	9.9
b. Imports/GDP	13.3	12.6	11.8	12.7
c. Income in terms Trade Growth	1.6	18.2
d. Export Volume Growth	3.9	23.9
2. Invisibles				
a. Invisible Receipts/GDP	8.8	8.2	7.7	7.1
b. Invisible Payments/GDP	4.5	4.9	4.6	4.9
c. Invisibles (Net)/GDP	4.3	3.2	3.1	2.2
3. Current Account				
a. Current Receipts@/GDP		18.7	16.9	17.3
b. Current Receipts Growth@		17.7	2.47	17.6
c. Current Receipts@/Current Payments		103.6	100.5	95.3
d. Current Account Balance/GDP		0.7	0.2	-0.8
4. Capital Account				
a. Foreign Investment/GDP		1.1	1.7	1.5
b. Foreign Investment/ Exports		10.6	18.1	15.1
5. Others				
a. Debt-GDP Ratio		20.0	21.0	22.4
b. Debt Service Ratio		14.7	13.9	17.2
c. Liquidity Service Ratio		15.7	14.9	18.4
d. Import Cover Of Reserves (in months)		13.8	11.3	8.6

Includes Errors and Omissions

.. Not available

@ Excluding official transfers.

Source: www.rbi.org.in

IMPORTANCE OF BOP STATISTICS

As said earlier, an attempt at forecasting exchange rates can be made if the factors affecting the demand and supply of a currency are known. In the last few sections, the different components of the BoP account and the factors affecting them (and eventually the exchange rate of a currency) were listed. A careful study of these factors and of the underlying economic factors the world over can prove quite helpful for predicting at least the direction of the movement in exchange rates, if not the magnitude.

A movement in the reserves position of a country can also provide some indications as to the possible movement of the exchange rate of its currency. A continuous depletion of reserves may indicate either of the following two circumstances:

- a. A repeated overall BoP deficit. As outflow exceeds inflow, there would be an excess supply of the domestic currency in the forex markets, thus putting a downward pressure on its exchange rates with other currencies.
- b. There may already be a pressure on the exchange rate due to the above mentioned reason, because of which the official reserves may be used to defend the domestic currency. This would be done by selling the reserves in exchange for the local currency to increase the total demand for the latter, in order to prevent the exchange rate from sliding down.

Both the scenarios predict an eventual depreciation of the domestic currency. Similarly, a continuous accretion to the reserves would be an indication of impending appreciation.

LIMITATIONS OF BALANCE OF PAYMENTS

Though BoP statistics are very helpful in predicting movements in the exchange rates, they are more useful for estimating general trends rather than the specific levels at which the exchange rates would stabilize. Besides, care has to be taken while interpreting BoP data. All the different balances (current account balance, capital account balance, overall balance) should be considered, along with the actual and expected trends in these balances and the expected developments in the international scene. The BoP data for one country can only give an idea as to whether that country's currency is likely to increase or decline in value. It would not help in predicting the currency's movement with respect to a particular currency. That movement can be estimated only if the BoP data for both the countries are studied together.

RELATIONSHIP BETWEEN BOP VARIABLES AND OTHER ECONOMIC VARIABLES

Implications of a Recurring Current Account Surplus/Deficit

As we know, the national income of a country is given by the equation:

$$Y = C + G + I + (X - M) \quad (\text{Eq. 1})$$

Where,

- Y = National Income
- C = Consumption
- I = Investment
- X = Exports
- M = Imports
- G = Government Expenditure

This equation can be rewritten as:

$$X - M = Y - (C + G + I) \quad (\text{Eq. 2})$$

Where the left hand side of the equation reflects the current account balance and the right hand side reflects the difference between output (or income) and absorption (or expenditure). Thus, a current account surplus implies that a country is not consuming as much as it is producing, or in other words, is living below its means. Japan is a classic example of a country living below its means. While this type of a situation may be beneficial to a developed country, a developing country already facing scarcity of resources can hardly afford to not consume what it is capable of producing. Instead, a developing country would need to borrow from outside to build-up its productive capabilities in order to achieve high rates of growth. It would be more beneficial for them if they could run a current account deficit and finance it by a capital account surplus (i.e., live beyond their means).

Yet, it cannot be said that running a current account deficit is in itself the solution to the growth problem faced by the developing countries. The way the deficit is being financed and the purpose for which it is being used are also very important. If the deficit is being financed by short-term borrowing which would need to be repaid before the corresponding investments start generating adequate returns, the country may get into problems because it would have to refinance its borrowings at increasingly higher costs. The second aspect would become clearer with the help of an equation. As we know, income can also be written as the sum of Consumption (C), Taxes paid (T) and Savings (S). The equation can be written as:

$$Y = C + T + S \quad (\text{Eq. 3})$$

Using Eq. (3), Eq. (2) can be rewritten as

$$\begin{aligned} X - M &= (C + T + S) - (C + G + I) \\ &= (S - I) + (T - G) \end{aligned} \quad (\text{Eq. 4})$$

Where the second term on the right hand side of the equation represents the budget deficit. As can be seen, a current account deficit can show either a reduction in the domestic savings, or an increase in investments, or an increase in the budget deficit. If the borrowings (i.e., the capital account surplus) are used to increase consumption (by the private sector or the government sector) or to set-off falling domestic savings instead of being invested in productive assets, the country may not be able to repay these debts as there would be no earnings from the use of such resources. Hence, though a current account deficit can be beneficial for some countries in the short-term, the sources of the funds as well as its uses are two important factors which have to be taken care of.

While running a current account deficit can be beneficial for some countries in the short-term, it is not sustainable in the long-term due to the accompanying payment problems. There may arise the need to correct the imbalance. Eq. 2 and Eq. 4 give us an insight into the effectiveness of the various possible solutions for improving the current account deficit. It is clear from the equations that the deficit can be reduced only if two conditions are met. The first condition is that the difference between national product and national spending should be made positive. The second condition is that domestic savings should exceed the sum of private domestic investments and the budget deficit. Any measure which does not have the desired effect on these variables will not be able to correct a trade deficit.

SUMMARY

- If adequate care is taken to understand and interpret the data provided by the Balance of Payments, it can prove a useful source of information to estimate the direction that a particular exchange rate is expected to take. The BoP data also helps in analyzing whether a particular course of action is likely to be helpful or not in eliminating or reducing a current account deficit.
- At the same time, BoP data cannot be considered in isolation for predicting a movement in the exchange rates. Other economic fundamentals are equally important for this exercise.

Part II – Global Financial System

Chapter V

International Monetary System

After reading this chapter, you will be conversant with:

- Exchange Rate Mechanisms
- History of Monetary Systems
- Recent Developments

As mentioned in chapter Theories of International Trade, a number of theories have been propounded explaining the reasons behind international trade. We have also seen that the financial markets are getting integrated, and people and firms are entering into more and more cross-border financial deals. In order to make these transactions feasible, a system for determination of the amount and method of payment of the underlying financial flows is needed. Since the domestic currencies of the parties involved will be different, the flows will take place in some mutually acceptable currency. The parties involved will then need to convert the amount involved into their domestic currencies. The set of rules, regulations, institutions, procedures, practices and mechanisms which determine the rate at which this conversion takes place (called the *exchange rate*) and the movements in the exchange rate over a period is called the international monetary system. This system forms the backbone of all cross-border transactions because it makes the settlement of international payments possible. The settlement of transactions takes place by conversion of currencies into one another and the transfer of funds across nations, which becomes possible due to the existence of the international monetary system. These transactions may be on account of international trade in goods or services, or due to acquisition or liquidation of financial assets, or because of creation or repayment of international credit. By making all these possible, a smoothly running international monetary system contributes to a more efficient utilization of world resources.

In this chapter, we will discuss the following topics:

- The various mechanisms of exchange rate determination.
- The different monetary systems that have been prevalent over different periods of time.
- The current monetary system.
- The role of the various institutions involved in sustaining these systems and their contribution in the current scenario.
- An analysis of the various currency crises.

EXCHANGE RATE MECHANISMS

The exchange rate is formally defined as the value of one currency in terms of another. There are different ways in which the exchange rates can be determined. Exchange rates may be fixed, floating, or with limited flexibility. Different systems have different methods of correcting the disequilibrium between international payments and receipts, one of the basic functions of these mechanisms.

Fixed Exchange Rate System

As the name suggests, under a fixed (or pegged) exchange rate system the value of a currency in terms of another is fixed. These rates are determined by governments or the central banks of the respective countries. The fixed exchange rates result from countries pegging their currencies to either some common commodity or to some particular currency. There is generally some provision for correction of these fixed rates in case of a fundamental disequilibrium. Examples of this system are the gold standard and the bretton woods system. The particular variations of the fixed rate system are:

- Currency Board System
- Target Zone Arrangement
- Monetary Union.

CURRENCY BOARD SYSTEM

Under a currency board system, a country fixes the rate of its domestic currency in terms of a foreign currency, and its exchange rate in terms of other currencies depends on the exchange rates between the other currencies and the currency to

which the domestic currency is pegged. Due to the pegging, the monetary policies and economic variables of the country of the reference currency are reflected in the domestic economy. If the fundamentals of the domestic economy show a wide disparity from that of the reference country's, there is a pressure on the exchange rate to change accordingly. This may result in a run on the currency, thus forcing the authorities to either change, or altogether abandon the peg. To prevent such an event, the monetary policies are kept in line with that of the reference country by the central monetary authority, called the *currency board*. It commits to convert its domestic currency on demand into the foreign anchor currency to an unlimited extent, at the fixed exchange rate. The currency board maintains reserves of the anchor currency upto 100% or more of the domestic currency in circulation. These reserves are generally held in the form of low-risk, interest bearing assets denominated in the anchor currency. An internationally accepted, relatively stable currency is generally selected as the anchor currency.

The currency board does not have any discretionary powers over the monetary policy. The interest rates are automatically set by the market mechanism. If demand for the anchor currency rises and people start converting more and more of the domestic currency for the anchor currency, the reserves with the currency board get depleted. As the currency in circulation has to be backed by the anchor currency reserves, the depletion of reserves results in a contraction of the domestic currency's supply. This, in turn, will result in an increase in the domestic interest rates. A high domestic interest rate increases the demand for the domestic currency as more and more people become interested in investing in the economy. This increases the supply of the anchor currency and eliminates the pressure on the domestic currency. The opposite will happen in case of an increase in the supply of the anchor currency. The interest rates, thus, act as the force which brings back the forex markets to equilibrium.

Unlike a central bank, a currency board does not even have the power to print unlimited amounts of money. Due to the requirement of the domestic currency being backed by reserves of anchor currency, the board can print only as much currency as can be backed by its existing reserves. This prevents the board from lending to either the government, or the domestic banks. As government's deficits are not automatically monetized, it has to finance its operations by either raising taxes, or by borrowing in the market. The market determined interest rates keep the government borrowing, and hence, spending under check; and thus forces fiscal discipline. At the same time, as neither of the sources of funds (taxes and borrowings) increases the money supply, there is no inflationary pressure on the economy due to government spending.

Since the board does not lend to even the domestic banks, it cannot act as the lender of last resort. On one hand, this ensures more prudent policies on the part of banks. On the other hand, it would result in even sound banks going under at the time of a financial panic.

The biggest advantage of a currency board system is that it offers stable exchange rates, which act as an incentive for international trade and investment. The discipline enforced on the government and the financial system also helps in improving the macroeconomic fundamentals in the long run.

Among the drawbacks, the foremost is the loss of control over interest rates. The equilibrium in the forex markets is established at the point where the domestic interest rates in the economy are in accordance with the underlying economic fundamentals of the domestic and the anchor currency economy and the fixed exchange rate. A high inflation in the domestic markets can result in low or even negative real interest rate. This may cause an asset price bubble as money is borrowed at low interest rates and put in financial and real assets. The excess demand for these assets makes their prices go up to unrealistically high levels. When the interest rates start rising due to any endogenous or exogenous reason, these prices come crashing down due to the high selling pressure and thus cause a

financial panic. Another effect of the inability of the board to set interest rates is that an important tool for controlling the level of economic activity becomes inoperative. Interest rates cannot be used to control the inflation level in the economy and hence the level of economic activity. The economy may thus become exposed to phases of painful contraction and inflation. Further, this system, in order to operate efficiently, needs wages to be flexible. In case of the domestic economy facing a higher degree of inflation than the anchor currency country, or in case of an exogenous shock like a fall in the export prices, a movement in the exchange rates is not possible in this system. Thus, the adjustment has to come via domestic wages. If these prove to be sticky, the domestic currency could become overvalued, and the domestic goods uncompetitive in the international markets.

A good example of a currency board is that of Hong Kong. In addition to the currency being pegged to the US dollar (at HKD 7.8/\$), a currency board (established in 1983) ensures that reserves to the extent of at least 100 percent of the domestic currency are maintained. Another country following this system is Argentina. The Argentine peso is convertible into one dollar since 1991.

TARGET ZONE ARRANGEMENT

A group of countries sometimes get together, and agree to maintain the exchange rates between their currencies within a certain band around fixed central exchange rates. This system is called a target zone arrangement. Convergence of economic policies of the participating countries is a prerequisite for the sustenance of this system. An example of this system is the European Monetary System under which twelve countries came together in 1979, and attempted to maintain the exchange rates of their currencies with other member countries' currencies within a fixed band around the central exchange rate.

MONETARY UNION

Monetary union is the next logical step of target zone arrangement. Under this system, a group of countries agree to use a common currency, instead of their individual currencies. This eliminates the variability of exchange rates and the attendant inefficiencies completely. The economic variables of the member countries have to be quite proximate for the system to be viable. An independent, common Central Bank is set up, which has the sole authority to issue currency and to determine the monetary policy of the group as a whole. The member countries lose the power to use economic variables like interest rates to adjust their economies to the phase of economic cycle being experienced by them. As a result, the region as a whole experiences the same inflation rate. This is the most extreme form of management of exchange rates.

Floating Exchange Rate System

Under this system, the exchange rates between currencies are variable. These rates are determined by the demand and supply for the currencies in the international market. These, in turn, depend on the flow of money between the countries, which may either result due to international trade in goods or services, or due to purely financial flows. Hence, in case of a deficit or surplus in the balance of payments (difference between the inflation rates, interest rates and economic growth of the countries are some of the factors which result in such imbalances), the exchange rates get automatically adjusted and this leads to a correction in the imbalance.

Floating exchange rates can be of two types: Free float and Managed float.

FREE FLOAT

The exchange rate is said to be freely floating when its movements are totally determined by the market. There is no intervention at all either by the government or by the central bank. The current and expected future demand and supply of currencies change on a day-to-day, and even a moment-to-moment basis; as the market receives, analyzes and reacts to economic, political and social news. This, in turn, changes the equilibrium in the currency market and the exchange rate is determined

accordingly. As the reactions to events do not follow a set pattern, the resultant movements in the exchange rates turn out to be quite random. Hence, a lot of volatility is observed in the markets following a free float system. This system is also known as the clean float.

MANAGED FLOAT

The volatility of exchange rates associated with a clean float increases the economic uncertainty faced by players in the international markets. A sudden appreciation of the domestic currency (a currency appreciates when it becomes dearer vis-à-vis the other currency and vice versa) would make the domestic goods more expensive in the international markets (as the same number of units of domestic currency, representing the good's cost, would then translate into a higher number of units of the foreign currency). This may result in making the domestic product uncompetitive, and hence reduce the exports. If any industry is totally dependent on exports, it may even get wiped out. A sudden depreciation may lead to increased prices of imported goods, thereby increasing the inflation rate in the economy. These uncertainties increase the risk associated with international trade and investments, and thus reduces the overall efficiency of the world economic system. In order to reduce these inefficiencies, central banks generally intervene in the currency markets to smoothen the fluctuations. Such a system is referred to as a managed float or a dirty float. This management of exchange rates can take three forms:

- i. The central bank may occasionally enter the market in order to smoothen the transition from one rate to another, while allowing the market to follow its own trend. The aim may be to avoid fluctuations which may not be in accordance with the underlying economic fundamentals, and speculative attacks on the currency.
- ii. Some events are liable to have only a temporary effect on the markets. In the second variation, intervention may take place to prevent these short- and medium-term effects, while letting the markets find their own equilibrium rates in the long-term, in accordance with the fundamentals.
- iii. In the third variation, though officially the exchange rate may be floating, in reality the central bank may intervene regularly in the currency market, thus unofficially keeping it fixed. For example, the rupee-dollar exchange rate was maintained at Rs.31.37 to a dollar for around two years in 1993-94.

Hybrid Mechanism

CRAWLING PEG

A crawling peg system is a hybrid of fixed and flexible exchange rate systems. Under this system, while the value of a currency is fixed in terms of a reference currency, this peg itself keeps changing in accordance with the underlying economic fundamentals, thus letting the market forces play a role in the determination of the exchange rate. There are several bases which could be used to determine the direction of the change in the exchange rate. One could be the actual exchange rate ruling in the market. Though the rate is officially fixed at a certain level, in the market it hovers around the fixed rate, and is allowed to move so if it is not too much in divergence with the official rate. If this market determined exchange rate continuously shows a declining trend over a period, the peg is revised downwards, and vice versa. Another possible base could be the recent figure for the difference between domestic inflation and the inflation rate in the anchor-currency country. The changes could even be based on the balance of trade figures or changes in the external debt of the country. The advantage of a crawling peg is that, though it gives a relatively stable exchange rate (changes in which are fairly predictable), the rate is never too much out of line with the underlying fundamentals of the economy.

HISTORY OF MONETARY SYSTEMS

Various variations and combinations of the above mentioned exchange rate mechanisms have been followed in the past. Each one of them had its own unique method of correcting a disequilibrium in the international monetary system. The following monetary systems along with their correction mechanisms are being discussed below:

- The Gold Standard
- The Gold-Exchange Standard
- Bretton Woods System
- Post Bretton Woods System
- The European Monetary System.

The Gold Standard

The gold standard was followed in its classical form from 1870 to 1914. While the United Kingdom and the United States were on the gold standard from 1821 and 1834 respectively, most of the countries had joined the system by 1870. The essential feature of this system was that governments gave an unconditional guarantee to convert their paper money or fiat money¹ into gold, at a pre-fixed rate at any point of time, on demand. The continued commitment of the governments to the guarantee, and the readiness of the people to believe it were the reasons the system could sustain for such a long time.

The exchange rate between two currencies was determined on the basis of the rates at which the respective currencies could be converted into gold, i.e. the price of gold in the two countries. For example, if in the US the price of one ounce of gold is fixed at \$400 and in the UK it is £200, then the exchange rate (called the mint parity) between the \$ and the £ would be \$2/£ (400/200). The exchange rate would stay at this equilibrium level because of the arbitrage² possibility involved. Let us assume that the prevailing exchange rate was \$2.5/£. So a person wanting to convert dollars into pounds would have to pay \$2.5 for every pound. He could, instead, buy an ounce of gold in the US for \$400 (or a fraction thereof for a proportionate price), transport it to the UK, and sell it for £200. Thereby, he would be able to get pounds at the exchange rate of \$2/£. As everyone would follow this route for converting dollars into pounds, there would be no demand for pounds in the forex markets. Yet the supply would remain unaffected. This demand-supply imbalance would cause the exchange rate to come down. This would keep happening till the exchange rate reaches the equilibrium level, i.e., \$2/£. An exactly opposite process would correct the exchange rate if it falls below the equilibrium level. Thus the exchange rate would be maintained at the equilibrium level. This discussion assumes that there are no transaction costs involved in buying and selling of gold and no transportation costs for shifting it from one country to another. In reality, however, there is a cost involved in all these activities. Thus, the exchange rate would be able to fluctuate between bands on either side of the equilibrium exchange rate, the bands being determined by the size of these costs. The end points of the range fixed by these bands is referred to as the gold points.

There was an inbuilt mechanism in the gold standard which helped correct any imbalances in trade that any two countries would face. If France is exporting more to Germany than it is importing from it, Germany would be facing a trade deficit and France a trade surplus. This trade deficit would result in excess supply of DM (Deutsche Mark) which would drive down the DM-FFr (French Franc) exchange

1 Fiat money is money which has insignificant intrinsic value, but a high face value due to the decree or fiat that it can be used for the settlement of all financial obligations.

2 Arbitrage is the process of buying and selling the same product at different prices at the same time; and thus making profits due to market inefficiencies which allow the prices in two markets to diverge.

rate below the mint-parity level. Since at this rate, the suppliers of DM would prefer to change their holdings into FFr through the 'sell DM for gold – ship it to France – sell gold for FFr' route, there would be a transfer of gold from Germany to France. When a government commits itself to convert unlimited amounts of its paper currency into gold on demand, at all points of time it would need to have enough gold with it to make sure that it does not run out of gold in case a lot of people want to go for the conversion simultaneously. In case a country does run out of gold, its credibility would be shattered and the whole system would collapse. To avoid such a situation, a gold reserve equal to a fixed percentage (which may even be up to 100 percent) of the circulating currency is required to be maintained. With gold moving away from Germany, its gold reserves would come down and hence it would be forced to reduce the money supply. On the other hand, the gold reserves in France would go up and its money supply would increase. According to the Quantity Theory of Money, change in the price level is directly proportional to change in the money supply. With an increase in the money supply, the same amount of goods are chased by more money, hence the prices of those goods increase; and vice versa. As the money supply in France increases, the price of the goods produced in France also increases. At the same time, there is a reduction in the money supply in Germany, and the price of German goods decreases. This reduces the competitiveness of French goods vis-à-vis German goods and the former become less attractive to both German as well as French consumers. This results in a reduction in exports from France and an increase in imports from Germany. This process continues till trade balance between the two countries is achieved. This process of correction of imbalance in international receipts and payments is known as the price-specie-flow mechanism.

Countries continued to be on the gold standard for a long time due to its inherent advantages. Most of the advantages arose due to discipline enforced by the price stability of gold. The price of gold (its purchasing power) generally moved in line with the price of other goods and services, facing the same inflation rate. Gold being a commodity money (i.e., needing the use of other goods and services to be located, mined, and minted), its cost of production also moved in line with the general inflation rate. This caused the cost of production and the purchasing power of gold to tend towards equality in the long run. The government needed to acquire additional gold before it could issue more money. As the cost of acquiring gold was equal to the value of the additional money that it could issue, the government had no incentive to finance its deficits by digging additional gold and printing more money. This enforced fiscal discipline on the government and protected the economy from inflation resulting from excessive government spending. This ensured price stability in the participating countries. The second advantage of the gold standard lay in the fact that exchange rate movements were quite predictable. In the short run, the exchange rates could move only within the gold points. In the long run, the exchange rates would change only if a country changed the price of its currency in terms of gold. A country experiencing an increase in gold reserves would be likely to lower the price of gold; while those experiencing an exodus of reserves would be likely to increase it. This predictability of exchange rate movements reduced the risk involved in international trade and investments, and thus made the process of allocation of world resources more efficient.

The gold standard was abandoned with the advent of the First World War in 1914.

The Gold-Exchange Standard (The Inter-War Period)

During World War I, Britain and other countries borrowed heavily from the US in order to pay for food and arms. Britain also sold a lot of its foreign assets for the same purpose. Meanwhile, the British industry was losing its competitive edge in the international markets. After the sale of its foreign assets, the earnings from those assets which earlier used to offset a part of its trade deficit, were also lost. The War ended in 1918, after which exchange rates were allowed to float for a few

years. Large reparations (compensation payable by a defeated nation for damages caused during war) were forced upon Germany. In the US, industries which had expanded during the war were apprehensive of facing competition from foreign firms. Many countries were facing high inflation. All these factors contributed to a change in the attitude of countries towards free trade and trade barriers were imposed by many of them. The imposition of trade barriers by the US worsened the situation as its debtor countries found it difficult to earn dollars and hence repay its dollar loans.

In 1925, Britain returned to a modified version of the gold standard at the pre-war parity. Many other countries also returned to the modified standard at around the same time. International trade was being constrained by the limited gold available for backing the corresponding payments. The need was felt for creation of additional liquidity in the international markets. Hence, under the new system called the gold-exchange standard, some of the countries committed themselves to convert their currencies into the currency of some other country on the gold standard, rather than into gold. Instead of holding gold as a reserve asset, they started holding reserves of that currency. Though for most of the countries this reserve currency was the pound, due to the growing importance of France and America some countries made their currencies convertible into the FF and the dollar. This gave a special status to these countries namely Britain, France and the US. While other countries had to reduce their gold or pound reserves in order to pay for their imports, these countries could create money for the same purpose. For example Britain could transfer pounds by creating a sterling liability owed to the other country. It thus acted as a banker to the world. Though this system provided the additional liquidity required, the methodology followed for creating the liquidity itself sowed the seeds for the failure of the system.

As mentioned earlier, Britain had returned to the modified system at the gold parity. As the economic situation had changed drastically since the abandonment of the system in 1914, the gold parity turned out to be overvalued. Another important change that had taken place since 1914, was that the costs and prices had lost the flexibility they enjoyed earlier, due to increased unionism being witnessed. For the automatic correction mechanism to work properly, flexibility of these factors was an essential prerequisite. This made it difficult for Britain to maintain the exchange rate. One drawback of the system was that while the correction mechanism worked in the long run, in the short run it ended up increasing the interest rates in the economy facing the trade deficit. This used to provide a cushion by means of increased capital inflows (which would come in to reap the benefit of a higher rate of interest than could be earned in other countries), which used to offset the trade deficit to some extent. In the absence of flexibility of prices and costs, the increase in interest rates became permanent. This affected the British industry badly and the country started facing deflation, which increased the unemployment levels.

Another drawback of the system was that though the prices were stable in the long run, there were alternate periods of inflation and deflation in the short run. The deflationary periods would expose the countries to increasing unemployment levels – a phase that various countries were going through during that period, and something they could ill-afford at that time. As a result, the countries found it beneficial in the short run not to let the correction mechanism work and to indulge in sterilization; thus protecting their domestic economic activity from external disturbances. Sterilization, or neutralization, is the policy of not letting a change in the reserves have any effect on the money supply. This may be done either by directly breaking the link between the reserves and the notes printed, or by increasing or reducing the ability of banks to create money.

The final blow came in the form of the Great Depression of the late 1920s and early 1930s, that started in the US and spread to other parts of the world. The effect of America increasing its interest rates and trying to deflate its economy was devastating for other countries. While the capital started flowing from Britain to

America (instead of towards Britain), other economies dependent on exports to America found their incomes falling drastically due to a combined effect of the trade barriers put up by America and the reduced American demand. These countries witnessed falling employment and consumption levels. They thus got into the vicious circle of low employment, low earnings, low demand, still lower employment. All this was happening in a period when the unemployment levels were worrying the countries more than the worsening current-account balances.

As has been mentioned earlier, under the new system, some currencies were convertible into FFr or the dollar. But these countries did not have enough gold reserves to back their commitments. Although Britain was acting as the banker to the world, even its gold reserves were not enough to back the financial obligations it was creating on itself. In addition, unlike a normal bank, it did not have any lender of last resort. As Germany defaulted on its payment obligations in the absence of any lenders (the American markets having dried up in the wake of the depression), the confidence in the monetary system started eroding. France started converting its pound holdings into gold in order to shore up its gold reserves and prepare itself for any eventuality. As a result, Britain's gold reserves started depleting rapidly. Around the same time, a major Austrian bank by the name of Credit Anstalt collapsed. This event, together with Britain's depleting reserves, spread a financial panic around the world as Britain's ability to honor its commitment became doubtful. Soon everyone started trying to convert their pound holdings into gold. Britain being unable to fulfill its commitment, abandoned the system in 1931 in order to save its economy from disaster.

With Britain's departure from the system, the pressure shifted to the dollar, which was the only remaining currency convertible into gold. This pressure eventually resulted in the US suspending the convertibility in 1933. With this, the gold-exchange standard effectively came to an end. A few countries had already left the gold standard since the depression started in 1929. Some more followed after Britain's departure from the system. These countries floated their currencies and imposed trade and capital controls to avoid a huge depreciation in their currency's value and to insulate themselves from external factors. Even the countries that remained on the gold-exchange standard had to impose trade controls and follow deflationary policies in order not to lose gold. As most of the countries were facing an economic downturn and needed external demand to boost the domestic economy, a series of competitive devaluations (where every country tries to devalue its currency more than the other countries', in order to boost its exports – also called beggar-thy-neighbor policy) started taking place. Due to the extreme volatility of exchange rates and the restrictions imposed on trade and capital flows, international trade came down to very low levels and international capital flows almost stopped.

Bretton Woods System

The Second World War effectively stopped all international economic activity. Global economic growth was severely affected. On one hand, the warring nations suffered huge damages on account of the war, and on the other hand, most of the countries were suffering from hyper-inflation. The continuing war also made any co-operation on the economic front impossible. In this scenario, the need was felt for an economic system which would again make international trade and investments possible. For this, a system of stable exchange rates was required, which would also ensure that the countries do not get any incentive by following inflationary policies. Also required, was some arrangement which would help countries to tide over their short-term balance of payments problems and help them remain within the system without causing undue turmoil in their economies.

In 1944, representatives of 44 countries met in Bretton Woods, New Hampshire, USA, and signed an agreement to establish a new monetary system which would address all these needs. This system came to be known as the Bretton Woods System.

The main terms of the agreement arrived at were as follows:

- Two new institutions were to be established, namely, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD, also called the World Bank). IMF was supposed to be more important and powerful than the World Bank. It was decided that the member countries would meet under the aegis of this institution and together take a decision on any important thing which might affect the world trade or the world monetary system. Hence, co-operation and mutual consultation was built into the system in order to avoid the universally harming policies being followed by most of the countries before the Second World War. The second most important function of these institutions was to provide funds to member-countries to help them tide over temporary balance-of-payments deficit. These institutions and their functions are explained in detail later.
- A system (which came to be known as the adjustable peg system) was established which fixed the exchange rates, with the provision of changing them if the necessity arose. Under the new system, all the members of the newly set up IMF were to fix the par value of their currency either in terms of gold, or in terms of the US dollar. The par value of the US dollar, in turn, was fixed at \$35 per ounce. All these values were fixed with the approval of the IMF, and reflected the changed economic and financial scenario in each of the countries and their new positions in international trade. Further, the member countries agreed to maintain the exchange rates for their currency within a band of one percent on either side of the fixed par value. The extreme points of these bands were to be referred to as the *upper* and the *lower support point*, due to the requirement that the countries do not allow the exchange rate to go beyond these points. The monetary authorities were to stand ready to buy or sell their currencies in exchange for the US dollar at these points, and thereby support the exchange rates. For this purpose, a country which would freely buy and sell gold at the aforementioned par value for the settlement of international transactions was deemed to be maintaining its exchange rate within the 1 percent band. Thus US, which was the only country fulfilling this condition, did not need to intervene in the forex markets.
- Currencies were required to be convertible for trade-related and other current-account transactions, though governments were given the power to regulate capital flows. This was done in the belief that capital flows destabilize economies. For the purpose of such conversion, gold reserves needed to be maintained by the US, and dollar reserves by other countries. As selling the local currency would result in an increase in the dollar reserves and buying it would result in a reduction in the reserves, the countries facing a downward pressure (which would inevitably be the ones facing a balance-of-payments deficit, as explained later) were under more pressure than countries facing an upward pressure on its currency (the ones enjoying a balance-of-payments surplus). The additional pressure existed because the deficit country could eventually run out of reserves, and hence needed to follow more prudent economic, monetary and fiscal policies; while the surplus countries would only face an accretion of reserves. This imbalance in the responsibilities imposed on the two sets of countries eventually led to the downfall of the system.
- Since there was a possibility of such exchange rates being determined as may not be compatible with a country's BoP position, the countries were allowed to revise the exchange rate up to 10% of the initially determined rate, within one year of the rates being determined. After that period, a member country could change the original par values up to five percent (on either side) without referring the matter to IMF, that too only if its financial and economic condition made it essential. A bigger change could be brought about only with the consent of IMF's executive board, which would allow it

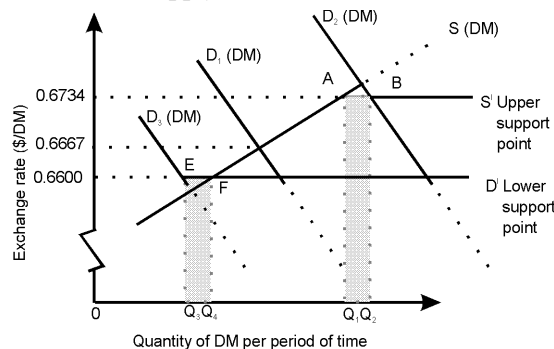
only in case of a “fundamental disequilibrium” in its balance-of-payments. Continuous reduction in reserves was supposed to serve as an indication of a fundamental disequilibrium.

- All the member countries were required to subscribe to IMF’s capital. The subscription was to be in the form of gold (one-fourth of the subscription) and its own currency (the balance). Each country’s quota in IMF’s capital was to be decided in accordance with its position in the world economy. This capital was needed to enable IMF to help the countries in need of reserves for defending their currency.

THE MECHANISM

The process for maintenance of the exchange rates under the Bretton Woods System shall be now explained. Let us take the example of the Deutsche mark and the US dollar. Let us assume that the parity exchange rate between these currencies was fixed at 1.5 DM per dollar or \$0.6667/DM. The exchange rate would have to be maintained between DM1.515/\$ and DM1.485/\$. These support points can also be written as \$0.6600/DM (1/1.515) and \$0.6734/DM (1/1.485). The demand and supply curves for the DM under the gold-exchange standard is shown in figure 1.

Figure 1: Demand and Supply Curves under the Bretton Woods System



Let the market demand for DM be shown by D_1 (DM) and the supply by S (DM). The equilibrium at which these curves intersect is initially the same as the parity, i.e., DM1.5/\$ or \$0.6667/DM. The demand for DM comes mainly from importers of German goods who need to pay for them in marks, and from investors who wish to invest in Germany and need marks for it. The demand curve for marks follows the normal shape of a commodity demand curve. As the price for marks (its exchange rate with dollars) goes up, its demand goes down. The supply of marks comes mainly from German importers who need other currencies to pay for their imports and use marks to buy them. It also comes from German investors who need other currencies to be able to invest in them. The supply curve for marks also conforms to the normal commodity supply curve’s shape. As the price of marks goes up, its supply increases. A reduction in the price of a currency in terms of another currency is termed as a depreciation in the exchange rate. An increase in its price is called an appreciation. Thus, the demand for a currency goes up when it depreciates, and the supply goes up when it appreciates.

Suppose there is a sudden increase in the demand for German goods. This would result in an increase in the demand for DM and the demand curve would shift to the right. Let the new demand curve be D_2 (DM). As can be seen from the illustration, the new equilibrium exchange rate lies beyond the upper support point. At this rate, the German central bank, i.e. the Bundesbank has to intervene in the forex market and has to supply adequate amount of DM in order to maintain the exchange rate at the upper support point. As the market supply has to be supplemented by government action irrespective of the size of the deficiency, under the gold-exchange standard the supply curve becomes perfectly elastic at the

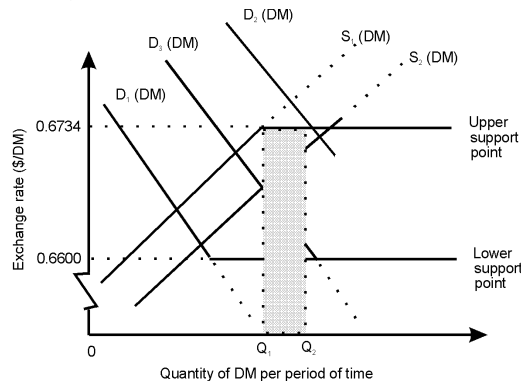
upper support point. Since at this exchange rate, the private supply of DM would be equal to only Q_1 , the rest of the demand for DM ($= Q_2 - Q_1$) would have to be supplied by the monetary authorities. As the Bundesbank supplies $Q_2 - Q_1$ marks, in exchange it ends up buying $(Q_2 - Q_1) \times 0.6734$ US dollars. This is reflected in the shaded area ABQ_1Q_2 . Hence, there is an accretion to Bundesbank's dollar reserves in case of an appreciation of the domestic currency beyond the upper support point.

If the demand for DM falls from the original equilibrium due to any reason, the demand curve shifts to the left [to $D_3(DM)$ in our illustration]. If the resultant exchange rate falls below the lower support level, the Bundesbank would again have to intervene and sell dollars for marks, thus making up the deficiency in the DM demand. Again, since the deficiency has to be made up by the authorities, however huge it may be, the demand curve becomes perfectly inelastic at the lower support level. At this exchange rate, the monetary authorities would have to demand $Q_4 - Q_3$ marks. In exchange for these marks, it would need to supply $0.66 \times (Q_4 - Q_3)$ dollars. This is shown by the shaded area EFQ_3Q_4 . Hence, a depreciation of the domestic currency beyond the lower support point causes a depletion of reserves.

PRICE ADJUSTMENT MECHANISM

Intervention by monetary authorities under the Bretton Woods system was not an end in itself, but a means to correct the imbalance underlying the movement of the exchange rate beyond the support points. Figure 2 explains how this correction was supposed to take place. We initially start with the demand and supply curves derived in figure 1, which become totally inelastic at the lower and the upper support point respectively. As before, the demand for DM increases to $D_2(DM)$, due to which the exchange rate goes beyond the upper support point. This forces the Bundesbank to intervene by demanding dollars. As the dollars have to be paid for in marks, it increases the supply of marks in the German economy. Once again, according to the quantitative theory of money, the increase in the money supply increases the prices of German goods and hence makes them less competitive in both the international and the domestic market. This increases the demand for imported goods in Germany and reduces the demand for German exports. The decreased demand for German exports reduces the demand for DM and shifts the demand curve to $D_3(DM)$. At the same time, the increased demand for imports in Germany increases the supply of DM and shifts the supply curve to $S_2(DM)$. The new equilibrium exchange rate again falls under the permitted range, thus eliminating the need for further intervention by the monetary authorities.

Figure 2: Price-Adjustment Mechanisms under the Bretton Woods System



This price-level adjustment mechanism works in the absence of sterilization. If the money supply and the local prices are not allowed to change, the mechanism cannot work. As a result, there will be a continuous increase or decrease in the dollar reserves, and eventually the parity exchange rate would have to be revised.

THE INSTITUTIONS

As mentioned earlier, two institutions were set up as a part of the Bretton Woods system. These institutions and their activities have to be studied in detail in order to understand the system in totality. A few more institutions came up as a part of this system. The following institutions are discussed below:

- The International Monetary Fund (IMF)
- The International Bank for Reconstruction and Development (IBRD, also called the World Bank)
- The International Finance Corporation (IFC)
- The International Development Association (IDA).

International Monetary Fund (IMF)

The International Monetary Fund was established to ensure proper working of the international monetary system. One of the important functions of IMF was to provide reserve credit to member countries facing temporary balance-of-payments problems. For this purpose, a currency pool was maintained. Each member country was required to contribute to this pool according to its quota, which was fixed on the basis of each country's importance in world trade. These contributions were to be partly in an international reserve currency and partly in the country's domestic currency. Initially, the first part of the payments were made in gold. Later it was replaced by SDRs (Special Drawing Rights, explained later). A country's quota would also determine its access to the pool and its voting powers at IMF. A country could draw from IMF in tranches for maintaining its currency's parity. A tranche represents 25% of a country's quota. Drawings of the first tranche is automatically approved by IMF. A further 100% of its quota can be borrowed in four steps. With each step, stricter conditions are imposed on the borrowing country, in order to ensure that structural corrections are carried out. In order to draw from IMF, a member country has to buy reserve assets and other currencies by paying its own currency to IMF. At the time of repayment of the loan, the borrowing country reverses the deal.

IMF's management is vested in its executive board. Out of its 22 directors, six are appointed by governments holding the largest quotas. The rest of the directors are elected by the remaining countries. The managing director, who is also the chairman of the executive board, is appointed by the executive board for five years. The board of governors, which is the highest governing body of IMF, meets once a year to take major policy decisions. Its members are generally the finance ministers or the central bank governors of the member countries. All the member countries are represented on this board.

IMF lends to its member countries under various schemes. These schemes are listed below:

- **Standby Arrangement:** This scheme was introduced in 1952. Under this scheme, countries can borrow at the first indication of its possible need. This would help the country in time as it would not have to wait for IMF's approval for the loan when the need actually arose.
- **Compensating Financing Facility:** This scheme was introduced in 1963 for providing financial assistance to countries facing temporary shortfall in reserves.
- **Buffer Stock Financing Facility:** Introduced in 1969, this scheme provides for countries receiving financial assistance from IMF in order to purchase approved primary products. This help is extended to prevent countries from suffering due to price shocks.
- **Extended Facility:** This scheme was introduced in 1974. It allows countries to borrow on a medium-term basis for overcoming balance-of-payments problems caused by structural imbalance.

- **Oil Facility:** It was introduced in 1974 and was terminated in 1976. Under this scheme, help was extended to countries most affected by the oil price rise.
- **Trust Fund:** As gold was demonetized in 1976, IMF set up this fund with the proceeds from the sale of gold held by it. This fund was used for providing special development loans on concessional terms to those 25 member-countries which had the lowest per capita income. It was discontinued in 1981.
- **Supplementary Financing Facility:** Under this scheme, established in 1977, financial assistance is provided to countries facing serious BoP problems and having high external debt.

In 1993, other facilities were extended to the member countries for assistance in exchange rate stabilization.

World Bank

The World Bank or the International Bank for Reconstruction and Development (IBRD), as its name suggests, was established to help countries in reconstructing their economies in the post World War II period and to help the developing countries increase their economic growth rate.

The World Bank generally makes medium- and long-term loans for infrastructure projects. Lately, it has started lending to countries having BoP problems, if they are willing to adopt growth-oriented economic policies. It requires a government guarantee for making these loans. For these activities, it raises funds through subscriptions from member countries and by issuing bonds which are generally meant for private subscription.

International Finance Corporation (IFC)

IFC was incorporated in 1956 to help the development of private enterprise in different countries. It thus supplements the activities of the World Bank. IFC helps the private sector in a number of ways. It finances their projects through loans and subscription to equity. It provides technical assistance to private enterprises. It also tries to bring private capital and private management together by creating conditions conducive to the flow of private capital. It does not insist upon government guarantee and generally takes up more risks than its counterparts.

International Development Association (IDA)

While the above mentioned agencies were set up to finance profitable projects, IDA endeavors to finance those projects in developing countries which may not be financially profitable, but indirectly may have a positive effect on the concerned economy. IDA was set up in 1960. The membership of World Bank is a prerequisite for membership of IDA. Hence, it is usually referred to as the soft loan window of the World Bank. It provides highly concessional loans (including long-term interest-free loans) to such projects. IDA also insists on a government guarantee.

THE FAILURE

Though, under this system, the member countries had the option of pegging their currencies to either gold or to the dollar, the only reserve asset mentioned in the agreement establishing the system was gold. However, as the gold stocks did not increase substantially in the years following the agreement, this provision acted as an impediment to the growth of international trade. Increase in such trade required a simultaneous increase in the official reserves held by various countries, in order to facilitate the payment for these trades. To get around this problem, countries started holding dollar reserves. They generally held the reserves in the form of interest bearing securities issued by the US government. This was encouraged by the US because of the seigniorage gains involved. While the cost of printing money was almost nil, the benefits were immense as the US could pay for its increased imports just by printing additional money, without suffering a reduction

in its reserves. Seigniorage gain refers to this benefit accruing from the ability to finance unlimited imports. Since other governments were ready to hold dollar reserves and not convert them into gold, the US started following a system of fractional reserves. The total number of dollars issued by the Federal Reserve (the American central bank) was far in excess of the value of the gold held by it. As it would not have been possible for the fed to convert all the dollars into gold, the system ran on the confidence of other countries on its ability to do so, and their non-insistence for an immediate conversion. This created a paradox in the system known as the Triffin paradox or the Triffin dilemma after a Yale University professor, Robert Triffin, who first spoke about it in 1960. According to him, it was necessary for the US to run BoP deficit in order to supply the world with the additional dollar reserves needed for increased international trade. Yet, as its deficit increased and the volume of dollar reserves held by other countries grew without a simultaneous increase in US's gold reserves, its ability to honor its commitment (of converting dollars into gold) would decrease. Such a situation would result in decreased confidence in the system, and since the system was running on the member countries' confidence, it would result in the system breaking down.

Another problem with the system was that it had become too rigid, despite the aim of the members being otherwise. As the system provided for realignment of exchange rates in case of a fundamental disequilibrium, predicting exchange rate movements became very easy. This put currencies at the mercy of private speculators. If a country started facing regular BoP deficits, people would start expecting a devaluation of its currency. Attempting to profit from such a scenario, private speculators would start selling the currency for gold or some other currency which was expected to remain strong, in the hope of buying it later at a reduced price. As these capital outflows built up, the reserves of the country would go down, eventually forcing it to devalue its currency. Thus, the expectations prove self-fulfilling. These outflows could only be stopped by a firm commitment by the concerned government at the very beginning, of not devaluing its currency. After making such a commitment, though, the country would find it very difficult to go for devaluation as such an act would make it lose its credibility, and the possibility of controlling the markets next time would be very bleak. The country would also not have any other choice but to devalue, as the other adjustment mechanisms were generally not acceptable to them (which implied a contraction of the economy, thus resulting in increased unemployment); leaving them in a catch-22 situation. A country whose currency faces an upward pressure would also face a similar problem, as the inflation resulting from an attempt to stop its currency from appreciating may not be acceptable; and the only other option left would be to revalue the currency.

In the early 50s, the US was running a BoP surplus, and hence there was a shortage of dollars in the international markets. By the late 50s, however, the US BoP situation had reversed and there was an excess supply of dollars. So much so, that there was a considerable reduction in US's gold holdings and the general belief became that the dollar had become overvalued and a correction in its value was due. This situation occurred due to two reasons. One was the devaluation of other currencies vis-à-vis the dollar in the previous decade, which made American goods less competitive in the international markets, and the other was the high inflation rate prevailing in the American economy. In 1960, the value of gold flared up in the London market where most of the private gold trading took place. This happened due to the speculation that the dollar was going to be devalued by increasing the price of gold. To prevent the markets from going too far off from the official price of \$35 per ounce, the US arrived at a gold pool arrangement with 7 other countries, under which they sold gold in London. This helped in controlling the gold prices in the short run. At around the same time, US inflation started coming down and its BoP situation started improving. By the early 60s, US was enjoying a current account surplus. This was being balanced by capital flows

out of US, mostly on account of US companies investing in Europe. In an attempt to reduce unemployment in US, monetary tightening was not introduced despite the overall BoP figure remaining negative. Believing that the increasing trend in the current account balance would continue and the BoP deficit was a short-term phenomenon, the government looked at short-term arrangements for tiding over the BoP difficulties. It tried to persuade foreign governments not to convert their dollar holdings into gold, opened credit lines with foreign central banks, and drew small amounts from IMF. It also entered into the General Arrangements to Borrow (GAB), an agreement with 9 other major countries to form the Group of Ten (G-10). The members of this group agreed to lend their currencies to IMF in case any one of them needed to draw a huge sum from it.

Despite all these steps, the BoP position did not turn positive as capital outflows continued. The main reason was the continuing high inflation rate in the US economy. With the US needing a lot of money to finance its commitments (to provide money for the reconstruction of the various war ravaged economies) under the Marshall Plan and its own expenses due to the Vietnam war, the money supply increased drastically, thus pushing the inflation to high levels. The US government then started imposing various restrictions on capital flows. An 'interest equalization tax' was introduced on purchase of foreign securities by US citizens and its citizens were prohibited from holding gold either within the country or outside. In 1965, American banks and companies were told to voluntarily restrict loans to foreigners, and foreign direct investments respectively. In 1968, these controls were made compulsory. By then, however, the current account had also weakened. The pressure on the dollar started building up.

Other deficit countries were also facing problems. Britain started facing a BoP deficit in the early 60s and wanted to devalue the pound. US objected as it felt that a pound devaluation would fuel expectations of a dollar devaluation and speculators would start taking positions against it, forcing it to be devalued. Due to the US objection, UK held on for some time, borrowing heavily from other governments and IMF to defend the pound's exchange rate. It finally gave up in 1967 and the pound was devalued. In 1968, capital started flowing out of France due to certain political disturbances there. In order to stop these disturbances, the French government had to increase wages, which resulted in making the French industry less competitive. This resulted in a pressure on the value of the French franc, especially vis-à-vis the DM. Neither France nor Germany took any action, as both of them wanted the other one to change the value of its currency with respect to the dollar. In 1969, the franc was finally devalued.

These problems put a lot of strain on the system. The pound devaluation did have the expected effect on the outlook for the dollar, and the pressures on that currency increased so much that even interventions by the gold pool group could not have the desired effect. In 1968, the sales by the gold pool in the private market were abandoned and the dollar was made non-convertible into gold for private market players. The Fed decided to convert only central banks' dollar holdings into gold.

After franc's devaluation, there was increased speculation, especially regarding the DM. When the German authorities could no more stop their currency from appreciating, they let it float temporarily, rather than importing US inflation via the price adjustment mechanism. This was the first break in the Bretton Woods system after 1950, in which year the Canadian dollar was allowed to float. The German authorities let the mark appreciate by 10%, at which level they re-established the peg with the US dollar.

As the system started facing these problems and the pressure on the dollar increased, a new reserve asset was created by IMF in 1967. Named SDRs (Special Drawing Rights), this international currency was allocated to the IMF member countries in proportion to their quotas. The biggest benefit of SDRs was that there would be a provision for international money to be created without any country needing to run a BoP deficit or to mine gold. Its value lay not in any backing by a

currency or a real asset (like gold), but in the readiness of the IMF member countries to accept it as a new form of international money. Any member country, when facing payment imbalances arising out of BoP deficits, could draw on these SDRs, as long as it maintained an average balance of 30% of its total allocations. It could then sell these SDRs to a surplus country in exchange for that country's currency, and use it for settlement of international payments. Every member country was obliged to accept up to 3 times its total allocations as a settlement of international payments. It is an interest bearing source of finance, i.e. countries holding their SDRs receive interest, and the ones drawing on them pay interest. This interest rate is determined on the basis of the average money market interest rates prevailing in France, Germany, Japan, the UK and the US. Only the member countries of IMF and specific official institutions are eligible to hold SDRs. SDR is also the unit of account for all IMF transactions.

The value of an SDR was initially determined as equal to that of dollar, i.e., one ounce of gold was equalized to 35 SDRs. Later, its value was revised and put equal to the weighted average value of 16 major currencies. Again, the basket of currencies was simplified and reduced to 5 currencies – US Dollar, Yen, Pound Sterling, DM and French franc. Both the times, the weights were based on the importance of the respective countries in world trade. Both the basket and the weights are supposed to be revised every five years to reflect the changed scenario in international trade and the various countries' importance in it. An important advantage of SDRs is that its value is more stable than that of individual currencies. This happens because it derives its value from a number of currencies, whose values are unlikely to vary in the same direction and to the same extent. This feature makes it a better unit of account than a single currency.

Despite the introduction of SDRs, the crisis continued to deepen. By this time, US's gold holdings had reduced considerably (both as an absolute figure and as a proportion of its foreign liabilities). By 1979, its reserve position turned negative as the BoP deficit increased drastically. In the first three months of 1971, huge pressure built up against the dollar, especially with respect to the mark. A number of countries had to buy a lot of dollars to defend their exchange rates. Germany, not intending to increase its money supply to unmanageable proportions, once again floated its currency. In April 1971, the US suffered a trade deficit for the first time, but it could not follow contractionary policies as it was simultaneously suffering from high unemployment. The only option left to it was to devalue. Even that it could not do on its own, as increasing the price of gold in terms of the dollar would not have had the desired effect due to other currencies being pegged to the dollar directly (rather than through gold prices). Also, an unexpected devaluation of the dollar would have penalized those countries which were trying to help the US by holding on to dollars instead of converting them into gold. Most of the countries held on to dollars in the first half of 1971. In the beginning of August, France needed gold to repurchase francs from the IMF, which it had sold earlier in harder times. It fulfilled this need by converting its dollar holdings into gold. As gold reserves of the US fell and rumors spread about Britain also trying to follow the same route as France, panic spread in the international markets about US's ability to honor its commitment to convert all dollar holdings into gold. This caused a run on its gold reserves as all countries rushed to get their dollar holdings converted when they could. This precipitated the matters so much that the US decided to stop converting dollars into gold and let its currency float on August 15, 1971. To improve its BoP position, it simultaneously imposed an additional 10% tariff on imports. Hence, the two most important pillars of the system were gone – fixing of prices of currencies in terms of gold and their convertibility into gold. As a reaction to this development, many of the countries let their currencies float.

The intention of the US behind these steps was not to shift from a pegged-exchange rate system to a floating rate system, but to seek a realignment of exchange rates. Therefore, it called for a meeting of the 10 largest IMF member countries, which was held in December 1971, at the Smithsonian Institute in

Washington, and considered the issue of realignment. As a part of the agreement arrived at in that meeting, which came to be known as the Smithsonian agreement, many of the countries revalued their currencies in terms of the dollar, while the dollar was devalued by raising the price of gold from \$35 to \$38 per ounce. The other part of the system, i.e., the facility of conversion of dollars into gold, however, was not re-established. The band around the parity rates was increased from one percent to 2.25 percent on each side, thus providing the central banks more flexibility in the management of exchange rate and monetary policy. It was also agreed to liberalize trade policies and to introduce more flexibility to exchange rates.

When the demand curve for exports is relatively inelastic, a devaluation of a country's currency does not immediately lead to an improvement in its current-account balance. In the initial period, the reduction in the price of the exports is much more than the increase in the volumes and hence there is a net reduction in exports. In the long run, however, the volumes pick up and the net exports start rising. The current-account curve, thus, traces a J-shape. It first becomes worse than its position before the devaluation, and then improves. This is called the J-curve effect. The US's BoP behaved in a similar manner after the Smithsonian agreement. It was misinterpreted to mean that the devaluation of the dollar was smaller than it should have been. In mid-1972, the UK floated the pound as a response to BoP problems. This again fuelled speculation against the dollar, with dollar being abandoned in favor of mark and yen. In February 1973, the dollar came under extreme selling pressure due to these factors and the high inflation rate which continued to reign in the US. It was contemplating devaluing the dollar once again, but was pre-empted by Switzerland which floated its currency. The dollar was, nevertheless, devalued by raising the price of gold to \$41.22 per ounce. In mid-March, 14 major industrial countries followed Switzerland by abandoning the system and floating their currencies. With this, the system came to an end.

Post-Bretton Woods System (The Current System)

As the Bretton Woods system was abandoned, most countries shifted to floating exchange rates. This fact was finally recognized by the IMF and the articles were amended in its agreement. The amendment was decided upon in Jamaica in 1976 and became effective on April 1, 1978. This was the second amendment to IMF's articles. Under the new articles, countries were given much more flexibility in choosing the exchange rate system they wanted to follow and in managing the resultant exchange rates. They could either float or peg their currencies. The peg could be with a currency, with a basket of currencies or with SDRs. The only restriction put was that the pegging should not be done with gold. Neither were the member countries allowed to fix an official price for gold. This was done to reduce the role of gold and to make SDRs more popular as a reserve asset. For the same reason, the value of an SDR was redefined in terms of a basket of currency (to make it more stable and hence preferable as a reserve asset), rather than in dollar terms. Also, the members were no longer required to deposit a part of their quota in gold, and IMF sold off its existing gold reserves. In order to make SDRs more attractive as a reserve asset, they were made interest-bearing. It was also allowed to be used for different types of international transactions. The member countries were also left free to decide upon the degree of intervention required in the forex markets, and could hence make it compatible with their economic policies. Secondly, IMF was given increased responsibility for supervising the monetary system. As a part of these increased responsibilities, IMF was required to identify those countries which were causing such changes in the exchange rates through their domestic economic policies, which proved disruptive to international trade and investment. It could then suggest alternate economic policies to these countries. IMF was also responsible for identifying any country which was trying to defend an exchange rate which was inconsistent with the underlying economic fundamentals. This was to be done by a constant monitoring of the reserves position of various countries. Lastly, the new articles made it easier for countries facing short-term imbalances in their BoP accounts to access IMF's assistance.

While countries were free to determine their exchange rate policies, under Article IV of the Agreement, they were required to ensure that the economic and financial policies followed by them were such as to foster 'orderly economic growth and reasonable price stability'. They also had to follow principles of exchange rate management, adopted by IMF in April, 1977. According to these principles:

- A member country neither should manipulate the exchange rates in such a way as to prevent a correction in the BoP position, nor should it use the exchange rates to gain competitive advantage in the international markets.
- A member country was required to prevent short-term movements in the exchange rates which could prove disruptive to international transactions, by intervening in the exchange markets.
- While intervening in the forex markets, a member country was required to keep other countries' interest in mind, especially the country whose currency it chooses to intervene in.

These principles attempted to bring some stability in the forex markets and to prevent another bout of competitive devaluations.

Given the freedom, different countries chose different exchange rate mechanisms. While some of them kept their currencies floating, some of them pegged their currencies either to a single currency or to a basket of currencies. A peg was maintained by intervention in the foreign exchange markets and by regulating forex transactions. Table 1 shows the status of currencies as on March 31, 1995.

Floating of currencies was expected to make the exchange rate movements more smooth. Instead a lot of volatility has since been experienced. To remove a part of this volatility, sometimes a group of nations come together to form closer economic ties by co-operating with each other in the management of their exchange rates. One such group is the European Monetary Union (EMU).

Table 1*: Exchange Rate Mechanisms followed by Various Countries

Currencies pegged to:	No. of currencies
The US dollar	27
French franc	14
SDR	6
Non-SDR basket	34
Other currency	5
Flexibility limited vis-à-vis a single currency(\$)	5
Co-operation arrangements (EMS)	10
Adjusted according to a set of indicators	5
Managed float/ wide band around a peg	22
Independent float	27
	155

* Source: Department of Economics, IOWA State University.

The European Monetary System

The basis of the European Monetary Union was the American desire to see a united Western Europe after the World War II. This desire started taking shape when the Europeans created the European Coal and Steel Community, with a view to freeing trade in these two sectors. The pricing policies and commercial practices of the member nations of this community were regulated by a supranational agency. In 1957, the Treaty of Rome was signed by Belgium, France, Germany, Italy, Luxembourg and the Netherlands to form the European Economic Community (EEC), whereby they agreed to make Europe a common market. While they agreed to lift restrictions on movements of all factors of production and to harmonize domestic policies (economic, social and other policies which were likely to have an effect on the said integration), the ultimate aim was economic integration. The European countries desired to make their firms more competitive than their American counterparts by exposing them to internal competition and

giving them a chance to enjoy economies of scale by enlarging the market for all of them.

The EEC achieved the status of a customs union by 1968. In the same year, it adopted a Common Agricultural Policy (CAP), under which uniform prices were set for farm products in the member countries, and levies were imposed on imports from non-member countries to protect the regional industry from lower external prices. An important roadblock in the European unification was the power given under the treaty to all the member countries, by which they could veto any decision taken by other members. This hindrance was removed when the members approved the Single European Act in 1986, making it possible for a lot of proposals to be passed by weighted majority voting. This paved the way for the unification of the markets for capital and labor, which converted the EEC into a common market on January 1, 1993. Meanwhile, a number of countries joined EEC. Denmark, Ireland and the United Kingdom joined in 1973. By 1995, Austria, Finland, Greece, Portugal, Spain and Sweden had also joined, thus bringing the membership to 15.

The structure of the EEC consists of the European Commission, a Council of Ministers and a European Parliament. The Commission's members are appointed by the member countries' governments and its decisions are subject to the approval of the Council, where, by convention, either the Finance Ministers or the heads of the central bank represent their respective countries. The members of the Parliament are directly elected by the voters of the member countries. In December 1991, the Treaty of Rome was revised drastically and the group was converted into the European Community by extending its realm to the areas of foreign and defense policies. The members also agreed to convert it into a monetary union by 1999.

As the Bretton Woods system was breaking down in 1973, six out of the nine members of the EEC jointly floated their currencies against the dollar. While Britain and Italy did not participate in the joint float, France joined and dropped out repeatedly. The currencies of the participating countries were allowed to fluctuate in a narrow band with respect to each other (1.125% on either side of the parity exchange rate), and the permissible joint float against other currencies was also limited (to 2.5% on either side of the parity, by the Smithsonian agreement). This gave the currency movements the look of a 'snake', with the narrow internal band forming the girth and the movements against other currencies giving the upward and downward wriggle. The external band restricting the movement of these European currencies on either side, gave the impression of a 'tunnel' thus giving rise to the term 'snake in the tunnel'. The idea of creating a monetarily stable zone started taking shape in 1978, which resulted in the creation of the European Monetary System in 1979. The system was quite similar to the Bretton Woods System, with the exception that instead of the currencies being pegged to the currency of one of the participating nations, a new currency was created for the purpose. It was named the European Currency Unit (ECU) and was defined as a weighted average of the various European currencies. Each member had to fix the value of its currency in terms of the ECU. This had the effect of pegging these currencies with each other. Since each currency could vary against the ECU and against other currencies within a certain band on either side of the parity rate (2.25% for others and 6% for Pound Sterling, Spanish peseta and Portuguese Escudo), a certain grid was formed which gave the limits within which these currencies could vary against each other. Whenever the exchange rate between two of the member currencies went beyond the permissible limit, both the countries had to intervene in the forex markets. This co-operation between the countries was expected to make the system more effective. Another important feature of this system was that the members could borrow unlimited amounts of other countries' currencies from the European Monetary Cooperation Fund in order to defend their exchange rates. This was expected to ward off any speculative activities against a member currency. Though the countries involved were also expected to simultaneously adjust their monetary policies, this burden was put more on the erring country. It was easier to fix the blame, as at the time of the fluctuation in the

exchange rate of two members, the erring country's exchange rate would also be breaching its limits with respect to the ECU and other member currencies. When these parity rates became indefensible, they could be realigned by mutual agreement. The system was, thus, much more flexible than the Bretton Woods System.

The ECU also served as the unit of account for the EMS countries. It served another important purpose in that loans among EMS countries (including private loans) could be denominated in the ECU. The ECU's value being the weighted average of a basket of currencies, it was more stable than the individual currencies. This made it more suitable for international transactions.

A number of realignments took place in the first few years of the system. However, the 1980s saw the system becoming more rigid. The German Central Bank, the Bundesbank, was committed to a low inflation rate, and hence to a tighter monetary policy. Some other countries (specially France and Italy, who had meanwhile joined the EMS) tried to control their domestic inflation by not realigning their currency's exchange rate with the DM and instead following the same monetary policy as the Bundesbank. The UK which joined the EMS in 1990, also followed the same policy. This resulted in a high unemployment rate in such countries. This cost was acceptable to these countries, till the situation changed drastically with the effects of the 1990 German unification slowly becoming visible. As the erstwhile West Germany bore the expenses of the unification, its budget deficit started rising, increasing the German prices and wages. To keep inflation under control, the Bundesbank had to increase the interest rates to an even higher level. If the DM was allowed to appreciate at that time, the Bundesbank would not have had to increase the interest rates too much, as German prices would have reduced in response to the higher DM. But as some other member countries of the EMS refused to let the DM appreciate, they had to increase their domestic interest rates in response. This happened at a time when many of the European countries were experiencing very high unemployment rates, and Britain was going through a recession.

The situation became worse with the decision of the EC countries to go ahead with monetary union. In 1989, the report of a committee chaired by the president of the European Commission, Jacques Delor, was published. It recommended that the members of the EC abolish all capital controls and follow one common monetary policy. This monetary policy was proposed to be formulated by a European Central Bank (ECB), and followed by the central banks of all the member countries, which would become a part of the European System of Central Banks (ESCB). It also recommended the irrevocable locking of the EC exchange rates and the introduction of a common currency for the member nations. In the same year, the first stage of the process of economic integration began, and most of the recommendations of the Delor Committee report were accepted. However, it was decided that to make the integration long-lasting, member countries were to achieve a high degree of economic convergence before being allowed to merge their economies with the rest of the group.

In December 1991, as a follow up to the Delor's report, the Treaty of Rome was revised extensively to provide for the monetary union. As these revisions were adopted in the Dutch town of Maastricht, they collectively came to be known as the Maastricht Treaty. The treaty laid down the timetable for the monetary union. According to the timetable, the union was to be completed by 1999, and the qualifying countries had to fulfill criteria regarding inflation rates, exchange rates, interest rates and budget deficits. As the markets believed these criteria to be too hard for some countries to achieve, speculative pressure against the currencies of these countries started building up. By September 1992, the pressure reached its peak. The first country to bear the brunt of the speculative attacks was Italy. Even as its government announced a set of fiscal reforms to be able to meet the convergence criteria, pressures against the lira continued. Finally, Germany and Italy entered into a deal under which Italy devalued the lira and Germany reduced its interest rates. The UK was also facing a similar attack on its currency, and had to withdraw from the EMS soon after the Italian devaluation. Despite having already devalued its currency, Italy followed Britain and pulled its currency out of

the EMS. Immediately afterwards, French voters approved the Maastricht Treaty. Yet, this approval could not stop an attack against the French franc. Even Bundesbank and the Banque de France (the French central bank) together could not postpone the inevitable for long. In July 1993, there was another attack on the franc as it became clear that the French and German interest rates would not converge. The French unemployment rates being very high and continuing to rise, it could be foreseen that a further possibility of interest rates rising there did not exist. At the same time, the German government could not be expected to reduce the interest rates as inflation was still not totally under control. It became clear that the franc had to be devalued vis-à-vis the DM, but neither of the countries was ready to adjust the parity rates of their currency. Finally, the EMS countries decided to change the band from 2.25% to 15%. Germany and the Netherlands kept the band between their currencies at 2.25%. The band for peseta and the escudo continued at 6%. Though this change in the band successfully warded off the speculative attacks against the franc, the monetary convergence got a severe setback as there was no more need for countries to converge their monetary policies. With the band becoming so wide, there was no real fixed exchange rate system left to talk about.

Despite these developments, the desire of the European countries to form a monetary union did not fade. After being ratified by all member countries, the Maastricht Treaty came into effect from November 1, 1993. Thus, the European and Monetary Union came into being. The first stage of the union continued up to the end of 1993. During this stage, capital flows and the financial sector were fully liberalized. The members were also required to keep their currencies within a 2.25% band of the parity rates. The second stage began in January 1994, with the establishment of the European Monetary Institute (EMI) in Frankfurt, which was the precursor to the ECB. Its job was to manage the EMS, co-ordinate national monetary policies, and to prepare for the creation of the ESCB. Its most important function was to monitor economic convergence among the member countries, a job to be shared by the EC, the Bundesbank and the Banque de France. In this stage, the governments were not allowed to borrow from their central banks at concessional rates and had to do so at market determined rates. They were required to systematically reduce their fiscal deficits and bring other economic indicators in line. In December 1995, a summit was held in Madrid, where the single European currency was named the euro, and a strict timetable for the EMU was finalized. In December 1996, the Dublin summit was held and it was decided to give full autonomy to the ECB. The rules which the ECB would have to follow for regulating monetary policy and to ensure exchange rate stability were also formulated. In May 1998, the heads of the member governments met in Brussels and were presented the reports of the various agencies responsible for monitoring the convergence of the various members. In accordance with the Maastricht Treaty, the member countries were required to fulfill the following criteria by the end of 1997:

- Fiscal deficit should be within 3% of GDP.
- Public debt should not exceed 60% of GDP.
- The inflation rate should not be more than 1.5% higher than that of three countries having the lowest inflation.
- The long-term interest rates should not be exceeding the long-term interest rates of the above-mentioned 3 countries by more than 2%.
- The currency should have stayed within the ERM band for a minimum period of two years without any realignments.
- The central banks should be autonomous.

In line with the reports prepared by these agencies, the heads of states voted for selecting the countries which were eligible to join the EMU. 11 countries were allowed entry into the union, they being Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Britain, Denmark and Sweden opted out of choice despite being eligible and Greece was found ineligible. At the same time, the ECB was established. The

day-to-day management of the ECB is the responsibility of an executive board. The board has a total of six members including a president and a vice-president. These members are appointed by consensus and enjoy an eight-year, non-renewable term. The managing body of the ECB is the governing council which consists of the executive board and the governors of the central banks of the EMU countries. The main functions of the ECB are to:

- Determine the monetary policy and to implement it.
- Support the member countries in implementing their economic policies, if that does not entail going against its main aim of maintaining price stability.
- Help the member countries in managing their forex reserves and to conduct forex operations.
- Ensure a smoothly operating interbank payments system.

The most significant development was the introduction of a single currency for the participants of the EMU – the euro. On January 1, 1999, the euro came into being. On this date, the exchange rates of the currencies of the participating nations with the euro were irrevocably fixed. There will be a transition period of three years during which these currencies will exist along with euro. However, from this date, all interbank payments will be in euros, there will be no interbank quotes between the dollar and local currencies, all new government debt will be denominated in euros, the ECB will conduct repo transactions only in euros, and all stock exchange quotations for equities and trades and settlements of government debt and equity will be in euro. On the retail level, the bank statements and the credit card bills will be giving the euro equivalents of the national currency figure. Above all, from the same date, the ECB started formulating a common economic policy for the participating nations. Between January 1, 1999, and December 31, 2002, all retail transactions were settled in the national currencies. As planned euro notes and coins was introduced on January 1, 2002.

Initially only 11 member states were joined the EMU, but as on 1st September, 2005, total number of member countries was 25 (table 2).

Table 2: EU25 Member States

1.	Austria	14.	Latvia
2.	Belgium	15.	Lithuania
3.	Cyprus	16.	Luxembourg
4.	Czech Republic	17.	Malta
5.	Denmark	18.	The Netherlands
6.	Estonia	19.	Poland
7.	Finland	20.	Portugal
8.	France	21.	Slovakia
9.	Germany	22.	Slovenia
10.	Greece	23.	Spain
11.	Hungary	24.	Sweden
12.	Ireland	25.	United Kingdom
13.	Italy		

Source: europa.eu.int/

Out of these member countries which traded their currency in for the euro are: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, and Greece. Overseas territories of some Eurozone countries, such as French Guiana, Réunion, Saint-Pierre, etc., Miquelon, and Martinique, also use the euro. These countries together are frequently referred to as the “Eurozone”, “Euroland” or more rarely as “Eurogroup”. The ten newest European Union members are expected to eventually use the euro in the near future. These countries are Cyprus, Estonia, Latvia, Lithuania, Malta, Slovenia, Slovakia, Czech Republic and Poland; and Hungary. The United Kingdom and Sweden have no plans at present to adopt the euro.

After the introduction of the euro, its exchange rate against other currencies, especially the US dollar, declined heavily. At its introduction in 1999, the euro

was worth USD \$1.18; by late 2000 it had fallen to below \$0.85. It then began what at the time was thought to be a recovery; by the beginning of 2001 it had risen to \$0.95. It declined again, finally reaching a low of below \$0.84 in July 2001. The currency then began to recover against the US dollar. In the wake of US corporate scandals, the two currencies reached parity on 15 July, 2002, and by the end of 2002 the euro had reached \$1.04 as it climbed further.

On 23rd May, 2003, the euro surpassed its initial trading value for the first time as it again hit \$1.18, and broke the \$1.35 barrier ($\text{€}0.74 = \$1$) on 24th December, 2004. On 30th December, 2004 it reached a peak of \$1.3668. Currently as on 29th August, 2005, it is traded at \$ 1.23239

RECENT DEVELOPMENTS

The most interesting development in the recent past in the field of monetary systems was the rise and fall of the South-East Asian economies. The members of the ASEAN block, especially Indonesia, Malaysia, and Thailand built up their economies on the strength of their monetary systems. Most of the South-East Asian countries pegged their currencies to the US dollar. The fixed exchange rates helped these countries in attracting foreign capital. Their domestic interest rates and returns on other financial assets were quite high compared to the investment avenues available in the western economies. These high returns, coupled with the fixed exchange rates provided the investors a chance to earn high returns without having to bear proportionate risks. As the capital continued to flow in, the increasing trade deficit kept getting financed, putting no pressure on the exchange rates. In fact, the fixed exchange rates pulled in more foreign capital than could be profitably deployed in these economies. The result was the deployment of these funds (which were largely short-term) into property markets and long-term ventures. Since the funds were not being used to create any real economic activity, the probability of their being serviced kept coming down. As the trend continued, the investors started getting worried about the serviceability of their investments. This worry turned into a panic and investors started pulling their money quickly out of these economies, everyone desiring to be the first one to get their money back safely. Since these short-term funds were put either in asset markets or in long-term investments, this action of the investors resulted in bringing the asset markets down. At the same time, the long-term investments could not be liquidated immediately to return the investors' money. The resulting defaults made the situation worse as any possibility of the local banks or companies getting any further funds faded away. This choked even the day-to-day operations of financially sound companies. The economies suffered and the pressure on their exchange rates mounted to such an extent that the countries had to give up the peg to the dollar and float their currencies. The currencies depreciated so drastically, that the whole economies went under due to the effect. The stupendous growth rates turned negative, the trade deficits widened further and the investors had to bear a heavy loss. This once again reflects the effect pegging of exchange rates (without appropriate economic policies being followed) can have on a country's economy.

SUMMARY

- The experiments with various kinds of monetary systems have shown us that there is no perfect monetary system. Each system has its drawbacks as well as positive points.
- Each system involves an adjustment mechanism, which has to be allowed to work to make the system last.
- The most important lesson that we learn from the past is that the monetary system should be allowed to evolve as a response to the changing environment, while maintaining some level of stability.
- How this balance can be achieved is an open question, to which countries and supranational institutions are still trying to find an answer.

Chapter VI

The Foreign Exchange Market

After reading this chapter, you will be conversant with:

- The Structure of Forex Market
- Exchange Rate Quotations
- Types of Transactions
- Settlement Dates
- Quotes for Various Kinds of Merchant Transactions
- The Indian Forex Markets

In the previous chapters, it has been mentioned that international trade and investments have grown at a tremendous pace in the last few decades. It has also been mentioned that to enable a smooth flow of goods, services and capital across national boundaries, a well functioning monetary system is needed, which would determine the amount of payments to be made in the relevant currency, and also provide the means of settling the same. The mechanism which determines the exchange rates between currencies, and hence the amount of payment, was discussed in the previous chapter. In this chapter, the settlement of these payments will be discussed.

The existence of a number of currencies gives rise to the need to transact in these currencies for settling international payments. As we know, in international transactions, at least one of the parties would be dealing in a foreign currency. For example, if an Indian exporter sells some goods to an American resident and the price of the goods is denominated in dollars, the exporter would be dealing in a foreign currency. Similarly, if an Italian resident makes an investment in the German money market, he would need to deal in the German mark (now Euro) which would be a foreign currency to him. Sometimes, the currency in which the transaction is denominated may be a foreign currency to both the parties involved. For example if a resident of Australia buys a car from a resident of Spain and the transaction is denominated in US dollar, both the parties will be dealing in a foreign currency. As it happens for other commodities, it would be difficult for buyers and sellers of currencies to find each other. This fact resulted in the development of a market which deals specifically in currencies, called the foreign exchange market. This is an OTC (Over-The-Counter) market, i.e. there is no physical marketplace where the deals are made. Instead, it is a network of banks, brokers and dealers spread across the various financial centers of the world. These players trade in different currencies through (and are linked to each other by) telephones, faxes, computers and other electronic networks like the SWIFT system (Society for Worldwide Interbank Financial Telecommunications). These traders generally operate through a trading room. The deals are mostly done on an oral basis, with written confirmations following later.

THE STRUCTURE OF FOREX MARKET

The main players in the foreign exchange market are large commercial banks, forex brokers, large corporations and the central banks. Central banks normally enter the market to smoothen out fluctuations in the exchange rate (as under dirty float) or to maintain fixed exchange rates.

Large commercial banks deal in the market both for executing their clients' (both corporates and individuals) orders and on their own account. They act as the market makers in the forex markets, i.e. they stand ready to buy or sell various currencies at specific prices at all points of time. The commercial banks give, on demand, a quote for a particular currency against another currency; i.e., the rate at which they are ready to buy or sell the former against the latter. At these rates they stand ready to take any side of the transaction (buy or sell) that the customer chooses. The maximum and the minimum amount of the currencies acceptable to the bank at these rates, though not specified at the time of making the quote, are generally understood according to the conventions of the market. These rates may not necessarily be applicable to amounts smaller or larger than those acceptable according to the going conventions. In the forex markets there are numerous market makers, and all of them would be giving different quotes for the same pair of currencies simultaneously, at any point of time. It would be very difficult for a player to keep track of all the quotes available in the market, and hence choose the one which is considered the most favorable. As a result, a number of trades may be taking place simultaneously at different exchange rates. The market-making activity of the commercial banks, along with speculation, makes markets extremely liquid, especially for the major currencies of the world.

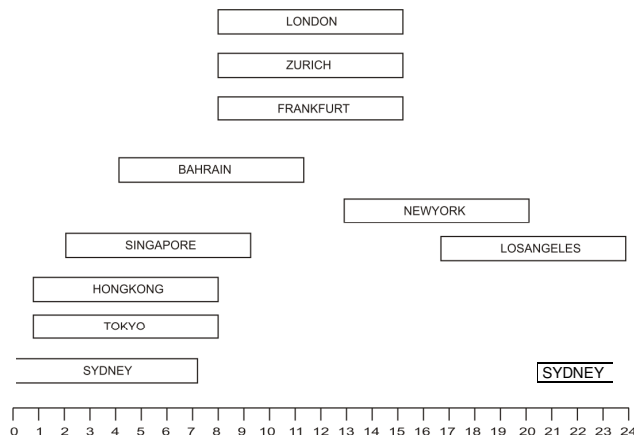
The foreign exchange brokers do not actually buy or sell any currency. They do the work of bringing buyers and sellers together. Though they deal in most of the major currencies, generally they specialize in a pair of currencies and hold exhaustive information about it. Other players in the market, specially the commercial banks, approach the brokers for information about the quotes of other commercial banks. The brokers serve three important purposes in the forex markets. First is, that instead of hunting around in the market for quotes, one can approach a broker and find out these prices. Second is, that brokers help the prospective buyer or seller keep their identity secret till the deal is struck. This prevents the quote being affected by the inquirer's position, i.e., whether he needs to buy or to sell. Lastly, even when there is no buying or selling requirement, commercial banks can keep their quotes from going too far away from the quotes being given by other banks, by inquiring about the market quotes from the brokers.

While small corporations generally approach the commercial banks for their needs, larger corporations sometimes operate in the market on their own. They generally deal in the market to satisfy their needs arising out of their normal business operations. Yet, some big multinational companies also operate in the market to bet on the movement of the exchange rates, in an attempt to make profits out of their expertise in dealing in the market.

The market in which the commercial banks deal with their customers (both individuals and corporates) is called the retail market, while that in which the banks deal with each other is called the wholesale or the interbank market. The size of the deals in the retail market is much smaller than those in the interbank market.

The world-wide forex market is a 24-hour market, i.e., it is open virtually all of the 24-hours of a day, in at least one of the financial markets of the world. When the New York market closes at 3 p.m., the Los Angeles market remains open as the corresponding time there is 12 p.m. When the Los Angeles market closes, it is opening time at Sydney and Tokyo. When Tokyo closes, the HongKong market is still open as it would be only 2 p.m. there. At the time of the HongKong market closing, the Singapore market can be accessed, it being only 1 p.m. there. Before the closing of the Singapore market, the Bahrain market opens. The closing time of the Bahrain market finds both Frankfurt and Zurich markets open, it being only 12 p.m. there. London being one hour behind these two, it remains open even after these two markets close down. Again, before the London market closes down, it is opening time at New York. Out of these markets, London, New York and Tokyo markets are the biggest ones. The effect of the market being open 24 hours a day, is that the impact of any relevant event is immediately reflected on the exchange rates. Besides, it provides the facility of buying or selling a currency at any time of the day, even if the local market has closed down for the day. Figure 1 depicts the opening and closing times of these markets w.r.t. the G.M.T.

Figure 1: Working Hours of the Various Financial Markets w.r.t. the GTM



In these markets, there are a few services which report the quotes given by various players on an on-line basis. Reuters, KnightRider and the Telerate are a few of such services. Some of these services now even offer screen-based trading, i.e., the quotes are automatically matched by the system and the order executed. In 1981, Reuters launched the first conversational dealing system, Reuters Monitor Dealing Service (RMDS). A conversational dealing system allows dealers to communicate trading requirements and simultaneously send messages on screen to a number of other dealers. RMDS was replaced by Reuters with an upgraded version called Dealing 2000-01 in 1989. This version allows conversations with up to four banks at the same time, instead of just one, and the response time is also quicker than that of RMDS. 2000-01 also displays the details of a concluded trade by means of an on-screen 'trading ticket'. Telerate and Quotron have also launched such conversational dealing systems. In April 1992, Reuters launched the first electronic broking system called Dealing 2000-02. Quotron also developed a similar Electronic Broking System (EBS). Telerate's similar system is called the Minex System.

The settlement of trades is completed by transfer of deposits denominated in relevant currencies between the parties involved. In the interbank market, it is normally done electronically. For example if the Deutsche Bank sells dollars to the Global Trust Bank in exchange for French Francs, the nostro account of the Deutsche Bank with a bank in the US will be debited and that of GTB will be credited with the amount of the US dollars. At the same time, the nostro account of GTB with a bank in France will be debited and that of Deutsche Bank will be credited with the amount of the French Francs. (Nostro account is the overseas account held by a domestic bank with a foreign bank or with its own foreign branch, in that foreign country's currency. The same account is called a vostro account from the holding bank's point of view. For example a dollar account held by State Bank of India with Bank of America in New York will be SBI's nostro account and a vostro account from Bank of America's point of view.) A currency's settlement always takes place in the country of origin of the currency. In the US, the Clearing House Interbank Payments System (CHIPS) is used for the settlement of forex transactions.

Though the exchange rate between any two currencies is determined by the overall equilibrium between their demand and supply, it is also true that there is no single equilibrium market price for a currency. Each trader tries to keep his quote at that level where his own position would be in equilibrium. A trader normally keeps a margin between the price at which he buys a currency and that at which he sells it. Thus, if the trader is able to match a purchase of a currency with a corresponding sale, he would be able to make a profit. In reality, however, it is very difficult to find matching orders of sufficient volumes for the trader to realize a substantial profit. At any point of time, the trader may find that he is selling more of a currency than he is buying, or vice-versa. This would result in the trader having a position in a currency, which exposes him to currency risk (risk of future prices moving against him). To avoid such net positions, the trader would have to frequently change his quote (in order to attract desired orders) so that his exposure would be minimized. In forex trading, minimizing the net positions alone are not enough. Since a trader's margins are very thin, volumes of trade become very important. A trader may find that though he is able to balance the buy and sell positions, the volume of trade coming his way is very low due to competitive prices quoted by other traders. A very low volume would result in miniscule profits. Hence, the trader has to make sure that his quote always remains competitive.

The world over, about 85% of forex trading arises as a result of transactions between market makers and speculative transactions, with only 15% of the transactions being trade or commerce related. This results in the expectations and the actions of these two groups having an overwhelming impact on the values of various currencies, at least in the short-term. On the other hand, the presence of the activities of these two groups is essential for liquidity in the market. Competition

between various market makers also ensures that the divergence in the market makers' quotes is not too large. Speculation in the forex markets is essentially a zero-sum game if it is considered as an activity only among speculators. The gain of one speculator must be the loss of another. Therefore, at least theoretically market makers taken together cannot make profits or incur losses. In reality, however, the presence of hedgers and the interventions resorted to by the central banks of various countries result in net speculative gains or losses.

In India, all dealings in foreign exchange are regulated by the Foreign Exchange Management Act, 1999 (FEMA). Reserve Bank of India is the regulatory authority for the Act. According to FEMA, only those entities can deal in foreign exchange, who are authorized to do so by RBI. The Act provides for entities to be authorized either as authorized dealers or as money changers. Authorized dealers are generally commercial banks and form a large part of the interbank market in India. Money changers can be either full-fledged money changers or restricted money changers. While the former are authorized to both buy and sell foreign currency from their customers, the latter can only buy the same. Money changers are allowed to deal only in notes, coins and travelers' cheques. The authorized dealers, on the other hand, are allowed to deal in all the items classified as foreign exchange by FERA. Thus, they are permitted to deal with all documents relating to exports and imports. The authorized dealers have to operate within the rules, regulations and guidelines issued by the Foreign Exchange Dealers' Association of India (FEDAI) from time to time. The offices/branches of authorized dealers (ADs) are classified into 3 categories. These categories are:

Category A: These are the offices/branches which keep independent foreign currency accounts with overseas correspondent banks/ branches in their own names.

Category B: These are the branches which do not maintain independent foreign currency accounts but have powers to operate the accounts maintained abroad by their head office or the branches categorized as 'A'.

Category C: The branches which fall in neither of the above categories and yet handle forex business through a Category A or B branch, fall under Category C.

The Indian foreign exchange market consists of three tiers. The first tier consists of all the transactions between the authorized dealers and the RBI. The second tier is the interbank market referred to earlier, i.e., the market in which the authorized dealers deal with one another. Money changers are required to offset their positions created by dealing with their customers, in this interbank market. The third tier is the retail segment, where authorized dealers and money changers deal with their customers.

Foreign Exchange

Foreign exchange is defined in terms of Sec. 2 of FEMA, 1999 as foreign currency including:

- i. All deposits, credits, balances payable in any foreign currency;
- ii. Any drafts, travelers' cheques, letters of credit and bills of exchange expressed or drawn in Indian currency and payable in foreign currency;
- iii. Any instrument giving anyone the option of making it payable either partly or fully in a foreign currency.

Here, the term currency in 'foreign currency' includes coins, bank notes, postal notes, postal orders and money orders.

In other words, foreign exchange includes all kinds of claims of the residents of a country to foreign currency payable abroad.

EXCHANGE RATE QUOTATIONS

An exchange rate quotation is the price of a currency stated in terms of another. It is similar to the expression of the price of a commodity. Yet, there is a peculiarity attached to exchange rate quotes. In case of a commodity, there is only one way to express its price— as number of units of money needed to buy one unit of the commodity. For example it is always Rs.10 per kg. of potatoes, never 100gm. of potatoes per rupee. In case of an exchange rate quotation, both the items involved are a form of money, i.e. both are currencies. So, the price of any one of them can be quoted in terms of one unit of the other. Due to this, there exist a number of ways to express the exchange rate between a pair of currencies. The various reporting agencies use the following quotes:

The Economic Times gives the quotes as on 26-07-2005

Table 1: Cross Currency Rates

	USD	EUR	JPY	GBP	CHF	CAD	AUD	HKD
HKD	7.7738	9.3654	0.0697	13.5559	5.9953	6.3798	5.9213	—
AUD	1.3129	1.5817	0.0118	2.2894	1.0125	1.0774	—	—
CAD	1.2185	1.468	0.0109	2.1248	0.9397	—	0.9281	0.1567
CHF	1.2966	1.5621	0.0116	2.2611	—	1.0641	0.9877	0.1668
GBP	0.5735	0.6909	0.0051	—	0.4423	0.4706	0.4368	0.0738
JPY	111.61	134.4621	—	194.6255	86.0757	91.5962	85.0133	14.3573
EUR	0.83	—	0.0074	1.4474	0.6401	0.6812	0.6322	0.1068
USD	—	1.2048	0.009	1.7438	0.7712	0.8207	0.7617	0.1286

It can be noticed that various methods of expressing exchange rates have been used. Throughout this book (unless otherwise specified), exchange rates will be mentioned in terms of A/B, where currency B is being bought or sold, with its value being expressed in terms of currency A. In such a quote, currency B is referred to as the base currency.

Various kinds of quotes are described in the following sections.

American vs. European Quote

A quote can be classified as European or American only if one of the currencies is the dollar. An American quote is the number of dollars expressed per unit of any other currency, while a European quote is the number of units of any other currency expressed per dollar. For example, Rs.48.28/\$ is a European quote, while \$1.6698/£ is an American quote. In almost all the countries, most of the exchange rates are quoted in European terms. The British pound, the Irish pound and the South African rand are a few examples of currencies quoted in American terms.

Box 1: Direct vs. Indirect Quote

A direct quote is the quote where the exchange rate is expressed in terms of number of units of the domestic currency per unit of foreign currency. An indirect quote is where the exchange rate is expressed in terms of number of units of the foreign currency for a fixed number of units of the domestic currency. An example of an indirect quote would be:

\$/100 Rs.: 2.1978/98

Here, the bank would be buying dollars @ \$2.1998/Rs.100 and selling dollars @ \$2.1978/Rs.100.

The corresponding direct quote would be:

Rs./\$: 45.4586/45.5000

Here, the bank would be buying dollars @ Rs.45.4586/\$ and selling dollars @ Rs.45.5000/\$.

Before August 2, 1993, the indirect methods of quoting exchange rates used to be followed in India. Since that date, however, the direct quote is being used.

In other countries, the concepts of American and European quotes are more popular in comparison to direct and indirect quotes.

BID AND ASK RATE

In the quotes given above, there was one single rate at which the currencies were being bought and sold. For example, the rupee-dollar exchange rate was given as Rs./\$ 45.50. In reality, the rate at which a bank is ready to buy a currency will be different from the rate at which it stands ready to sell that currency. These rates are called the bid and the ask rates respectively. The difference in these rates represents the cost the bank incurs in these transactions, a small return on the capital employed, and the compensation for the risk it takes. This risk arises on account of the possibility of the exchange rate moving in an unfavorable direction before the bank is able to offset the transaction. The single rate mentioned above is generally the mid-rate, i.e. the arithmetic mean of the bid and the ask rates. The difference between the bid rate and the ask rate is called the bid-ask spread, or simply the spread. This spread is seen to be higher in the retail market than in the interbank market. This is because of the higher volumes and greater liquidity in the interbank market (lower the liquidity, higher the risk of the transaction being set off at a disadvantageous rate, and hence, higher the spread). An additional reason is that the counter-party risk (the risk of the other party not fulfilling its commitment) is lower in the interbank market since most of the players are large commercial banks. As this bid-ask spread arises due to the presence of transaction costs, the absence of these costs would result in a single rate being quoted by banks for both buying and selling the currency.

Before we go into the explanations for the bid and the ask rates, it will be useful to look at some important conventions regarding these quotes. These are:

- The bid rate always precedes the ask rate. Hence, in the quote Rs./\$: 45.45/45.50, 45.45 is the bid rate while 45.50 is the ask rate.
- The bid and the ask rate are separated by either a slash (/) or a dash sign (-).
- The quote is always from the banker's point of view. That is, the banker is ready to buy dollars at Rs.45.45 per dollar and sell at Rs.45.50 per dollar. A banker's buy rate is the rate at which the customer can sell a currency and vice-versa. So, if a customer wishes to sell dollars, it will have to sell them at the bank's buying rate of Rs.45.45 per dollar.

Let us understand these rates with the help of an example. Let the exchange rate of the Indian rupee with the US dollar be

Rs./\$: 45.45/45.50

Here the US dollar (currency B) is being bought and sold, with its price quoted in terms of the Indian rupee (currency A). In this quote, bid rate is the rate at which the bank is ready to buy one dollar, which is the first term from the left, i.e. Rs.45.45. In other words, it is the number of rupees that a bank is ready to pay in exchange for one dollar. The bank is bidding for the dollar at this rate. The ask rate is the rate at which the bank stands ready to sell one dollar in exchange for rupees. It is the number of rupees the bank is ready to accept for, or is asking for selling a dollar. This rate is Rs.45.50. The bid rate is always lower than the ask rate. This is because the bank will be ready to pay less for a unit of currency than it receives, in order to make a profit.

Interbank Quote vs. Merchant Quote

Merchant quote is the quote given by a bank to its retail customers. On the other hand, a quote given by one bank to another (or to any other customer in the interbank market) is called an interbank quote. It has been mentioned that a quote is invariably the banker's quote. The question that arises, is that since both the parties involved in the interbank market are banks, whose quote will it be taken as. The convention is that the bank requesting the quote is the customer and the quote will be taken as that of the bank giving the quote, i.e. the one which is acting as the market-maker.

MARKET MECHANISM AND CONVENTIONS

Let us now see how deals are struck in the interbank market. Suppose a bank requires £1,000,000. The dealer of the bank approaches another bank and asks for a quote in the sterling, without mentioning whether he wants to buy or sell. The market-making bank gives him a two-way quote (i.e., both the bid and ask rates for sterling). If the ask rate for the pound is acceptable to the banker, he says – “One mine” – implying that he has bought £1,000,000. The trade will enter the books of both the banks and written confirmations of the trade would be sent later. The settlement of the trade will take place through any of the available electronic money transfer systems (like CHIPS). Suppose the bank wanted to sell pounds and found the quoting bank’s bid rate acceptable, it would instead have said – “One yours” – implying that it has sold £1,000,000 to the market making bank.

While giving a two-way quote, a bank keeps the bid and ask rates at such levels which both buyers and sellers of the relevant currency are likely to find attractive, and hence the bank expects to receive both buy and sell orders from the market. If the bank is getting orders for only one side of the transaction, it would mean either of two things – either the rates quoted by the bank are out of alignment with the rates being quoted by other players in the market, or there is too much buying or selling pressure in the market for that particular currency. In either of the cases, the bank would have to adjust its quote. Let us take the scenario where the bank is ending up getting only buy orders for a particular currency (i.e., the bank is only buying the currency), without being able to sell. It would mean that the market is getting a competitive rate for selling the currency to the bank, but the bank’s selling rate is too high to attract buyers. On the other hand, it could also mean that there are too many sellers in the market. In both the cases, the bank will have to reduce its rates on both the buy and sell side. The lower bid rate will attract a fewer number of sellers, while the lower ask rate would encourage customers to buy from the bank. In case the bank is getting too many orders to sell currency to customers, it would have to increase both the bid and the ask rates, in order to attract more customers interested in selling the currency and fewer interested in buying it.

The quotes are generally given in the market as : Rs./\$: 43.425/43.575

It is also a practice to state the same quote as : Rs./\$: 43.425/575

With 575 representing the last three digits of the ask rate, the rest of the digits being common with the bid rate.

Since the dealers in currencies would anyway be aware of the going rate, the big figures are not specified. In the interbank market the quote is generally further shortened to:

Rs./\$: 425/575

There are a few currencies which are quoted in 100s rather than 1s or 2s. The reason is that their value is too small to be quoted otherwise. An example is the Japanese yen. Its quote generally looks like:

¥/\$: 109.28/31

When the quote is given with such currencies as the base currency, the quote is for 100 units of the currency rather than one unit. For example the corresponding \$/¥ quote will be:

\$/100¥: 0.9150/52

The last after-decimal digit of a quote is known as a point and the last two as a \$/¥.

The quotes given by different banks for the same pair of currencies may not necessarily be the same, but they have to be within certain limits to prevent arbitrage. Let us see an example to understand these limits. Suppose there are two banks A and B. Their quotes for the Euro/\$ rate are:

A — Euro/\$: 1.6688/1.6693

B — Euro/\$: 1.6683/1.6686

As A's bid rate is greater than B's ask rate, there is a risk-free arbitrage opportunity available. (Arbitrage is the process of buying and selling the same asset at the same time, to profit from price discrepancies within a market or across different markets. When it does not involve any commitment of capital or the taking on of risk, it is referred to as risk-free arbitrage). Dollars can be bought from B at Euro 1.6686/\$ and sold to A at Euro 1.6688/\$, thus making a gain of Euro 0.0002 per dollar. Thus, any bank's bid rate has to be lower than other banks' ask rate, and its ask rate greater than other banks' bid rate. Sometimes, banks deliberately maintain their rates out of alignment with the rest of the market, because they require only one type of transactions to come to them. For example a bank may have an overbought position in marks (i.e., it may have bought more marks than it sold). In such a case, it may like to keep its ask rate lower so as to attract customers who want to buy marks.

Note: According to FEDAI rules, exchange rates in the merchant as well as the interbank markets are to be quoted up to 4 decimals, with the last two digits being in multiples of 25 (for e.g., Rs/\$: 45.4220/45). The card rates of banks (the reference rates given by the dealing room to the 'B category' branches at the beginning of the day) should be either quoted in two decimals, or quoted in 4 decimals with the last two figures being 0 (for e.g., Rs/\$: 45.5000 or 45.50). Also, all merchant transactions are to be settled after rounding off the final rupee amount to the nearest whole rupee. For this, amounts up to 49 paise are to be ignored, and amounts from 50 to 99 paise are to be rounded off to the next rupee. Throughout the chapter, these rules have been ignored and the Rs/\$ quotes are given up to 2 decimals, only to make the computations convenient. These quotes result in a higher spread, while in the actual market the spread does not usually exceed 1 or 2 paise. The student should keep this digression from the real-time market quotes in mind while going through the chapter.

Box 2: Euro and its Constituents

On January 1, 1999, the various European currencies were irrevocably locked to the euro (and through it to each other) at the following rates:

DM/Euro	:	1.95583
FF/Euro	:	6.55957
S/Euro	:	13.7603
BF/Euro	:	40.3399
DG/Euro	:	2.20371
FmK/Euro	:	5.94573
£Ir/Euro	:	0.787564
Lit/Euro	:	1936.27
Lux F/Euro	:	40.3399
Esc/Euro	:	200.482
Ptas/Euro	:	166.386

Up to July 1, 2002, these currencies coexisted with the euro, and their exchange rates with other world currencies were calculated through the ruling euro rates. Recalling from Chapter International Monetary System, from January 1, 1999, all interbank payments are made in euros, there is no interbank quotes directly between the dollar and local currencies, all new government debt are denominated in euros, the ECB conduct repo transactions only in euros, and all stock exchange quotations for equities and trades and settlements of government debt and equity are in euro. On the retail level, the bank statements and the credit card bills give the euro equivalents of the national currency figure.

Inverse Quotes

For every quote (A/B) between two currencies, there exists an inverse quote (B/A), where currency A is being bought and sold, with its price expressed in terms of currency B. For example for a €/ \$ quote, there exists a \$/€ quote. The implied inverse quote can be calculated from a given quote in a very simple way. Let us take the example of a €/ \$ quote. Let the €/ \$ quote in Frankfurt be:

$$\text{€/\$: } 1.6688/1.6693$$

The (€/ \$) bid rate is the rate at which the bank is ready to buy dollars (which also means the rate at which it is ready to sell €, which will be the ask rate in the \$/€ quote). Hence the (€/ \$) bid rate would correspond to the (\$/€) ask rate. In €/ \$ terms, this rate is 1.6688. In \$/ € terms, it would be the reciprocal of this figure, i.e. $1/1.6688$ which is equal to $\$0.5992/\text{€}$. Similarly, the (€/ \$) ask rate would correspond to the (\$/€) bid rate. In €/ \$ terms, this rate is 1.6693, which is equal to $\$0.5990/\text{€}$ ($1/1.6693$). Hence, to calculate the implied inverse quote, the bid and the ask terms of the given quote have to be reversed and their reciprocals calculated. For this particular example, the calculations can be shown as:

$$\text{Implied } (\$/\text{€})_{\text{bid}} = 1/(\text{€/}\$)_{\text{ask}} \quad (\text{Eq. 1})$$

$$\text{Implied } (\$/\text{€})_{\text{ask}} = 1/(\text{€/}\$)_{\text{bid}} \quad (\text{Eq. 2})$$

So, the implied inverse rate is:

$$\text{\$/€: } 0.5990/0.5992$$

These equations can be generalized as:

$$\text{Implied (B/A) quote: } \frac{1}{(\text{A/B})_{\text{ask}}} / \frac{1}{(\text{A/B})_{\text{bid}}} \quad (\text{Eq. 3})$$

Now suppose that the actual B/A quote differs from the implied inverse quote. The result may be an arbitrage opportunity similar to the one when two banks quote widely different rates for a pair of currencies. Let the \$/€ quote in New York be:

$$\text{\$/€: } 0.5976/0.5981$$

In this scenario, there is a possibility of buying € in New York for $\$0.5981/\text{€}$ and selling them in Frankfurt for $\$0.5990/\text{€}$, thus making a riskless profit of $\$0.0009/\text{€}$. This arbitrage activity involving buying in one market and selling in another is termed as two-way arbitrage. Such arbitrage opportunities quickly go away on profit-making by arbitrageurs. As they buy € in New York, the ask rate of the \$/€ quote goes up, and as € is sold in Frankfurt, the ask rate of the €/ \$ quote will go up till its reciprocal becomes lower than the increasing ask rate of the \$/€ quote. Hence, to avoid arbitrage opportunities, the ask rate of the actual B/A quote should be higher than the bid rate of the implied B/A quote and the bid rate of the actual B/A quote should be lower than the ask rate of the implied B/A quote (i.e., the two quotes must overlap).

As can be observed, the synthetic inverse rate acting only as a limit on the actual inverse rate, is due to the presence of transaction costs (the costs to be incurred by a player in the market for buying or selling a currency) as a difference between the bid and ask rates. One more transaction cost is the lumpsum payment required to be made to the dealer, from whom a currency is bought or sold, as his fees or commission. These transaction costs make arbitrage activity less effective, as the profit stands reduced by the amount of the costs required to be incurred by the arbitrageur. Hence, the actual inverse rates can differ from the synthetic inverse rates by the amount of the transaction costs. In the absence of such transaction costs, the inverse rates would have to be exactly equal to the synthetic inverse rates. If there were no spread between the bid and the ask rates for a currency (i.e., a person could buy a currency at the same price at which he could sell it) and there was no commission or fees to be paid to the dealer, the \$/€ price in New York

would have to be the exact reciprocal of the €/£ price in Frankfurt. Let us assume that the €/£ rate in Frankfurt were:

$$\text{€/£: } 1.6688$$

Then the \$/€ rate in New York would be $1/1.6688$, i.e., $\$0.5992/\text{€}$. Otherwise, an arbitrageur would have the opportunity of making profits, and in the process, would drive the rates in the two markets towards equalization.

Cross Rates

In the foreign exchange markets, it is a practice to quote most of the currencies against the dollar; and to calculate the exchange rates between other currencies with the dollar as the intermediate currency. For example the €/£ rate will be calculated through the €/£ quote and the \$/£ quote. The €/£ rate thus calculated is called a cross rate or the synthetic rate. Though generally the third currency used is the dollar, the cross rate between two currencies can be calculated using any other currency as the intermediate currency.

These synthetic rates can be calculated using a process similar to the one we used in calculating the implied inverse quote. Let us assume that we need to calculate the Switzerland franc/Canadian dollar (SFr/Can\$) rate from given SFr/\$ and \$/Can\$ quotes. Let the given quotes be:

$$\text{SFr/\$} : 5.5971/5.5978$$

$$\text{\$/Can\$} : 0.7555/0.7562$$

For calculating the synthetic rates, we shall have to see how the arbitrageur will operate if he wishes to operate in the markets giving the SFr/\$ and the \$/Can\$ rate, instead of using the direct SFr/Can\$ quote. The $(\text{SFr/Can\$})_{\text{bid}}$ rate will be the number of francs which a bank would be ready to pay to buy one Can\$. The arbitrageur, say X, can sell 1 Can\$ for: $\$0.7555$

The bank will be ready to buy one dollar for: SFr5.5971

Hence, for selling one Can\$, X will get

$$0.7555 \times 5.5971 = 4.2286 \text{ francs}$$

That is, for buying one Can\$, the bank would be ready to pay: SFr4.2286

Hence, the synthetic $(\text{SFr/Can\$})_{\text{bid}}$ rate

$$= 4.2286$$

$$= 5.5971 \times 0.7555$$

$$= (\text{SFr/\$})_{\text{bid}} \times (\text{\$/Can\$})_{\text{bid}}$$

Similarly, the $(\text{SFr/Can\$})_{\text{ask}}$ rate will be the number of francs the bank will require to be paid for selling one Can\$. In terms of the \$/Can\$ rates, a bank would take 0.7562 dollars to sell one Can\$. To be able to pay these dollars, X would need to buy them in the SFr/\$ market. X can buy a dollar in that market for SFr 5.5978. Hence, X can buy one Can\$ for:

$$5.5978 \times 0.7562 = 4.2330 \text{ francs.}$$

In other words, the bank would be ready to sell one Can\$ for: 4.2330 francs

So, the synthetic $(\text{SFr/Can\$})_{\text{ask}}$ rate

$$= 4.2330$$

$$= 5.5978 \times 0.7562$$

$$= (\text{SFr/\$})_{\text{ask}} \times (\text{\$/Can\$})_{\text{ask}}$$

Hence, the synthetic quote is:

$$\text{SFr/Can\$} : 4.2286/4.2330$$

These rates can be generalized as:

$$\text{Synthetic } (A/C)_{\text{bid}} = (A/B)_{\text{bid}} \times (B/C)_{\text{bid}} \quad (\text{Eq. 4})$$

$$\text{Synthetic } (A/C)_{\text{ask}} = (A/B)_{\text{ask}} \times (B/C)_{\text{ask}} \quad (\text{Eq. 5})$$

where A, B and C are three currencies.

These synthetic rates can also be calculated if the inverse quotes are available for any of the required rates. For example, if instead of the (B/C) rates, the (C/B) quote is available, the implied inverse rate can be calculated and used. In such a case, the synthetic rates can be calculated as:

$$\text{Synthetic } (A/C)_{\text{bid}} = (A/B)_{\text{bid}} \times 1/(C/B)_{\text{ask}} \quad (\text{Eq. 6})$$

$$\text{Synthetic } (A/C)_{\text{ask}} = (A/B)_{\text{ask}} \times 1/(C/B)_{\text{bid}} \quad (\text{Eq. 7})$$

As in case of implied inverse rate, the synthetic quote and the actual quote between a pair of currencies should overlap (i.e., the bid rate of one should always be lower than the ask rate of the other). There are two reasons for this. First, if the actual rates are too much out of line with the cross rates, then market players in genuine need of a currency would buy and sell through the markets giving them more favorable rates. The second reason is the arbitrage opportunity which would arise in case of a misalignment of actual and cross rates. In both the cases, the resultant demand-supply mismatch would force the synthetic cross rate and the actual rate to come in line with one another. Let us see how the arbitrage process works. As we have seen, the synthetic quote between the franc and the Can\$ is:

$$\text{SFr/Can\$} : 4.2286/4.2330$$

This synthetic quote has been calculated from the following given quotes:

$$\text{SFr/\$} : 5.5971/5.5978$$

$$\text{\$/Can\$} : 0.7555/0.7562$$

Now suppose that the actual quote between the franc and the Can\$ is:

$$\text{SFr/Can\$} : 4.2333/4.2343$$

As we see, the synthetic ask rate is less than the actual bid rate, giving the arbitrageurs a chance to make a profit by three-point arbitrage (the process of making arbitrage profits involving three markets, where three transactions have to be entered into to achieve the desired results). To make profits, a person should buy low and sell high. The rate at which the arbitrageur, say X, can sell one Can\$ against the franc is SFr 4.2333/Can\$. The rate at which X can buy one Can\$ (through the synthetic market) is SFr 4.2330/Can\$. Let us say that X starts with one franc.

With one franc, he can buy:

$$\frac{1}{5.5978} \text{ dollars.}$$

Since 0.7562 dollars fetch one Can\$, with 1/5.5978 dollars X can buy:

$$\frac{1}{0.7562} \times \frac{1}{5.5978} \text{ Can\$}$$

These Can\$ can then be sold by X in the SFr/Can\$ market for:

$$\begin{aligned} & 4.2333 \times \frac{1}{0.7562} \times \frac{1}{5.5978} \text{ francs} \\ & = \text{SFr} 1.000058. \end{aligned}$$

Thus, X makes a profit of sFr 0.000058 for every franc bought and sold.

Now let us see what will happen if the actual rates are:

$$\text{SFr/Can\$} : 4.2278/4.2283$$

The actual ask rate is now lower than the synthetic bid rate. X can now buy Can\$ at SFr 4.2283/Can\$ and sell them through the synthetic market at SFr 4.2286/Can\$. In the SFr/Can\$ market, X can sell one franc for:

$$\frac{1}{4.2283} \text{ Can\$}$$

As each Can\$ can be sold for 0.7555 dollars, X can sell the Can\$ for:

$$0.7555 \times \frac{1}{4.2283} \text{ dollars}$$

Since each dollar fetches 5.5971 francs, X can sell the dollars for:

$$\begin{aligned} & 5.5971 \times 0.7555 \times \frac{1}{4.2283} \text{ francs} \\ & = \text{SFr} 1.000073 \text{ francs.} \end{aligned}$$

So, X makes a profit of 0.000073 francs for every franc bought and sold.

These arbitrage processes will adjust the rates in both the cases in all the three markets in such a way, that the actual SFr/Can\$ rates will come in alignment with the synthetic rates. We can write the conditions for no arbitrage possibility as:

$$(A/C)_{\text{bid}} \leq (\text{actual})(A/C)_{\text{ask}} \text{ (synthetic)} \quad (\text{Eq. 8})$$

$$(A/C)_{\text{ask}} \geq (\text{actual})(A/C)_{\text{bid}} \text{ (synthetic)} \quad (\text{Eq. 9})$$

Using equations 4 and 5, we can rewrite the above equations as:

$$(A/C)_{\text{bid}} \leq (A/B)_{\text{ask}} \times (B/C)_{\text{ask}} \quad (\text{Eq. 10})$$

$$(A/C)_{\text{ask}} \geq (A/B)_{\text{bid}} \times (B/C)_{\text{bid}} \quad (\text{Eq. 11})$$

where all the rates are actual rates.

Equations 10 and 11 are called the no-arbitrage conditions. These signify the limits imposed by the synthetic rates on the actual quote for a pair of currencies (upper and lower limits for the bid and the ask rates respectively). The actual rates only have to be within these limits but they need not necessarily be the same as the synthetic rates. In fact, the synthetic rate having been calculated from two quotes, includes the bid-ask spread of both the quotes. This results in the synthetic rate having a very high bid-ask spread. In reality, a bank giving direct quotes between two such currencies may be able to quote at much lower spread, provided its business volumes in these currencies is high. In the example given above, the actual SFr/Can\$ quote may be something like:

$$\text{SFr/Can\$} : 4.2298/4.2313$$

As in the case of inverse rates, transaction costs allow the actual A/C quote to deviate from the synthetic cross rates to some extent. As mentioned earlier, in the absence of such costs, the bid and the ask rates will be the same. These single rates will force the actual A/C quote to be exactly equal to the synthetic cross rates.

According to Eq. 10,

$$(A/C)_{\text{bid}} \leq (A/B)_{\text{ask}} \times (B/C)_{\text{ask}}$$

It can be rewritten as:

$$1 \leq \frac{(A/B)_{\text{ask}} \times (B/C)_{\text{ask}}}{(A/C)_{\text{bid}}}$$

or,

$$(A/B)_{\text{ask}} \times (B/C)_{\text{ask}} \times (C/A)_{\text{ask}} \geq 1 \quad (\text{Eq. 12})$$

Similarly, Eq. 11 says that:

$$(A/C)_{\text{ask}} \geq (A/B)_{\text{bid}} \times (B/C)_{\text{bid}}$$

It can be rewritten as:

$$1 \geq \frac{(A/B)_{\text{bid}} \times (B/C)_{\text{bid}}}{(A/C)_{\text{ask}}}$$

or,

$$(A/B)_{\text{bid}} \times (B/C)_{\text{bid}} \times (C/A)_{\text{bid}} \leq 1. \quad (\text{Eq. 13})$$

TYPES OF TRANSACTIONS

Foreign exchange transactions can be classified on the basis of the time between entering into a transaction and its settlement. They can basically be classified into spot and forward contracts. Spot transactions are those which are settled after 2 business days from the date of the contract. A forward contract (also called an outright forward) is one where the parties to the transaction agree to buy or sell a commodity (here, a currency) at a predetermined future date at a particular price. This future date may be any date beyond two business days. The price and the terms of delivery and payment are fixed at the time of entering into the contract. In the forex markets, forward contracts generally mature after 1, 2, 3, 6, 9, or 12 months.

A forward contract is normally entered into to hedge oneself against exchange risk (i.e., the uncertainty regarding the future movements of the exchange rate). By entering into a forward contract, the customer locks-in the exchange rate at which he will buy or sell the currency.

Forward Quotes

Forward quotes are given just like spot quotes given earlier. The same rules regarding calculation of implied inverse rates, synthetic cross rates etc. apply to the forward rates also. The conditions to be fulfilled for ensuring that there is no scope for two-way arbitrage and three-way arbitrage are also the same. For example, the three-month forward rate between the £ and the ¥ may look like:

$$3\text{-m } ¥/£ : 182.70/75$$

The implied inverse rate would be:

$$\begin{aligned} 3\text{-m } £/100¥ &: (1/182.75 \times 100) / (1/182.70 \times 100) \\ &= 0.5472/0.5473 \end{aligned}$$

If the 2-month forward \$/Aus\$ and the \$/SGD quotes are

$$2\text{-m } \$/\text{Aus\$} : 0.6883/88$$

$$2\text{-m } \$/\text{SGD} : 0.5754/58$$

then the SGD/Aus\$ synthetic cross rates will be

$$\begin{aligned} 2\text{-m } \text{SGD}/\text{Aus\$} &: (1/0.5758 \times 0.6883) / (1/0.5754 \times 0.6888) \\ &= 1.1953/70 \end{aligned}$$

DISCOUNT AND PREMIUM

A currency is said to be at premium against another currency if it is more expensive in the forward market than in the spot market. In this case, its forward rate will be higher than its spot rate. This happens when the future spot rate is expected to be higher than the current spot rate. Conversely, a currency is said to be at a discount if it is cheaper in the forward market than in the spot market. In this case, its forward rate will be lower than its spot rate. This happens when the future spot rate is expected to be lower than the current spot rate. Let us assume the Rs./\$ quotes to be:

$$\text{Rs./\$} : 45.42/44$$

$$3\text{-m } \text{Rs./\$} : 46.62/70$$

Here, the bank is ready to give only Rs.45.42 currently in exchange for a dollar, while it is ready to give Rs.46.62 after 3 months. Similarly, the bank is charging only Rs.45.44 for selling a dollar now, while it is charging Rs.46.70 for a delivery 3 months hence. So the dollar is expected to be more expensive in the future, and hence is at a premium against the rupee. On the other hand, the rupee is expected to be cheaper in the future and hence is at a discount against the dollar.

Let us now assume the \$/£ quotes to be:

\$/£ : 1.6721/26

3-m \$/£ : 1.6481/92

Here the dollar is at a premium against the pound, while the pound is at a discount against the dollar. It is possible that a currency may be at a premium against one currency, while being at a discount against another at the same time. It is also possible that a currency be at a premium against another for a particular forward maturity, while being at a discount against the same currency for another forward maturity. Example the \$/£ quotes may be:

\$/£ : 1.6721/26

2-m \$/£ : 1.6726/34

3-m \$/£ : 1.6481/92

Here, the pound is at a premium against the dollar for the 2-month maturity, but at a discount for the 3-month maturity. It is also possible to have such a situation where a currency is at a premium against another for a particular forward maturity, but a discount between two forward maturities. Example the \$/£ quotes may be:

\$/£ : 1.6721/26

1-m \$/£ : 1.6730/37

2-m \$/£ : 1.6726/35

Here, the pound is at a premium against the dollar for both the forward maturities, but at a discount between the one-month and the two-month maturities.

There is an important aspect about forward rates which needs to be observed here. Notwithstanding whether the base currency is at a premium or at a discount, the bid-ask spread increases as one goes into future. In the Rs/\$ quotes (where the base currency, i.e. the dollar is at a premium), the spread increased from 2 paise to 8 paise. In the \$/£ quotes (where the base currency is at a discount), the spread increases from 5 points to 11 points. This happens because the liquidity in the market decreases with increasing maturity of the contract. This makes it difficult for the bank to offset the positions created in the retail market. Longer the maturity, lower the trading volume, higher the possibility of loss on account of movement of exchange rates in an unfavorable direction. It is important to remember that the risk (due to which the spread increases for a forward maturity) is not of the exchange rate moving unfavorably between the date of the contract and its maturity, but that of an unfavorable movement in the exchange rate between the time of the contract and the time when the bank offsets its position.

The difference between the spot rates and the forward rates can be expressed in terms of swap points. In the rupee-dollar example, the swap points will be 120/126 (46.62 – 45.42 and 46.70 – 45.44). In the dollar-pound example, the 3-month swap points would be 240/234 (1.6721 – 1.6449 and 1.6726 – 1.6492). From this we can observe the following rules:

- i. When the swap points are low/high (as in the rupee-dollar example given above), currency B is at premium, A is at a discount. Add swap points to spot rate to get the outright forward rate, deduct swap points from the outright forward rate to get the spot rate.

- ii. When the swap points are high/low (as in the dollar-pound example given above), currency B is at a discount and A is at a premium. Deduct the swap points from the spot rate to arrive at the outright forward rate, add them to the outright forward rate to arrive at the spot rate.
- iii. The bid side swap points (i.e., on the left side of the swap points quote) are to be added to or subtracted from the spot bid rate (depending on whether the currency is at premium or discount) to arrive at the forward bid rate. The ask side swap points added to or subtracted from the spot ask rate, give the forward ask rate.

The annualized percentage premium on currency B can be calculated as follows:

$$\frac{\text{Forward (A/B)}_{\text{mid}} - \text{Spot (A/B)}_{\text{mid}}}{\text{Spot (A/B)}_{\text{mid}}} \times \frac{12}{m} \times 100$$

where m is maturity of the forward contract in months.

A negative figure signifies that currency B is at a forward discount and A is at a premium, with a positive figure signifying the opposite.

In the rupee-dollar example, the annualized percentage premium on the dollar can be calculated as follows:

$$\text{Spot (Rs./\$)}_{\text{mid}} = \frac{45.42 + 45.44}{2} = \text{Rs.}45.43/\$$$

$$\text{3-m (Rs./\$)}_{\text{mid}} = \frac{46.62 + 46.70}{2} = \text{Rs.}46.66/\$$$

$$\text{Premium} = \frac{46.66 - 45.43}{45.43} \times \frac{12}{3} \times 100 = 10.82\%$$

Similarly, in the \$/£ example, the annualized discount on the pound for the 3-month maturity works out to 5.67%.

An important point that needs to be noted here is that the pound being at 5.67% annualized discount does not necessarily mean that the dollar will be at a 5.67% annualized premium against the pound. Let us verify with the help of an example. The implied inverse quotes in the Rs/\$ example would be:

$$\$/\text{Rs.} : 0.022007/0.022016$$

$$\text{3-m } \$/\text{Rs.} : 0.021413/0.021450$$

Hence,

$$\text{Spot } (\$/\text{Rs.})_{\text{mid}} = \frac{0.022007 + 0.022016}{2}$$

$$= \$0.0220115/\text{Rs.}$$

$$\text{3-m } (\$/\text{Rs.})_{\text{mid}} = \frac{0.021413 + 0.021450}{2}$$

$$= \$0.0214315/\text{Rs.}$$

Therefore, the annualized percentage discount on the rupee will be:

$$= \frac{0.0214315 - 0.0220115}{0.0220115} \times \frac{12}{3} \times 100 = -10.53\%.$$

Thus, while the dollar is at a 10.82% premium against the rupee, the rupee is at a 10.53% discount.

Usually the forward rates are not quoted straight. Instead, the premium or discount is quoted for different periods. The following is an extract from 'The Economic Times', which describes the rates in the Mumbai interbank market.

Table 2: Forward Premia (indication only) PAISE PER USD

March	Jan.	Feb.	Mar.	Apr.	May	June
Exporters	5	22	44	70	91	116
Importers	7	24	47	73	94	119
Annualized	7.52	5.73	5.85	6.4	6.3	6.43

We can observe from the table that forward premiums/discounts are quoted in subsidiary unit of the currency (paise here). Exporters and importers for May means that exporters selling foreign currency under the forward contract will receive a premium of 91 paise per dollar, and the importers buying foreign currency under the forward contract will pay a premium of 94 paise per dollar.

In the Indian context, when the maturity of a forward contract is extended by cancelling the existing contract and entering into a new contract for the extended duration, it is referred to as rolling over a forward contract. Rolling over of a forward contract can be used to hedge for longer term maturities for which forward contracts are not available. For example, in India, forward contracts for maturities greater than one year are not allowed. Suppose a party has an exposure for 3 years for which it wishes to hedge itself against movements in exchange rates. In such a case it can hedge itself at least partially by initially booking a forward contract for the maximum maturity available, and then rolling over the contract at the end of that time period. However, this does not act as a perfect hedging mechanism, but provides an opportunity to hedge exposures at least partially. This is because at the time of booking the initial contract, the customer would not know the price he would need to pay at the time of rolling it over.

FORWARD RATES VS. EXPECTED SPOT RATES

If the speculators in the market were risk-neutral and there were no transaction costs, then the forward rate would be equal to the market's expected future spot rate. This is so, because otherwise it would be possible to buy in one market and sell in the other in order to make profits. Let us take the case where the forward rate is lower than the expected spot rate. In such a case, the speculator would buy a forward contract expecting to sell in the spot market in the future at a higher price. The resulting increased demand in the forward market would increase the forward rate and drive it towards equalization with the expected future spot rate. If the forward rate is higher, speculators would sell in the forward market, thus pushing the forward rate down. In reality, however, there is also the risk of the spot rate turning out to be different from the expected spot rate and the speculators are not really risk-neutral. They expect to be compensated for the risk that they take on. In addition, there is the presence of transaction costs to be contended with. These two factors result in the forward rate being different from the spot rate to some extent.

Broken-date Forward Contracts

A broken-date contract is a forward contract for a maturity which is not a whole month or for which a quote is not readily available. For example, if the quotes are available for a 6 month forward and a 9 month forward, but a customer wants a quote for a 7 month forward, it will be a broken date contract. The rate for a broken date contract is calculated by interpolating between the available quotes for the preceeding and the succeeding maturities. Let us assume that in July, the quote for a contract maturing on August 31 is

SFr/\$: 5.5879/85

At the same time, the quote for a contract maturing on October 31 is

SFr/\$: 5.5908/20

Now suppose a customer wants to enter into a forward contract with the bank maturing on September 29, for purchasing dollars from the bank. For this purpose, the bank has to give a quote. It can be observed that the dollar is at a premium and the swap points are 29/35 between August and October maturity. On the ask side, the premium is 35 points which is spread over $(30 + 31)$ 61 days. The required maturity is 29 days away from the August maturity. Hence, the premium charged by the bank over and above the August rate will be $35 \times 29/61$, i.e., 17 points. Hence, the rate charged will be $5.5885 + 0.0017 = \text{SFr } 5.5902/\$$. Similarly, the buy and the sell rates can be calculated for any intervening date between two given maturities.

Option Forwards

Under the forward contract discussed until now, the settlement of the contract has to take place on a specific date. This type of a contract can be used only when the customer knows the precise time as to when he would need to buy/sell a currency. There are circumstances in which the customer may know the estimated time when the need to deal in a foreign currency may arise, but may not be sure about the exact timing. For example, an exporter who has shipped his goods abroad, may be aware that the ship would be expected to reach its destination in a month's time and expects to receive his payment within one month from the consignment being received by the buyer. Yet, he would not know the exact date the ship will reach and hence the date on which he will receive his payment. Similarly, for an importer, the time of requirement of foreign currency will depend upon the time when he receives communication from the foreign supplier regarding the despatch of goods. Another example could be of a person who has bid for a contract. If the person's need for dealing in foreign currency is dependent upon his bid being accepted, then he may not be knowing when the need will arise. These kind of needs can be fulfilled by a contract called the option forward contract or the option forward. Under this contract, the customer of the bank has the option to ask for the contract to be settled anytime during a particular period, referred to as the option period. For example, a customer enters into an option forward contract on September 29 for selling dollars to the bank. The contract matures on December 31. The customer takes the option to sell dollars to the bank anytime in December. Here, the month of December is the option period. Giving quotes for this kind of a contract is not as straightforward as giving a quote for an outright forward contract. This is so because the rate at which the exchange of currencies will take place is fixed, while the timing of the exchange is not. If the bank quotes a rate which is appropriate for deals done at a particular period of time, and the exchange actually takes place at an unfavorable time, the bank would incur a loss on the deal. For example, if the bank enters into a contract to sell dollars to a customer when the dollar is commanding a forward premium, and the bank's quote reflects the premium only up to the beginning of the option period, it will incur a loss if the customer exercises the option at the end of the option period (because the bank would get lesser premium than it would have charged for the complete period). Similarly, if the dollar were at a forward discount and the bank's quote were to reflect the discount for the full period, the bank would be incurring a loss were the customer to exercise the option in between the option period. To avoid a loss (or rather, to make the maximum profit), banks follow these rules for giving a quote:

1. When the bank is buying a currency, it will add on the minimum premium possible (when the currency is at a premium) and deduct the maximum discount possible (when the currency is at a discount) from the spot rate. This would result in the bank quoting the rate applicable to the beginning of the option period when the currency is at a premium, and the rate applicable to the end of the option period when the currency is at a discount.

2. When the bank is selling a currency, it will add the maximum premium possible (when the currency is at a premium) and deduct the minimum discount possible (when the currency is at a discount) from the spot rate. This would result in the bank quoting the rate applicable to the end of the option period when the currency is at a premium, and the rate applicable to the beginning of the option period when the currency is at a discount. Thus the bank considers the applicable quotes for the beginning and the end of the option period and gives a quote which is disadvantageous to the client, which, in effect, is the cost incurred by the client for the flexibility.

Suppose the Euro/Swiss franc rate is given as:

Spot Euro/SFr :	1.2245/49
3 – m forward :	10/15
4 – m forward :	15/25

The Swiss franc is at a premium. If the bank contracts to sell SFr, with the option to take delivery exercisable by the customer anytime during the 4th month, the bank will load the maximum premium to the spot rate. It will implicitly be assuming that the customer will demand delivery when the currency is most expensive, and hence will charge the maximum rate. So it will quote the rate Euro 1.2274/SFr (1.2249 + 0.0025). If the contract were to buy SFr with the option to give delivery exercisable by the customer anytime during the 4th month, the bank would have assumed that the customer would choose to exercise his option when the SFr is at its cheapest, i.e., at the beginning of the fourth month. Hence, the bank would have loaded the minimum premium to the spot rate while giving the quotation. The rate would have been Euro 1.2255/SFr (1.2245 + 0.0010).

Note that the 3-m forward rate is the rate applicable to the beginning of the option period (as the end of the 3rd month is the beginning of the fourth month), and the 4-m forward rate is the rate applicable to the end of the option period.

Suppose the Can\$/£ rate is:

Can\$/£ :	2.5643/49
2 – m :	20/15
3 – m :	30/20

The bank enters into a forward contract whereby the customer has the option to buy pounds from the bank anytime during the third month. As the pound is at a discount and the bank would like to sell it at the maximum price possible, it will deduct the minimum discount from the spot rate, which is 15 points. The bank will hence quote Can\$ 2.5634/£ (2.5649 – 0.0015). If the forward contract is such that it gives the customer the right to *give* delivery anytime during the third month, the bank would have deducted the maximum discount in order to buy pounds at the cheapest rate possible. The rate would be Can\$ 2.5613/£ (2.5643 – 0.0030).

How would the bank decide on its quote if a currency is at a premium at the beginning of the option period, and at a discount during the option period? The bank would follow the simple rule of buying at the lowest and selling at the highest *price*. For example, if the SFr/Aus\$ quotes were

SFr/Aus\$:	3.4925/30
1 – m :	3.4935/45
2 – m :	3.4930/42

For an option forward giving the right to the customer to buy Aus\$ anytime during the second month, the bank would quote the rate of SFr3.4945/Aus\$. If the customer's option were to sell Aus\$, the rate given by the bank would be SFr3.4930/Aus\$.

Swaps

A transaction whereby two currencies are exchanged by the parties involved, only to be exchanged back later, is termed a currency swap. The quantity exchanged of one of the currencies remains constant in both the legs of the swap, though the quantity of the second generally changes. So, a swap is nothing but the selling of one currency at a point of time to purchase it back later at a lower or a higher price.

A currency swap is a combination of two transactions – one spot and one forward – with an exchange of currencies taking place at predetermined exchange rates. The forward leg is in the opposite direction to that of the spot leg, i.e. the party selling currency A in the spot leg buys it in the forward leg and vice versa. As mentioned, the price of the currencies is different in the spot leg from that of the forward leg. This happens because of the expected depreciation/appreciation of the currency w.r.t. the other currency. For example, two parties may enter into a swap whereby the first party sells one million pounds to the second party against dollars in the spot leg @ \$1.6708/£, and the second party sells one million pounds to the first party against dollars one month forward @ \$1.6652/£. Here the number of pounds exchanging hands is constant, whereas the number of dollars exchanging hands is changing, depending on the exchange rate applicable to the two legs of the swap transaction. As opposed to a swap transaction, an outright forward is not accompanied by any spot deal.

A swap transaction whereby the foreign currency is bought in the first leg and sold in the second leg against the local currency is called a swap-in or buy-sell swap. For example, a swap-in dollars in India would mean dollars bought against the rupee in the first leg and sold in the second leg. A swap-out or a sell-buy swap is the exact opposite, i.e. the foreign currency is sold in the first leg and bought in the second leg against the local currency. A forward-forward swap is one where both the legs of the transaction take place in the future. For example, if dollars are bought one month forward @ Rs.45.50/\$ and sold two months forward @ Rs.45.70/\$, it will be a forward-forward swap.

One of the uses of swaps is for hedging by entities investing or borrowing abroad. Hedging is the process through which an attempt is made to eliminate risk (or at least reduce it to tolerable levels) in a transaction. Take the example of a Canadian citizen who is investing in US bonds. He would know the amount of US dollars he would receive on maturity, but not the \$/Can\$ exchange rate that would prevail at that time. This would make his Can\$ returns uncertain. To remove this uncertainty, the investor can enter into a swap-in dollars, whereby he would buy the dollars spot (which he could then use to invest in the bonds) and sell them forward at the time of maturity. This would fix the exchange rate at which he would translate his dollar earnings to Can \$, thus making his Can\$ returns certain. Similarly, a person raising money abroad may enter into a swap-out to fix his total cost of borrowing.

Swaps can also be used in place of option forwards. In the example of a person entering into a contract to sell dollars, with the month of December as the option period (given in the section on option forwards), the same objective can be met through use of swaps. Initially, the customer can sell dollars forward, maturity December 1. If by the end of November, he realizes that he would be receiving the dollars only by December 20, he can enter into a buy-sell swap for 20 days. This way he would be able to hedge his position in a cheaper way. Of course, for resorting to a cheaper method, he would have to pay the price of not knowing the premium/discount that will be applicable to the swap transaction till he actually enters into it. Hence, while option forward is likely to be more expensive than a swap transaction, it removes the exchange risk completely. On the other hand, in such situations the risk is not completely removed in a swap transaction, due to the uncertainty of the total cost of hedging.

The most important players in the swap markets are the banks. They use the swap markets to hedge their positions arising from merchant transactions. For example,

if a bank sells more spot dollars than it has purchased, it creates a short (oversold) position. If the bank does not cover its open position, it may lose if the dollar appreciates since it will have to buy the dollar at a higher price. To cover its position, bank can buy dollars in the interbank spot market. A bank having a long (overbought) position can cover itself by selling dollars in the interbank spot market. But if the bank has sold forward more dollars than it has bought forward (or vice-versa), it will have to cover its position in the interbank forward market. While it is easy to find a counterparty in the spot market, it is difficult to find a counterparty with an exactly opposite exposure having a matching maturity. Hence, the banks prefer hedging by using swaps instead of outright forwards. Another reason for banks preferring swaps is that swaps have finer rates than outright forwards. A bank having an overbought forward position will enter into a swap to sell forward in the relevant maturity and buy the currency spot. Then the bank can sell the currency spot to counter the spot buying. Conversely, a bank with an oversold forward position can enter into a sell-buy swap, whereby it buys in the relevant forward maturity and sells spot. To cover the spot sale it can buy spot in the interbank market. In the interbank markets, the delivery week for the forward leg of the swap can be specified. Banks generally use rollovers to cover the resultant intra-week exposures.

The difference in the spot and the forward leg prices of a swap are given as swap points, just as in the case of a forward quote. In fact, the swap points applicable to outright forwards and swaps are the same. Yet, the way in which these points are to be added to/subtracted from the spot rate is different from the way in which the forward rate for a currency is calculated. The way to calculate the exchange rate applicable to the forward leg of a swap transaction is shown in the following example.

Assume that the following quotes are available in the inter-bank market:

Rs./\$: 45.42/46

3-m : 60/70

Suppose a bank wants to go for a buy-sell swap. It will buy dollars spot @ Rs.45.42/\$. (As the bank would be dealing in the interbank market, it would have to buy at the ask rate. This needs to be remembered for the subsequent workings also). As the swap points are in low/high order, the dollar is at a premium. The bank will get 60 points premium if it sells dollars forward. To arrive at the rate applicable to the forward leg of a swap transaction, the relevant swap points are added to/deducted from (depending on whether the currency is at a premium or discount) the rate at which the spot leg of the transaction has taken place. Hence, the rate for the forward sale will be Rs.46.06/\$ ($45.46 + 0.60$). As we can see, the rate which the bank gets for selling dollars in the forward leg of the swap is better than what it would have got had it sold dollars outright forward ($45.42 + 0.60 = 46.02$).

If a bank wanted to go for a sell-buy swap, the rate applicable to the spot sale would have been Rs.45.42/\$. The dollar being at a premium, the bank would need to pay the 70 points premium for buying dollars forward. In accordance with the above-mentioned principle, the rate applicable to the forward leg would be ($45.42 + 0.70$) Rs.46.12/\$. This rate is again better than the outright forward rate of ($45.46 + 0.70$) Rs.46.16/\$.

Since the swap points are added to/deducted from the specific spot rate which is used for the spot leg of the swap, the spot rate does not really matter (as the real profit or cost of the swap is reflected in the swap points, which remain the same irrespective of the spot rate used). In fact, in many cases, the rate applied to the spot leg of the swap transaction may not equal either the bid or the ask rate of the bank's spot quote.

A forward-forward swap can be considered as a combination of two spot-forward swaps. For example, a swap to buy dollars after 3 months and to sell dollars after 4 months can be taken as a combination of two spot transactions – (a) to sell dollars spot and buy them after 3 months, and (b) to buy dollars spot and sell them

after 4 months. Identical rates are applied to the spot legs of both the swaps, and hence the spot transactions cancel out. The forward legs of the two swaps remain, and the premium/discount applicable to these decide the net profit/cost of the forward-forward swap.

SETTLEMENT DATES

The settlement date of a forex transaction, also called its value date, is the day on which the transaction is settled by a transfer of deposits as explained in an earlier section. The settlement date for a spot transaction is generally the second *business* day from the date of the transaction, except for transactions between the US dollar and the Canadian dollar, and those between the US dollar and the Mexican peso. In these two cases the settlement takes place the next business day. This gap between the transaction date and the settlement date is needed in order to enable the banks to confirm and clear the deals through the communication networks.

The term business day implies that neither of the days between the transaction date and the settlement date (including the settlement date) should be a holiday, either in any of the settlement locations, or in the dealing location of the market-making bank (i.e. the bank who gave the quote). The settlement locations are the countries whose currencies are involved in the transaction, and the dealing locations are the countries in which the banks involved in the transaction are located. For example, if a German bank sells Mexican peso against Canadian dollars to an Indian bank, Mexico and Canada would be the settlement locations, while Germany and India would be the dealing locations. In case any of the following two days is a holiday in either of these locations, the settlement date is shifted to the next business day.

According to these rules, a transaction entered into on a Monday would be settled on the following Wednesday (assuming that both Tuesday and Wednesday are working days in both the settlement locations and the dealing location of the market-making bank). Following the same rules, a transaction entered into on a Thursday would be settled on Monday, Saturday and Sunday being holidays in most of the countries. In order to avoid credit risk, both the parties turn over their deposits on the same day as a rule. The exception is made in case of transactions involving any of the mid-east currencies. These countries have their weekly off on Friday and have Saturdays and Sundays as working days. So if a deal is struck on a Wednesday involving any of these currencies against, say, the franc, the franc deposit will be turned over on Friday, while the mid-east currency will be transferred on Saturday. For a deal struck on Thursday, the mid-east currency deposit will be transferred on Saturday, while the francs will be transferred on Monday.

The settlement date for a forward contract depends on two things – the settlement date for a spot transaction entered on the same date as the forward contract, and the maturity of the forward contract in months. For arriving at the settlement date for a forward contract, first the settlement date for the corresponding spot transaction is calculated, and then the relevant number of calendar months are added to it. For example, if a 3-month (or 90 days) forward contract is entered into on July 20, first the spot settlement date will be calculated (in accordance with the previously specified rules). Suppose that it comes to July 23 because of July 21 being a holiday. Then the settlement date for the forward contract will be October 23. If it is a holiday on that day, the settlement date will be shifted to the next business day, i.e. October 24. By adding ‘calendar months’ it is meant that the specified number of months will be added to the spot settlement date, not 30 or 31 days (or the multiples thereof). Suppose the spot settlement date is the last date of a month, then the settlement date for the forward contract will be the last date of the relevant month, irrespective of the number of days in the two months. For example, if a one-month forward contract is entered into on January 29, the spot settlement date would be January 31. The settlement date for the forward contract would be February 28 (or February 29 if it is a leap year). One important point that has to be remembered while rounding off the settlement date due to holidays, etc. is that the rounding off should not shift the settlement date to the next calendar

month. For example, if the settlement date of the forward contract is coming to October 31 which is a holiday, the settlement cannot be done on November 1. In such a case, the settlement date will be shifted to the previous business day. So, the settlement date would be October 30.

The maturities of forward contracts are generally in whole months. Yet, banks generally stand ready to offer forward contracts of maturities in accordance with the specific need of the client. This quite often gives rise to contracts with broken-date maturities. For example, a bank may enter into a forward contract to deliver a specified number of dollars to a client after 55 days. For calculating the settlement date of such a contract, first the relevant number of whole months is added to the spot maturity date. Then out of the total maturity of the forward contract, the number of days which represent these whole months (which is obtained by multiplying the number of whole months by 30) are deducted. The balance number of days are then added to the settlement date, which was arrived at by adding the whole months to the spot settlement date. Let us say, the transaction date for the 55-day forward contract is October 25. The corresponding spot value date will be October 27. There is one whole month in 55 days. So one month will be added to October 27 to get November 27. Then 30 will be deducted from 55, leaving a balance of 25 days. When added to November 27, this gives us December 22, which will be the settlement date for the 55-day forward contract.

Short-Date Contracts

As said in the previous section, the settlement date for a spot transaction is two business days after the transaction date. There are some transactions which are an exception to this rule, i.e. where the settlement date is less than two business days after the date of the transaction. Such transactions, for which the settlement date is before the spot settlement date, are referred to as short-date contracts.

These transactions can be in the form of either outright contracts or swaps. The various swaps available in the market are: between today and tomorrow (called the cash/tom, C/T; it is also referred to as the overnight swap, O/N), between today and spot day (cash/spot, C/S), between tomorrow and next day, i.e. the spot day (tom/next, T/N or tom/spot, T/S) and between spot and the next day (spot/next, S/N). Strictly speaking, the S/N is not a short-date contract since the settlement does not take place before the spot day.

As in the case of swaps, the interbank market gives swap points for these contracts. A bank buying a currency has to pay the higher of the swap points as premium, and gets the lower of the swap points as discount. On the other hand, a bank selling a currency to the market will get the lower of the premium points, but will have to pay the higher of the swap points if the currency is at a discount. Here again, the spot rate to/from which these points are added/subtracted becomes irrelevant.

The First Quote

At the start of the day, when a bank is required to give the first quote, the dealer has to consider a number of factors which affect the exchange rate between two currencies. The foremost would be the previous night's closing rate. That rate would serve as the starting point, which would be adjusted for expected changes on account of other factors.

The most important factor is the expected demand-supply position in the market on that day. This factor reflects the effect of a number of other factors. For example, at the beginning of a day, there are certain expectations regarding the inflow and outflow of a foreign currency. The prevalent interest rate in the domestic economy reflected by the call money market rates also affects the expected demand and supply, as investors' demand for the domestic currency (and hence for the foreign currency) would depend on the level of domestic interest rates (higher the rates, more the demand for the domestic currency as investors

would need to buy it for investing in the local call money markets. If the investors choose to cover their positions in the forward exchange market, it would also result in an increase in the supply of the domestic currency in the forward market, thereby increasing the forward premium on the foreign currency). The demand-supply position would also be affected by the expected happenings in the stock markets. Suppose the Foreign Institutional Investors (FIIs) are expected to unload their holdings in the domestic stock market. This would leave them with surplus funds, which they would need to convert into foreign currency in order to be able to invest elsewhere, thus increasing the demand for the foreign currency. The overnight rate is adjusted according to the demand and supply position expected to prevail in the market on that day. If the supply is expected to exceed demand, the rate is revised to be on the lower side. If the supply is expected to be less than the expected demand, the rate is revised to be on the higher side.

In addition to these factors, the bank's own overnight position as to whether it is net long in the foreign currency or is net short, also affects the quote it gives to the market. A net short position would result in the bank trying to buy the foreign currency, and hence a higher rate. A net long position will have the opposite effect on the quote.

The bank's view regarding the cross currency market would also affect the bank's quote. For example, if the bank expects the dollar to firm up in the international markets and hence goes long on the dollar there, it would need to go short on dollars in the local market to set off its position. In such a case, the bank would need to give a lower rupee/dollar quote than it would otherwise have given, in order to be able to sell dollars.

There are a number of economic and other factors in addition to the ones mentioned above, which would affect the first quote. All these listed factors and other factors which are likely to influence the exchange rates would need to be considered by the dealer giving the day's first quote. Whether the dealer's analysis is in line with the market's analysis or not, will be made clear by the buy or sell orders he receives from the market. If the dealer's quote is out of line with the market's expectations, he may have to change his quote accordingly.

QUOTES FOR VARIOUS KINDS OF MERCHANT TRANSACTIONS

There are different kinds of purchase and sale transactions in the retail market. The simplest is the outward or inward remittance. In this kind of transaction, the bank has to simply receive or send a currency through Telegraphic Transfer (TT), demand draft, postal order or Mail Transfer (MT). Since the work involved in such transactions is the least, a bank offers better rates for them. These rates are called the TT buying and TT selling rates. While the TT selling rate is applied for outward remittances in foreign currency (not being proceeds of import bills) and to cancellation of an earlier booked forward purchase contract, the TT buying rate is applied to inward remittances and for cancellation of a forward sale contract.

In India, TT buying and selling rates have to be determined in accordance with FEDAI rules. These rates are to be based on the base rate which may be derived from the on-going market rate. This base rate is marked up to cover the dealer's margin (profit). The maximum permissible margin was earlier prescribed by FEDAI. Now it is left to the discretion of the ADs, subject to restrictions on the maximum spreads and other provisions relating to the calculation of exchange rates as specified by FEDAI. Bank managements generally specify the guidelines to their ADs in this regard. The ADs are also restricted from loading too high a margin by the competition that exists in this field. The margins prescribed by FEDAI which are now indicative are:

TT purchase	0.025% to 0.080%
TT sale	0.125% to 0.150%

The maximum permissible spreads between the TT Buying and TT selling rate are as follows:

US\$: 1.00 percent of the mean rate (the mid-rate)

Pound, DM, Yen, French franc, Swiss franc, Dutch Guilders and Australian dollars: 2.00 percent of the mean rate.

Other currencies: No limit at present but ADs are instructed to keep the spread to a minimum.

The TT rates are to be arrived at in the following manner:

Spot TT Buying Rate

Take the base rate and deduct the appropriate margin from it. For example, if the base rate for dollars is Rs.45.42 and the AD wishes to charge 0.08% margin, the spot TT buying rate would be:

Base rate	45.42
Less: Margin @ 0.08%	<u>0.036</u>
Spot TT buying rate	45.384

Spot TT Selling Rate

Take the base rate and add the appropriate margin to it. For example, if the base rate for dollars is Rs.45.50 and the AD wishes to charge a margin of 0.15%, then the TT selling rate would be:

Base rate	45.50
Add: Margin @ 0.15%	<u>0.068</u>
Spot TT buying rate	45.432

Forward TT Buying Rate

Take the base rate. Add (deduct) the on-going forward premium (discount) to (from) the base rate, depending upon the delivery period. From this, deduct the appropriate margin. For example, if a customer wants to sell dollars one month forward, with the base rate at Rs.45.42 and one month premium on dollar being 15 paise, the forward TT buying rate would be calculated as:

Base rate	45.42
Add: Premium	<u>0.15</u>
	45.57
Less: Margin @ 0.08%	0.0364
Forward TT buying rate	45.5336

Forward TT Selling Rate

Take the base rate. Add (deduct) the on-going forward premium (discount) to (from) the base rate, depending upon the delivery period. To this, add the appropriate margin. For example, with the base rate for dollar at Rs.45.50 and the one month forward premium at 20 paise, the one month forward TT selling rate will be:

Base rate	45.50
Add: Premium	<u>0.20</u>
	45.70
Add: Margin @ 0.15%	<u>0.0688</u>
Forward TT selling rate	45.6312

In addition to these rates, the ADs are required to charge the following amounts from their customers for various kinds of transactions:

1. No additional charge for inward remittances for which credit has already been made to the nostro account of the AD.

2. An additional margin of 0.125% to be charged on the TT buying rate and interest to be recovered from the customer @15% for 10 days' transit period, for inward remittances (for example DDs) where the amount has not been credited to the nostro account of the AD and the reimbursement has to be obtained from the overseas drawee bank (in case of a DD) or the overseas correspondent bank (in other cases).
3. On inward remittances by way of customer's personal cheque, an additional margin of 0.15% on the TT buying rate is to be charged. In addition, interest for transit period of 15 days is to be recovered from the customer at domestic commercial rate of interest.
4. For all foreign currency outward remittances (not being proceeds of import bills), a minimum flat charge of Rs.100 is to be made.
5. On all outward rupee remittances the charge is to be:

Up to Rs.10,000	0.25% subject to a minimum of Rs.10
Over Rs.10,000	0.125% subject to a minimum of Rs.25

The second kind of merchant rate is the bill buying and bill selling rate. These rates are applied to transactions in foreign currency denominated bills of exchange. As for TT rates, the bill buying and selling rates have to be calculated in accordance with FEDAI guidelines. The base rate is loaded with a margin, which is left to the discretion of the AD. The indicative exchange margins given by FEDAI are:

Bill buying	0.125% to 0.150%
Bill selling (over the TT selling rate)	0.175% to 0.200%

Bill Buying Rate

This rate is applied when the AD is giving the rate for an export transaction. The transaction can be either in the way of realization of a collection bill (where the amount has already been credited to the AD's nostro account and the AD is only required to convert it into rupees), or in the form of purchase or discounting of an export bill (where the AD will be providing finance to the exporter till the bill gets collected and then convert the amount received into rupees). For the first type of transaction, the appropriate margin is deducted from the base rate to arrive at the bill buying rate. For the second type of transactions, the bill buying rate can be arrived at in the following manner. Take the base rate. Add (deduct) the on-going premium (discount) to (from) the base rate, the amount of premium (discount) depending on the notional due date (which includes the remaining tenor of the bill, the normal transit period and the grace period; the normal transit period and the grace period being specified by FEDAI guidelines). From this, deduct the appropriate margin. This will give the applicable bill buying rate. In addition, the AD will also charge interest from the customer for the credit extended for the period between the purchasing/discounting of the bill and the notional due date.

The bill buying rate can be calculated as follows. Let the base rate for dollar be Rs.45.42 and the premium for two months (till the notional due date) be 40 paise. If the AD requires a 15% margin, the rate will be:

Base rate	45.42
Add: Premium	0.40
	45.82
Less: Margin @ 15%	0.0687
Bill buying rate	45.7513

In addition, for both kinds of transactions, the AD has to charge a commission @ 0.25% subject to a minimum of Rs.10 as collection charges. The banks have been given the discretion of waiving the commission for an instrument having value up to Rs.5,000.

Bill Selling Rate

The bill selling rate is applied when the AD is giving the quote for an import transaction. This rate can be arrived at by adding the appropriate margin to the base rate. For example, if the base rate for dollars is Rs.42.70 and the AD requires a 0.02% margin over the TT selling rate, the bill selling rate will be:

Base rate	45.50
Add: Margin @ 0.15%	<u>0.0682</u>
TT Selling rate	45.5682
Add: Margin @ 0.2%	<u>0.0911</u>
Bill selling rate	45.6593

The third kind of merchant transaction is the purchase and sale of foreign currency notes and Traveler's Cheques (TCs). The rate applicable to such transactions is calculated in the following manner:

TC Buying Rate

Take the one month forward buying rate given by RBI as the base rate. If the RBI rate is not available, take the on-going market rate. Deduct margin from the base rate @1%. The resultant rate will be the TC buying rate. For example, if the one month forward rate is Rs.45.55, the TC buying rate would be:

Base rate	45.55
Less: Margin @ 1%	<u>0.4555</u>
TC buying rate	45.0945

TC Selling Rate

Take the TT selling rate and add a margin of 0.5% to it. Adding the margin is optional for the AD. On this gross amount, a commission is added (again at the option of the AD) at a maximum rate of 1%. If the TC is issued against foreign currency remittance, then the commission will be charged @ 0.25%. This gives the TC selling rate. For e.g., if the TT selling rate is Rs.42.7641/\$ as calculated earlier, the TC selling rate would be:

TT selling rate	45.5682
Add: Margin @ 0.5%	<u>0.2278</u>
	45.7960
Add: Commission @ 1%	<u>0.4579</u>
TC selling rate	46.2539

The TC buying and selling rates thus arrived at, may be rounded off to the nearest 5 paise to get the final TC buying and selling rates.

The following table is an extract from The Economic Times, giving the TT & TC buying and selling rates:

Table 3

Currency	TT Buy	TT Sell
US Dollar	45.52	45.92
Euro	53.05	54.07
Japanese Yen (100)	41.46	42.41
Swiss Franc	34.15	34.92
Pound Sterling	75.67	77.07
Canadian Dollar	34.15	34.92
Danish Kroner	7.13	7.30
Singapore Dollar	26.00	26.54
Swedish Kroner	5.91	6.05
Australian Dollar	31.14	31.92

Traveler's Cheques

Traveler's Cheques	Buying	Selling	Currency Notes	Buying	Selling
US Dollars	44.55	46.60	US Dollars	44.35	46.80
Pound Sterling	74.30	77.60	Pound Sterling	73.95	77.95

THE INDIAN FOREX MARKETS

Prior to 1992, the Indian forex markets were totally regulated. The value of the Indian rupee was fixed, first in terms of the pound and later the US dollar. This value was revised once in a while when the regulator felt the need. All inward and outward remittances were required to be converted at this rate of exchange. The liberalization of the forex markets started in 1992. In March 1992, a dual exchange rate system was put into place. This was known as Liberalized Exchange Rate Management System (LERMS). Two exchange rates were prevailing during this period, one determined by RBI and the other determined by the market. This was the beginning of moving towards a market oriented rate. Under this system, 40% of current account receipts were required to be converted at official rate and the balance could be converted at market determined rates. This was later modified to become the Unified Exchange Rate System which came into effect from March 1, 1993. Under this system, all forex transactions are required to be routed through the ADs at market determined rates. The RBI also announces its rates (which act as reference rates) based on market rates. As mentioned earlier, only permitted persons can deal in foreign exchange (ADs etc.). Hence, any other person desiring to buy or sell foreign exchange can do so only through these permitted persons, and only for permissible transactions.

In August 1994, RBI announced relaxations on current account transactions and delegated further powers to ADs. They can now allow remittances for various purposes like travel, studies, medical treatment, gifts and services to the extent specified by RBI under the various provisions of the Exchange Control Manual. From time to time, RBI comes out with rules regarding the various players who are allowed to operate in the forex market, the various permissible instruments (like forward contracts, swaps etc.), the conditions in which these instruments can be used, etc. It thus regulates the operations of the market. Some of the important regulations, and the relevant FEDAI guidelines as on January 7, 1999 are given below:

Forward Exchange Contracts

- Can be booked only for genuine transactions and where there is exposure to exchange risk, not for speculative purposes.
- Cannot be booked for anticipated transactions, only for firm exposure.
- Can be booked in the currency in which the importer is exposed to exchange rate or in any other permitted currency, i.e. any freely convertible currency.
- Value of the forward cover should not exceed the value of the goods contracted for.
- The period and the extent of the exposure to be covered is left to the choice of the importer. However, the last date of delivery of the forward contract should not exceed six months from the date of shipment/expected shipment date (in case of contracts booked for covering exports or imports).
- Rollover forward covers are permitted to be booked as necessitated by the maturity dates of the underlying transactions, market conditions and the need to reduce costs to the customers. Each time a forward contract is rolled over, the new contract can be for a maximum period of six months.
- In case of merchanting trade transactions (i.e., transactions where some good is imported only to be exported elsewhere, in the same or a refined form), forward contracts will have to be booked simultaneously for both legs of the transactions or for the net amount of expected profit.

- No ready sale or purchase should be made for a transaction for which a forward contract has already been booked.
- Forward contracts can be cancelled by the party concerned whenever required. The exposure can be covered again by the customer through the same or another AD subject to genuine exposure risk and permissibility of the transaction. However, for non-trade transactions, contracts once cancelled cannot be rebooked. Corporates can rollover such contracts on maturity at ongoing rates.
- Forward cover can be taken by resident corporate clients in respect of dividend due to overseas investors who have made a direct foreign investment in India. The cover can be provided only after the Board of Directors has decided upon the rate of dividend.
- Forward cover can also be taken for foreign currency loans to be raised, anytime after the final approval for the loan arrangements have been obtained from RBI.
- For GDR issues forward cover can be obtained once the issue price has been finalized.
- On each forward sale/purchase contract booked, the ADs are required to charge a minimum commission of Rs.250 (FEDAI rules).

Other Regulations

- Exporters and certain other recipients of forex, at their option, can retain a portion of the proceeds in forex in a foreign currency account opened with ADs in India. This account is known as Exchange Earners' Foreign Currency deposit.
- Cross currency exposures can be covered in the overseas market through ADs, without necessarily covering the rupee/dollar leg of the transaction.
- All actual out of pocket expenses of the bank such as postage, telex charges including those of the corresponding bank shall be recovered from the customer.
- R – Returns are required to be submitted by ADs to the Exchange Control Department of RBI – pertaining to the transactions in foreign exchange, and in rupee with overseas banks during each fortnight. These returns serve as the principal source of information for compilation of BoP data. They also help RBI to check whether the powers delegated to ADs have been correctly exercised.

Early Delivery/Extension/Cancellation of Forward Exchange Contracts

In many cases, a customer books a forward contract on the basis of an estimation regarding the time when he would need to deal in the foreign currency. With the uncertainties prevailing in international trade, in many cases the customers may find themselves receiving export proceeds beyond the estimated due date, or preferring to pay for their imports before the due date to take advantage of a depreciating foreign currency or for any other reason. The actual date of delivery or purchase of foreign currency may vary from the date for which forward contract is booked, for a variety of reasons. In such circumstances, forward contracts may be extended or cancelled, or an early delivery could be requested by the customer, if the bank is willing to accommodate him. In these cases, the customers will have to bear the losses arising out of the premature/extended performance or cancelling of the contract. The charges that the customer has to pay to the bank are regulated by FEDAI Rule No.8. The rule says that:

1. Customers can request for an early delivery/extension/cancellation of a forward contract on or before the maturity date of the contract.
2. The bank has to charge a minimum sum of Rs.100 for entertaining any such request from the customer.

3. **Early Delivery:** If a bank accepts or gives early delivery, in addition to the flat charge of Rs.100, the bank has to charge/pay the swap charges for the early delivery period from/to the customer, irrespective of whether the bank actually enters into a swap or not. This swap cost/ gain may be recovered from/paid to the customer, either at the beginning of the swap period or at its end, as the bank may deem fit. As a result of the swap, if the bank faces an outlay of funds, it has to charge interest from the customer at a rate not less than the prime lending rate, for the period of the swap. If there is an inflow of funds, the bank may, at its discretion, pay interest to the customer at the rate applicable to term deposits with maturity equal to the period of the swap. The timing of this cash flow too is left to the discretion of the bank.

Let us see an example for early delivery. An exporter enters into a forward contract with a bank to sell 1 million US dollars to the bank, settlement date December 31. The contract price is Rs.45.40/\$. On November 28, the exporter asks the bank to take delivery on November 30. The spot rate on that date is 45.22/27. The dollar is at a premium, with one month swap points being 10/15. To offset its position created by the early delivery, the bank will have to enter into a one month sell-buy swap. In the process, it will have to sell dollars spot @ Rs.45.22 and will have to pay a premium of 15 paise for the swap. This swap cost of 15 paise will be charged to the customer. On November 30, the bank buys dollars from the exporter @ Rs.45.40/\$, i.e., the earlier contracted rate. Since on that day the bank pays Rs.45.40/\$ (to A) and receives Rs.45.22/\$ (from the market), there will be an outlay of funds to the extent of 18 paise per dollar for the duration of the swap, i.e. one month. The bank will charge interest at a rate not lower than the prime lending rate on this outlay for one month from the customer. In addition to the swap cost and the interest, A will have to pay Rs 100 to the bank. The net inflow to A can be calculated in the following manner:

Assume that the bank charges interest @ 17%.

Inflow from dollar sale: 1,000,000 x 45.40	=		Rs.45,400,000
Swap charges paid: 0.15 x 1,000,000	=	150,000	
Interest paid: 0.18 x 1,000,000 x 0.17/12	=	2,550	
Flat charge	=	<u>100</u>	
Total outflow	=		<u>152,650</u>
Net inflow	=		45,247,350

4. **Extension:** An extension of a contract entails cancelling an existing contract and rebooking a corresponding forward contract. The cancelling is required to be done at the relevant TT buying or selling rate as on the date of cancelation, and the rebooking would be done on the ongoing rate for a new forward contract. The bank is required to collect/pay the difference between the rate at which the original contract was entered, and the rate at which it is canceled, from/to the customer. This may be done either at the time of cancelation or at the time of maturity of the original contract. This would be in addition to the flat charge. Let us take an example:

Illustration 1

Extension before due date

An importer enters into a forward contract with a bank whereby the bank will sell 1 million dollars to the importer @ Rs.45.40, settlement date November 30. On November 15, the importer requests the bank to extend the contract up to December 31. On the day of the request, the forward TT buying rate for November 30 is Rs.45.45, and the Bill selling rate for maturity December 31 is Rs.45.50. The bank will cancel the original contract (i.e., enter into an exact opposite contract, here, to sell dollars) at Rs.45.45 and book a new

forward contract at Rs.45.50. The difference of 5 paise (45.40 – 45.45) per dollar would be passed on to the customer on either November 15, or on November 30. On December 31, the importer will buy dollars from the bank @Rs.45.50. In addition, at the time of cancellation, the importer will pay Rs.100 to the bank. The net outflow for the importer will be:

On cancellation:	Rs.
Gain on cancellation: $0.05 \times 1000,000 =$	50,000
Less: Flat charges	: <u>100</u>
Net amount receivable	: <u>49,900</u>
On December 31, the importer buys dollars from the bank for:	
$45.50 \times 10,00,000 = 45,50,000$	
The importer's net outflow (ignoring timing of the different flows) :	4,55,00,000
Less: Net amount receivable	<u>49,900</u>
	<u>4,54,50,100</u>

Illustration 2

Extension as on due date

You as a banker booked a forward contract for USD 4,00,000 at Rs.45.5200 covering a TT remittance against a bill for collection and covered yourself in the local interbank market at Rs.45.5650, however on the maturity date your customer requested you to extend the contract by one month.

Assuming the on-going market rates for US dollar are as under:

Spot rate USD 1	: Rs.45.6925/7075
1 month forward	: Rs.700/800
2 months forward	: Rs.1000/1100
3 months forward	: Rs.1300/1400

What will be the extension charge customer has to pay if you require an exchange margin of 0.05% for TT buying and 0.07% for TT selling rate.

Solution

The forward purchase contract will be cancelled at the TT selling rate for US dollar	= Rs.45.7075
Add: Exchange margin at 0.07% (45.7075×0.0007)	+ Rs.0.0319
	<u>= Rs.45.7394</u>
Dollar bought from customer under original contract at	Rs.45.5200
It is sold to him under the cancellation contract at	Rs.45.7394
Exchange difference per dollar payable by customer	Rs.0.2194
Exchange difference for USD 4,00,000 is $Rs.4,00,000 \times 0.2194$	Rs.87,760
So Rs.87,760 will be recovered as cancellation charges from the customer.	
The banks will book a fresh forward purchase contract for the customer at the rate given below:	
Spot rate for buying dollar in the interbank market	Rs.45.6925
Add: One month premium	+ Rs.0.0700
	<u>Rs.45.7625</u>
Less: Exchange margin at 0.05% (45.7625×0.0005)	– Rs.0.0228
Forward TT buying rate for dollar	<u>Rs.45.7397</u>
On extension Rs.87,760 will be recovered as cancellation charges from the customer and the fresh contract will be booked at Rs.43.4397.	

- Cancellation:** In case of cancellation of a contract, it is required to be canceled at the appropriate TT selling or buying rate, and the difference between the contracted rate and the cancellation rate is to be collected from/paid to the customer. In addition, the flat rate is required to be collected.

6. If in the above example, the importer had requested the bank to cancel the contract on November 15 rather than getting it extended, the customer would have got 5 paise per dollar and would have paid charges of Rs.100 to the bank. The importer's net inflow/outflow would be:

Gain on cancellation: $0.05 \times 10,00,000$	=	Rs.50,000
Less: Flat charges	=	<u>100</u>
Net amount receivable	=	49,900

Any amount to be collected/paid by the bank on account of early delivery/extension/cancellation of a forward contract (except for the flat charge) shall be ignored if it is less than or equal to Rs.50.

Illustration 3

The bank entered into a forward contract with its customer on 15th March for US dollars 5000 @ Rs.44.6500 delivery due on 15th June. It covered itself in the market at Rs.44.6025. On May 5, the customer requests the bank to extend the contract up to July 15. Calculate the extension charges recoverable from the customer assuming the following rates in the interbank market on May 5.

Spot	USD 1 = Rs.44.1300/1400
Spot/ May	44.2300/2425
Spot/June	44.6300/6425
Spot/July	44.9300/9500

Exchange margin 0.10% on buying as well as on selling.

<u>On Cancellation:</u>		
The forward purchase contract will be cancelled at the forward sale rate for delivery in June.		
Interbank forward selling rate	Rs.	44.6425
Add: Exchange margin at 0.10%	Rs.	0.0446
	Rs.	44.6871
Rounded off, the rate applicable is Rs.44.6870.		
Bank buys dollars under original contract at	Rs.	44.6500
It sells under the cancellation contract at	Rs.	44.6870
Difference per dollar payable by customer	Rs.	0.0370
Exchange difference for USD 5000 payable by customer is Rs.185		
<u>On Rebooking:</u>		
The forward purchase contract will be rebooked with delivery on July15. Since forward dollar is premium, the forward margin will be rounded off to lower month of June.		
Forward market buying rate for June	Rs.	44.6300
Less: Exchange margin at 0.10%	Rs.	0.0446
	Rs.	44.5854
Rounded off the rate quoted will be Rs.44.5850		
<u>Summary</u>		
The bank will recover Rs.185 from the customer and rebook the contract at Rs.44.5850 per dollar.		

SUMMARY

- There are a number of intricacies involved in the operations of the foreign exchange market. In every forex market around the world, there is a regulatory authority which ensures the smooth functioning of the these markets, regulating their operations to varying extent.
- The understanding of the operations of these markets and the regulatory framework is essential for a finance manager trying to manage foreign currency risk for his firm.
- Another important aspect is the interlinkages between the various financial markets, i.e., the money markets, the real markets and the forex markets.
- These links are discussed in the following chapter.

Appendix 1

Following is the list of currencies of major countries, along with the symbols used to represent them:

Country	Currency	Symbol
Argentina	Peso	Arg\$
Australia	Dollar	\$A/Aus\$
Austria	Schilling*	S/ATS
Bahrain	Dinar	BD
Belgium	Franc*	BF/BEF
Brazil	Real	R
Canada	Dollar	Can\$
Chile	Peso	Ch\$
Denmark	Krone*	DKr
Finland	Markka/Mark*	FmK/FIM
France	Franc*	FF/FRF
Germany	Deutsche Mark*	DM/DEM
Greece	Drachma*	Dr
Hong Kong	Dollar	HK\$/HKD
India	Rupee	Rs.
Indonesia	Rupiah	Rp
Iran	Rial	Rls
Ireland	Pound/Punt*	£Ir/IEP
Italy	Lira*	Lit/ITL
Japan	Yen	¥
Korea	Won	W
Kuwait	Dinar	KD
Luxembourg	Franc*	LuxF/LUF
Malaysia	Ringgit	M\$
Mexico	Peso	Mex\$
Netherlands	Guilder (Dutch)*	NLG/DG/\$f
New Zealand	Dollar	\$NZ
Pakistan	Rupee	PRs.
Portugal	Escudo*	Esc/PTE
Russia	Rouble	Rb
Singapore	Dollar	S\$/SGD
South Africa	Rand	R
Spain	Peseta*	Ptas/ESP
Sweden	Krona*	SKr
Switzerland	Franc	SFr/CHF
Thailand	Baht	B
UAE	Dirham	Dh
UK	Pound (Sterling)	£/£ Stg./GBP

The Euro (€) has become the single currency for the EMU countries since January 1, 1999. The currencies marked* were coexisted with euro till July 2002, after which euro is the only legal tender for EMU countries.

Chapter VII

Exchange Rate Determination

After reading this chapter, you will be conversant with:

- Purchasing Power Parity Principle (PPP)
- Interest Rate Parity (IRP)
- Relationship between PPP and IRP
- Reasons for Departure from IRP

In the preceding chapters, we have seen that exchange rates are affected by a number of factors. Two of the most important factors are price levels and interest rates across different countries. In this chapter, the relationship of these two variables with exchange rates will be examined. The following topics will be covered in the chapter:

- Purchasing Power Parity Principle (PPP)
- Empirical Evidence Regarding the Validity of PPP
- Reasons for PPP not Holding Good
- Interest Rate Parity (IRP)
- The Relationship between PPP and IRP
- Reasons for Departure from IRP.

PURCHASING POWER PARITY PRINCIPLE (PPP)

The Purchasing Power Parity Principle (PPP) was enunciated by a Swedish Economist, Gustav Cassel in 1918. According to this theory, the price levels (and the changes in these price levels) in different countries determine the exchange rates of these countries' currencies. The basic tenet of this principle is that the exchange rates between various currencies reflect the purchasing power of these currencies. This tenet is based on the Law of One Price.

The Law of One Price

The assumptions of Law of One Price are:

- **Movement of Goods:** The Law of One Price assumes that there is no restriction on the movement of goods between countries, i.e., it is possible to buy goods in one market and sell them in another. This implies that there are no restrictions on international trade, either in the form of a ban on exports or imports, or in the form of quotas.
- **No Transportation Costs:** Strictly speaking, the Law of One Price would hold perfectly if there were no transportation costs involved, though there are some transactions (explained later) which bypass this assumption.
- **No Transaction Costs:** This law assumes that there are no transaction costs involved in the buying and selling of goods.
- **No Tariffs:** The existence of tariffs distorts the Law of One Price, which requires their absence to hold perfectly.

According to the law of one price, in equilibrium conditions, the price of a commodity has to be the same across the world. If it were not true, arbitrageurs would drive the price towards equality by buying in the cheaper market and selling in the dearer one, i.e. by two-way arbitrage. For example, if the cost of steel in Germany (in dollar terms) were \$300/tonne and in the US it were \$350/tonne, arbitrageurs would start buying steel in Germany to sell it in the US. This would increase the steel prices in Germany and reduce the US prices. This process will continue till steel becomes equally priced in both the countries.

The equalization of prices is possible only in perfect-market conditions, where there are no transportation costs and no restrictions on trade in the form of tariffs. In the presence of these two, the price of a commodity can differ in two markets by the quantum of transportation cost between the two countries and/or the amount of tariff imposed on the commodity. Continuing the earlier example, if the cost of transporting a tonne of steel from Germany to the US were \$25, the arbitrage would continue to take place only till the difference between the price of steel in the two countries was reduced to \$25. However, the process of the genuine buyers of a commodity buying from the cheaper market imposes stricter conditions on the prices in the commodity markets by driving the price to equality in the different markets. Hence, if the cost of transporting steel from the two markets to the buyer

country is the same, the price of steel will have to be the same in both the markets. If there is some difference in the transportation costs, then the price may differ to the extent of such difference in the transportation costs. Since this difference in transportation costs is expected to be less than the cost of transporting the commodity from one market to the other (Germany and the US in our example), the genuine buyers' preference brings the world prices of a commodity closer than is required by arbitrage. Even where arbitrage does not take place, the actions of genuine buyers make the world prices remain close.

We have seen that the price of any commodity has to be the same across countries, when they are expressed in the same currency everywhere (dollar price in our example). What about prices denominated in the local currencies? This is where the *law of one price* links exchange rates to commodity prices. According to this law, the domestic currency price of a commodity in various countries, when converted into a common currency at the ruling spot exchange rate, is the same throughout the world. So the price of a commodity in country A can be easily calculated by converting its price in country B's currency at the ruling spot exchange rate between the two countries' currencies. To continue our example,

$$P_{\text{Germany}} = S(\text{€}/\$) \times p_{\text{US}}$$

Where,

p_{Germany} is the price of steel in Germany

$S(\text{€}/\$)$ is the spot exchange rate between mark and dollar and

p_{US} is the price of steel in the US.

This equation can be generalized as:

$$p_A^x = S(A/B) \times p_B^x \quad (\text{Eq. 1})$$

Where,

p_A^x is the price of commodity 'x' in country A.

$S(A/B)$ is the spot exchange rate of the two countries' currency

p_B^x and is the price of commodity 'x' in country B.

There are three forms of PPP which emerge from the law of one price – the absolute form, the relative form and the expectations form.

The Absolute form of PPP

If the law of one price were to hold good for each and every commodity, then it will follow that:

$$P_A = S(A/B) \times P_B \quad (\text{Eq. 2})$$

Where,

P_A and P_B are the prices of the same basket of goods and services in countries A and B respectively.

Eq. 2 can be rewritten as:

$$S(A/B) = \frac{P_A}{P_B} \quad (\text{Eq. 3})$$

According to this equation, the exchange rate between two countries' currencies is determined by the respective price levels in the two countries. For example, if the cost of a particular basket of goods and services were Rs.2,125 in India and the same cost \$50 in the US, then the exchange rate between the rupee and the dollar would be $2,125/50 = \text{Rs.}42.50/\$$.

Absolute PPP makes the same assumptions as the Law of One Price. It also makes a few additional assumptions:

- No Transaction Costs in the Foreign Currency Markets: It assumes that there are no costs involved in buying or selling a currency.
- Basket of Commodities: It also assumes that the same basket of commodities is consumed in different countries, with the components being used in the same proportion. This factor, along with the Law of One Price, makes the overall price levels in different countries equal.

Though the explanation provided by the absolute PPP is very simple and easy to understand, it is difficult to test the theory empirically. This is due to the fact that the indexes used in different countries to measure the price level may not be comparable due to:

- The indexes being composed of different baskets of commodities, due to different needs and tastes of the consumers.
- The components of the indexes being weighted differently due to their comparative relevance.
- Different base years being used for the indexes.

Due to these reasons, these price indexes cannot be used to evaluate the validity of the theory.

The Relative form of PPP

The absolute form of PPP describes the link between the spot exchange rate and price levels at a particular point of time. On the other hand, the relative form of PPP talks about the link between the changes in spot rates and in price levels over a period of time. According to this theory, changes in spot rates over a period of time reflect the changes in the price levels over the same period in the concerned economies.

Relative PPP relaxes a number of assumptions made by the Law of One Price and the absolute PPP. These are:

- Absence of transaction costs
- Absence of transportation costs
- Absence of tariffs.

The relaxation of these assumptions implies that even when these factors are present, in certain conditions the relative PPP may still hold good. (These conditions are explained in a subsequent section). The relative form can be derived from the absolute form in the following manner:

Let \bar{S} (A/B) denote the percentage change in spot rate (expressed in decimal terms) between currencies of countries A and B over a year, and \bar{P}_A and \bar{P}_B denote the percentage change in the price levels (expressed in decimal terms), i.e. the inflation rates in the two countries over the same period of time. If

$$P_A = S(A/B) \times P_B \text{ (Eq. 2)}$$

then, at the end of one year,

$$P_A(1 + \bar{P}_A) = S(A/B) \{1 + \bar{S} (A/B)\} \times P_B (1 + \bar{P}_B) \quad (\text{Eq. 4})$$

Here, the left-hand side of the equation represents the price level in country A after one year, the first term on the right-hand side of the equation represents the spot exchange rate between the two currencies at the end of one year, and the last term gives the price level in country B after one year. These terms are arrived at by multiplying the figures at the beginning of the year by 1 plus the percentage change in the respective figures.

Dividing Eq. 4 by Eq. 2, we get

$$(1 + \bar{P}_A) = \{1 + \bar{S} (A/B)\} \times (1 + \bar{P}_B) \quad (\text{Eq. 5})$$

We can rewrite the equation as:

$$1 + \bar{S} (A/B) = \frac{1 + \bar{P}_A}{1 + \bar{P}_B}$$

$$\rightarrow \bar{S} (A/B) = \frac{1 + \bar{P}_A}{1 + \bar{P}_B} - 1 \quad (\text{Eq. 6})$$

$$\rightarrow \bar{S} (A/B) = \frac{\bar{P}_A - \bar{P}_B}{1 + \bar{P}_B} \quad (\text{Eq. 7})$$

Eq. 7 represents what is advocated by the relative form of the Purchasing Power Parity Principle. According to the equation, the percentage change in the spot rate (A/B) equals the difference in the inflation rates divided by 1 plus the inflation rate in country B. For example, if the inflation rate in India were 10% and that in the US were 3%, the Rs/\$ rate would change over a period of one year by $(0.10 - 0.03)/1.03 = 0.068$ i.e., 6.8%.

The effect of different inflation rates can be understood clearly from Eq. 6. Continuing the example of India and the US, a higher inflation rate in India than in the US makes the first term on the RHS of the equation greater than 1, and hence the RHS positive. A positive change in the Rs/\$ spot rate implies that one year hence, a dollar would command a higher number of rupees, i.e. the dollar would appreciate. It follows that a country facing a higher inflation rate would see its currency depreciating.

Going back to Eq. 7, we can see that the term $1 + \bar{P}_B$ is likely to be very small. For example, if the inflation rate is 3 percent, the term will be equal to 1.03. Hence, Eq. 7 can be approximated as:

$$\bar{S} (A/B) = \bar{P}_A - \bar{P}_B \quad (\text{Eq. 8})$$

According to Eq. 7.8, the exchange rate changes at a rate equal to the difference between the inflation rates in the two countries. So the Rs/\$ rate would change at 7% (i.e., $0.10 - 0.03$), which is close to the 6.8% arrived at earlier. However, it has to be kept in mind that higher the inflation figures, greater the difference between the figure arrived at from Eq. 7 and Eq. 8.

The relative form of PPP is superior to the absolute form in that the former is not affected by certain inefficiencies which prevent the latter from holding good. For example, suppose that due to transaction costs, the prices in country A were consistently lower by a fixed proportion, than those warranted by the absolute PPP. This can be written as:

$$P_A = S(A/B) \times P_B (1 - x) \quad (\text{Eq. 9})$$

with 'x' being the proportion by which the prices in country A are consistently lower. Then, at the end of the year

$$P_A (1 + \bar{P}_A) = S(A/B) \{1 + \bar{S} (A/B)\} \times P_B (1 + \bar{P}_B)(1 - x) \quad (\text{Eq. 10})$$

Dividing Eq. 10 by Eq. 9, we again get

$$(1 + \bar{P}_A) = \{1 + \bar{S} (A/B)\} \times (1 + \bar{P}_B)$$

Hence, the relative form of PPP does not get affected by consistent violations of the absolute form.

The Expectations form of PPP

According to this form of PPP, the expected percentage change in the spot rate is equal to the difference in the expected inflation rates in the two countries. This theory assumes that speculators are risk-neutral and markets are perfect. Let the expected percentage change in the spot rate be denoted by $S^*(A/B)$, the expected inflation rate in country A by P_A^* , and the expected inflation rate in country B by

P_B^* . If a person buys the underlying basket of commodities in country A and holds it for one year, he can expect to earn a return equal to the expected inflation rate in country A, i.e. P_A^* . On the other hand, if he decides to buy the same basket of commodities in country B, hold it for one year, and then convert his returns in currency B into currency A at the spot rate that is expected to rule at that time [i.e., $S^*(A/B)$], his expected returns will be equal to the expected inflation rate in country B, i.e. P_B^* , plus the expected change in the spot rate. If the speculators are risk-neutral, as this theory assumes, then these two returns should be equal, i.e.

$$P_A^* = P_B^* + S^*(A/B) \rightarrow S^*(A/B) = P_A^* - P_B^* \quad (\text{Eq. 11})$$

Eq. 11 is called the expectations form or the efficient markets form of PPP. As can be observed, it is similar to Eq. 8, with all the variables being expressed in expected terms. So, if the Indian inflation rate is expected to be 8% over the next year, and the US inflation rate is expected to be 2%, the Rs./\$ exchange rate can be expected to change by 6%.

One of the features of perfect markets is that people are expected to behave rationally. Rational behavior implies that expectations would reflect the true behavior of variables over the long-term. This, in turn, means that the expected change in the exchange rate and the expected inflation rates would equal the actual average change in the exchange rates and the actual average inflation rates. If this were true, then Eq. 11 holding good would imply that Eq. 8 also holds good in the long-term. Interpreted in another way, it also means that Eq. 11 may hold perfectly even if Eq. 8 does not, as long as the latter holds good on an average, over a long period.

Let us now see whether the purchasing-power parity principle is observed to hold in the real world.

Empirical Evidence Regarding PPP

A multitude of studies have been conducted over a number of years to verify whether the law of one price and the various forms of PPP actually hold good. These studies were conducted using various sets of data and various methods of testing. According to the findings of a study conducted by J David Richardson, the law of one price does not seem to hold good in the short-term, especially for goods having an inelastic demand (as these are the goods for which differential prices can be charged in different countries without the demand getting affected). In case of other goods, it does hold good, though only in the long-term.

As for the relative PPP, the results of the various studies have been quite conflicting. Irving B Kravis and Richard E Lipsey conducted a study and arrived at the conclusion that PPP does not hold precisely. They found that there were substantial departures over long periods even for traded goods, while for non-traded goods PPP does not seem to hold even over short periods. According to a study conducted by Hans Genberg, PPP does not seem to hold good either with fixed exchange rate regimes, or with flexible exchange rate regimes. Niels Thygesen's study points out that a change in spot rates is not reflected in a change in prices for quite a long period of time. One of the studies conducted by J Hodgson and P Phelps arrives at the conclusion that a change in prices does affect the exchange rate, though with a long time lag. Yet another study by Rogalsi and Vinso found that a change in prices gets immediately reflected in the exchange rate movements, as the forex markets are perfect and reflect all the available information with immediate effect.

Though highly conflicting results have been obtained by different studies, those based on the generally available data largely indicate that PPP does not hold good, i.e., the movements in exchange rates are not explained by movements in price levels, and vice versa. A major reason for this happening is that there are a number

of other factors which also affect the movements in exchange rates, especially in the short-term, which may dominate the effect of inflation. This limits the effect of price movements on the exchange rates. There are three other major reasons for the PPP not holding good.

Reasons for PPP not Holding Good

Earlier sections mention the assumptions applicable to the Law of One Price and to the various forms of PPP. If any of these assumptions does not hold good, the PPP would also not hold. Besides, even if PPP were actually holding good, the results of an empirical study could get affected by the statistical methods employed. These factors give rise to the following reasons for PPP not holding good:

- Constraints on movement of commodities.
- Price index construction.
- Effect of the statistical method employed.

CONSTRAINTS ON MOVEMENT OF COMMODITIES

As mentioned earlier, one of the constraints on movement of goods is transportation cost, either between the two countries producing the same commodity, or between the buyer country and the two producing countries. Another constraint is the presence of tariffs. These factors allow deviations in prices, and hence, a deviation from absolute PPP. At the same time, it was also shown earlier that if the quantum of deviation in prices on account of these factors is consistent over time, relative PPP may still hold.

One factor which affects both absolute as well as relative PPP, is the presence of quotas imposed on the amount of goods that may be exported from, or imported to a country. As this restricts the quantity of goods arbitrageurs can move from one place to another, it allows for deviations from prices which would reign, were PPP to hold good. Another such factor is the impossibility of moving some items from one place to another. These include perishable goods like milk and vegetables, immovable goods like land and buildings etc., and some kind of services such as those related to tourism. The immovability of such items allows their prices to deviate from one country to another. Product differentiation is another factor which allows different prices to exist for goods produced in different countries. For example, the price of apples grown in the US may be different from those grown in India because of the difference in the quality.

PRICE INDEX CONSTRUCTION

Movement in prices are generally measured by price indexes. Price indexes used in different countries are based on different baskets of commodities, with the proportions of the commodities in accordance with the usage and taste of the residents of the particular country. When these indexes are used to measure the movement in price levels, the results do not conform to PPP. Many a times, the base year of these indexes is different. While this does not hinder the use of these indexes for verifying relative PPP, these indexes become inappropriate for verifying absolute PPP.

EFFECT OF THE STATISTICAL METHOD EMPLOYED

There are two major ways in which the statistical method can affect the results of an empirical study. The first is through incorrect measurement of the difference in the inflation rates in the two economies. The second is through ignoring the fact that there is a two-way link between the spot exchange rate and inflation rates. Both the factors affect the other, i.e. while the inflation rates affect the exchange rates, the former also get affected by any change in the latter. Any statistical method which fails to recognize this two-way cause-effect flow, is likely to produce erroneous results.

The fact that PPP does not always hold good, gives rise to the concept of real exchange rate. The spot rate, adjusted for the change in price levels in the two countries during a specified period, gives the real exchange rate. Any change in the

real exchange rate is called the real appreciation or depreciation of the currency. One of the ways to calculate the real exchange rate is:

$$S_r(A/B) = S(A/B) \times \frac{I_B}{I_A}$$

Where,

$S(A/B)$ is the spot rate at a point of time,

I_A and I_B are the price indexes in the respective countries having the same base year,

and S_r is the real exchange rate.

For example, if the spot rate is Rs.42.50/\$, and the price index in India and the US is at 110 and 103 respectively, the real exchange rate will be

$$\begin{aligned} S_r &= 42.50 \times \frac{(103)}{(110)} \\ &= \text{Rs.}39.80/\$ \end{aligned}$$

If the real exchange rate in the base period (i.e. at the beginning of the period over which the relevant inflation rates are applicable) was Rs.40/\$, the rupee can be said to have appreciated in real terms.

INTEREST RATE PARITY (IRP)

The PPP gives the equilibrium conditions in the commodity market. Its equivalent in the financial markets is a theory called the Interest Rate Parity (IRP) or the covered interest parity condition. According to this theory, the cost of money (i.e., the cost of borrowing money or the rate of return on financial investments), when adjusted for the cost of covering foreign exchange risk, is equal across different currencies. This is so, because in the absence of any transaction costs, taxes and capital controls (i.e., restrictions on international investments and financing), investors and borrowers will tend to transact in those currencies which provide them the most attractive prices. Besides, the arbitrageurs will always be on the lookout for an opportunity to make riskless profits. The resultant effects on the demand and supply would drive the value of currencies towards equalization. This process is explained in detail in the following sections.

Just like the price of commodities across different countries influence the buyers' and sellers' decision as to where they should transact, the ruling interest rate on financial assets denominated in different currencies affect investors' and borrowers' decision regarding the market they would like to transact in. Let us start with the investors.

Investors' Decision

Any individual or corporate is unlikely to have fully-matched income and expenditures in each and every period. While there are periods where the current expenditure is more than the current income giving rise to a requirement to borrow, there are also periods where the opposite holds true giving rise to a chance to invest. These periods of surplus or shortfall may range from a few days to a few years. Suppose a corporate has surplus funds for a period of one year. It could either invest them in securities denominated in the domestic currency, or in securities denominated in any other currency. The returns it will earn if it invests in securities denominated in a foreign currency will depend on two factors – the interest rate on those securities, and the change in the value of the relevant currency. Suppose the currency in which the company's investments are denominated depreciates during the period of the investment. In that case, the gain by way of interest earned will stand eroded by the loss on conversion to the domestic currency. With the exchange rates being flexible, there is always the risk

of exchange rates moving unfavorably. Since an investment in securities denominated in the domestic currency does not face any exchange risk, the same risk will have to be removed from other investments as well, in order to make their returns comparable. The investor can do this by entering into a forward contract for the relevant maturity. By taking the forward rate into consideration, the investor will be able to know the total returns that can be earned on securities denominated in different currencies, which will enable him to invest where his returns are maximized.

Let us assume the domestic currency to be A and the foreign currency to be B. An investor can earn a return of r_A on domestic deposits, and a return of r_B on the foreign currency denominated securities. For making an investment in the latter, the investor will have to first convert his holdings in currency A into currency B. Let the spot rate at which this conversion takes place be $S(A/B)$. At the same time, let the relevant forward rate be $F(A/B)$. For every unit of currency A, the investor will get $1/S(A/B)$ units of currency B. This, when invested, will at the end of one year give

$$1/S(A/B) \times (1 + r_B) \text{ units of B}$$

These, when converted at the forward rate, will give

$$\frac{F(A/B)}{S(A/B)} \times (1 + r_B) \text{ units of A}$$

At the same time, an investment in the domestic currency will, at the end of one year, give

$$(1 + r_A) \text{ units of A.}$$

Now suppose that

$$(1 + r_A) > \frac{F(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq. 12})$$

In such a case, investors will prefer to invest in securities denominated in currency A rather than in currency B, as it would fetch them a higher return. If the opposite were true, i.e.

$$(1 + r_A) < \frac{F(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq. 13})$$

the investors will prefer to invest in securities denominated in currency B. The investors will be indifferent as to the choice of currency only if

$$(1 + r_A) = \frac{F(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq. 14})$$

i.e. the returns on both the investments were equal.

Let us see an example. Let us assume that

$$\begin{aligned} \text{Spot (Rs./\$)} &= \text{Rs.45/\$} \\ \text{RRs.} &= 14\% \\ r\$ &= 5\% \\ \text{1 year F(Rs./\$)} &= \text{Rs.49.2/\$} \\ \text{Investible funds} &= \text{Rs.1,000.} \end{aligned}$$

If the investor invests in a rupee deposit, at the end of one year he would have

$$\text{Rs.1,000} (1 + 0.14) = \text{Rs.1,140}$$

If instead, he wants to invest these funds in a dollar deposit, he would first need to convert his rupee holdings into dollars. The Rs.1,000 will fetch him

$$\text{\$} \frac{1,000}{45} = \$22.22$$

A dollar deposit of \$22.22 would, after one year, fetch

$$\$22.22 (1 + 0.05) = \$23.33$$

Converted into rupees at the forward rate, this would give

$$\text{Rs.}(23.33 \times 49.2) = \text{Rs.}1147.836.$$

Since the covered yield on the dollar deposit is higher than the rupee yield, the investor would like to invest money in the former.

Using Eq. 14, we can say that the forward rate at which the investor would be indifferent between the two deposits, would be where

$$\begin{aligned} F(\text{Rs./\$}) &= S(\text{Rs./\$}) \times \frac{(1 + r_{\text{Rs.}})}{(1 + r_{\$})} \\ &= 45 \times \frac{(1.14)}{1.05} = \text{Rs.}48.85/\$ \end{aligned}$$

An easier interpretation of Eq. 14 is possible. Let us subtract $(1 + r_B)$ from both sides of the equation. This gives us

$$(1 + r_A) - (1 + r_B) = \left[\frac{F(A/B)}{S(A/B)} \times (1 + r_B) \right] - (1 + r_B)$$

Solving the equation, we get

$$r_A = r_B + \frac{F(A/B) - S(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq. 15})$$

The RHS of Eq. 15 gives the covered yield on currency B. The second term on the RHS of the equation is nothing but the forward premium on currency B. Hence, investors will be indifferent between securities denominated in the two currencies when the domestic currency interest rate is equal to the foreign currency interest rate plus the forward premium on the foreign currency. If the former exceeds the latter, investors will prefer securities denominated in the domestic currency. In case the opposite is true, investors will prefer foreign-currency securities.

On expanding Eq. 15, we see that one of the figures is

$$\frac{F(A/B) - S(A/B)}{S(A/B)} \times r_B$$

which is the forward premium on the interest element. As this figure is likely to be miniscule (for example, if the interest rate is 5% and the forward premium is 4%, this figure will be 0.2%, i.e. 0.002), we may drop it without significantly affecting the accuracy and rewrite Eq. 15 as

$$r_A = r_B + \frac{F(A/B) - S(A/B)}{S(A/B)} \quad (\text{Eq. 16})$$

The difference between Eq. 15 and Eq. 16 is that the former takes into account the forward premium on the principal as well as the interest component, while the latter considers the forward premium only on the principal portion.

Till now we have considered the annual rates of interest and annual forward premium. If the investment is for a shorter period, Eq. 12 can be modified as

$$1 + \frac{r_A}{m} < \frac{F_n(A/B)}{S(A/B)} \times \left(1 + \frac{r_B}{m}\right)$$

Where,

r_A is the annualized return on currency A securities for maturity 'n'.

r_B is the annualized return on currency B securities for maturity 'n'.

F_n is the forward rate for maturity 'n'.

m is equal to $12/n$ where n is in months.

Here, it is assumed that the interest rate is compounded annually.

Similarly, Eq. 13 can be modified as

$$1 + \frac{r_A}{m} < \frac{F_n(A/B)}{S(A/B)} \times \left(1 + \frac{r_B}{m}\right)$$

Eq. 15 can be modified as

$$r_A = r_B + m \left[\frac{F_n(A/B) - S(A/B)}{S(A/B)} \right] \times \left(1 + \frac{r_B}{m}\right)$$

For example, if

$$S(\text{Rs./£}) = 75.95$$

Annualized return on a 3-month deposit in Rs. = 10%.

Annualized return on a 3-month deposit in £ = 5.8%.

$$3\text{-m } F(\text{Rs./£}) = 76.40$$

Then the covered yield on a £ deposit will be:

$$\begin{aligned} 0.058 + 4 \left[\frac{76.40 - 75.95}{75.95} \right] \times \left(1 + \frac{0.058}{4}\right) \\ = 0.082 = 8.2\%. \end{aligned}$$

Since the covered yield on pound deposit is lower than the yield on rupee deposit, the investor would prefer to invest in the rupee deposit.

Borrowers' Decision

When the need to borrow money arises, the borrower has the option to borrow in the domestic currency, or in foreign currency. Again, his decision will be based on the cost of domestic currency borrowing as compared to the covered cost of foreign borrowing.

For every unit of domestic currency borrowed, the borrower will have to pay at the end of the year

$$(1 + r_A) \text{ units of A.}$$

Borrowing 1 unit of A is equivalent to borrowing $1/S(A/B)$ units of currency B. At the end of one year, the borrower will have to repay

$$\frac{1}{S(A/B)} \times (1 + r_B) \text{ units of B.}$$

When converted at the forward rate, this gives

$$\frac{F(A/B)}{S(A/B)} \times (1 + r_B) \text{ units of A.}$$

Hence, the borrower will borrow in currency A if

$$(1 + r_A) < \frac{F(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq. 17})$$

On the other hand, he will borrow in currency B if

$$(1 + r_A) > \frac{F(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq. 18})$$

He will be indifferent to the choice of currencies if

$$(1 + r_A) = \frac{F(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq. 19})$$

Again, Eq. 19 can be rewritten as

$$r_A = r_B + \frac{F(A/B) - S(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq. 20})$$

As we see, Eq. 20 is the same as Eq. 15. Here, the RHS of the equation gives the covered cost of foreign currency borrowing.

Let us again take an example. Let

$$\begin{aligned} S(\text{Rs./\$}) &= \text{Rs.45.40/\$} \\ r_{\text{Rs.}} &= 10\% \\ r_{\$} &= 4\% \\ 1 \text{ yr } F(\text{Rs./\$}) &= \text{Rs.48.37/\$} \end{aligned}$$

If the borrower wants to borrow Rs.1,00,000 now, he may borrow either in rupees or in dollars. If he borrows in rupees, at the end of the year he would need to pay

$$\text{Rs.1,00,000} (1.10) = \text{Rs.1,10,000.}$$

If instead, he borrows in dollars, he will need to borrow

$$\frac{\$1,00,000}{45.40} = \$2202.64$$

At the end of the year, he would need to pay back

$$\$2202.64 (1.04) = \$2290.75$$

To repay these many dollars, he would need

$$\text{Rs.}(2290.75 \times 48.37) = \text{Rs.1,10,803.58}$$

As the covered cost of borrowing in dollars is higher than the cost of borrowing in rupees, the borrower would prefer to borrow in rupees. Again, from Eq. 19 we can say that the borrower would be indifferent between the two currencies if

$$\begin{aligned} F(\text{Rs./\$}) &= S(\text{Rs./\$}) \times \frac{(1 + r_{\text{Rs.}})}{(1 + r_{\$})} \\ &= 45.40 \times \frac{(1.10)}{(1.04)} \\ &= \text{Rs.48.37/\$} \end{aligned}$$

Covered Interest Arbitrage

In addition to investors and borrowers, one more class of players benefit from cost of money varying from one currency to another – the arbitrageurs. If Eq. 14 does not hold good, the arbitrageur can make riskless profits by borrowing in the cheaper currency and investing in the costlier, using the forward market to lock-in his profits. For example, if Eq. 12 were to hold good, the arbitrageur would borrow in the foreign currency, convert the receipts to the domestic currency at the on-going spot rate, and invest in the domestic currency denominated securities, while covering the principal and interest from this investment at the forward rate. At maturity, he would convert the proceeds of the domestic investment at the prefixed forward rate and pay-off the foreign liability, with the difference between the

receipts and payments serving as his profit. In case of Eq. 13 holding good, the arbitrageur would borrow in the domestic currency, convert it into foreign currency at the spot rate, invest the proceeds in foreign currency denominated securities, and cover the principal and interest from this investment at the forward rate, thus locking his domestic currency returns. This process of borrowing in one currency and simultaneously investing in another, with the exchange risk hedged in the forward market is referred to as covered interest arbitrage.

For example, if

$$S(\text{Rs./\$}) = 45.40$$

Annualized return on a 6-month deposit in Rs. = 12%

Annualized return on a 6-month deposit in \$ = 6%

$$6\text{-m } F(\text{Rs./\$}) = 47.31$$

Then, the covered yield on the dollar deposit will be

$$0.06 + 2 \left[\frac{47.31 - 45.40}{45.40} \right] \times \left(1 + \frac{0.06}{2} \right) = 0.1467 = 14.67\%.$$

As the covered yield on the dollar deposit is higher than the cost of borrowing rupee funds, the arbitrageur would borrow funds in the rupee market and invest them in the dollar market. Suppose he borrows Rs.1,000. He can convert them at the spot rate into

$$\text{\$ } \frac{1,000}{45.40} = \text{\$}22.02$$

Investing these, at the end of 6 months he will receive

$$\text{\$}22.02 \left(1 + \frac{0.06}{2} \right) = \text{\$}22.68$$

If these dollars are converted in the forward market, the arbitrageur will receive

$$\text{Rs. } (22.68 \times 47.31) = \text{Rs.}1,073$$

On the rupee borrowings, he will have to repay

$$\text{Rs.}1,000 \left(1 + \frac{0.12}{2} \right) = \text{Rs.}1,060.00$$

The arbitrageur can use the proceeds from the dollar investments to pay-off this liability. At the end of the process, he would have made a profit of

$$\text{Rs. } (1,073 - 1,060) = \text{Rs.}13$$

It follows from the above discussion, that whenever Eq. 15 is not satisfied, it will result in:

- Investors preferring investing in one currency over another;
- Borrowers preferring to borrow in one currency over another;
- Arbitrageurs borrowing in one currency and investing in another.

All these three activities result in the forex markets and money markets getting affected in a manner that makes the interest rates and exchange rates adjust, so that Eq. 15 becomes true. For example, if Eq. 12 were true, the above mentioned activities would result in:

- Foreign currency interest rate going up as a result of increased borrowing in that currency;
- Domestic interest rate falling as a result of increased investments in the currency;

- The spot rate falling due to increased supply of foreign currency in the spot market. For a given level of forward rate, this results in an increase in the forward premium on the foreign currency;
- The forward rate increases due to increased demand for the foreign currency in the forward market. For a given level of spot rate, this will result in an increase in the forward premium on the foreign currency.

The second factor will result in a reduction in the yield on domestic investments, while rest of the factors will result in an increase in the covered cost of borrowing in the foreign currency. This process will continue till the inequality is removed and Eq.15 satisfied.

Now suppose that Eq.13 held good. The opposite process will make the cost of domestic borrowing go up and the covered yield on foreign investments come down. This will keep happening till the equality between the yields is restored.

Thus, at any point of time, the market forces will make sure that

$$r_A = r_B + \frac{F(A/B) - S(A/B)}{S(A/B)} \times (1 + r_B)$$

or,

$$r_A - r_B + \frac{F(A/B) - S(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq.21})$$

Eq.21 is referred to as the Covered Interest Rate Parity Condition. When this condition holds good, investors and borrowers have no preference regarding the currency they would like to deal in, and there is no possibility of arbitrage profits. If we observe the approximate equivalent of Eq.15, i.e. Eq.16, we find that

$$r_A - r_B + \frac{F(A/B) - S(A/B)}{S(A/B)} \quad (\text{Eq.22})$$

i.e., forward premium on a currency will be equal to the difference in the interest rates on the two currencies, known as the interest rate differential. There can be various combinations of changes in the four variables, which can bring about an equilibrium across the money and forex markets. The effects of the equalization process described above, in terms of the quantum of change that will occur in each of the variables, depends on the liquidity of the individual markets. The less liquid the market, the greater will be the impact borne by it. Throughout the world, the spot market and the money market are generally observed to be more liquid than the forward market. This makes the forward market absorb most of the required changes. Hence, we can deduce that the interest rate differential determines the forward premium, rather than the opposite being true.

RELATIONSHIP BETWEEN PPP AND INTEREST RATE PARITY

Uncovered Interest Parity Condition

In the previous chapter it was observed that if risk were ignored, then the expected spot rate would be equal to the forward rate. It follows from Eq.14 that

$$(1 + r_A) = \frac{S^\pi(A/B)}{S(A/B)} \times (1 + r_B) \quad (\text{Eq.23})$$

Where,

$S^\pi(A/B)$ is the expected spot rate at the end of one year.

By definition, $S^\pi(A/B) = S(A/B) \times \{1 + S^*(A/B)\}$

Where,

$S^*(A/B)$ is the expected percentage change in the spot rate.

Hence, Eq. 23 can be written as

$$(1 + r_A) = \{1 + S^*(A/B)\} \times (1 + r_B)$$

Solving, we get,

$$1 + r_A = 1 + S^*(A/B) + r_B + \{S^*(A/B) \times r_B\}$$

Since the last term on the right-hand side is likely to be very small, we may ignore it and get the approximate equivalent equation:

$$r_A = S^*(A/B) + r_B$$

or,

$$r_A - r_B = S^*(A/B) \quad (\text{Eq. 24})$$

Eq. 24 is referred to as the uncovered interest parity condition or the International Fisher effect. According to it, the expected percentage change in the spot rate should be approximately equal to the interest differential.

The Fisher Effect

The interest rate which we have been using till now is the nominal interest rate. The nominal interest rate does not represent the real increase in the investor's wealth, as the increase is subject to the inflation rate. The real increase is reflected by the real interest rate, a concept made popular by Irving Fisher. According to Fisher, the nominal interest rate is a combination of the real interest rate and the expected rate of inflation. More explicitly, the Fisher effect or the Fisher equation states that

$$1 + r = (1 + i) \times (1 + P^*)$$

Where,

r = nominal rate

i = real rate

P^* = expected inflation rate

Solved, it gives

$$r = i + P^* + (i \times P^*)$$

Since the last term will be quite small, we can say that on an approximate basis,

$$r = i + P^*$$

i.e., the nominal rate is equal to the real rate plus the expected inflation rate.

The Relationship

According to the expectations form of the PPP,

$$S^*(A/B) = P_A^* - P_B^* \quad (\text{Eq. 11})$$

According to the uncovered interest rate parity condition,

$$S^*(A/B) = r_A - r_B \quad (\text{Eq. 24})$$

It follows that

$$r_A - r_B = P_A^* - P_B^*$$

Rearranging, we get

$$r_A - P_A^* = r_B - P_B^* \quad (\text{Eq.25})$$

Eq. 25 is the Fisher open condition. It says that the nominal interest rates minus the expected inflation rates, i.e., the real interest rates are equal across different countries. Intuitively also, the real interest rates should be equal across countries, otherwise the resultant capital flows will bring them to equality.

It can be observed that any of the three equations can be derived from the other two. If we assume two of them to hold good, it will automatically follow that the third also holds good. So, if we assume that the Fisher open condition and the expectations form of PPP hold good, we will be implicitly assuming that uncovered interest parity also holds good. Similarly, if uncovered interest parity is assumed to be true and the real interest rates are expected to be equal across different countries, it is implied that expectations form of PPP is assumed to be true.

REASONS FOR DEPARTURE FROM INTEREST RATE PARITY

While introducing the topic of interest rate parity, it was mentioned that this theory holds good in the absence of a few factors like taxes, capital control and transaction costs. In reality, the presence of these factors allow interest rates and forward premiums to deviate from the covered IRP. Covered IRP does not hold good perfectly because of the following reasons:

- Transaction costs
- Political risks
- Taxes
- Liquidity preference
- Capital controls.

Transaction Costs

The process which brings interest rates and exchange rates into line, involves investing in one market and/or borrowing in another, and converting one currency into another. The transaction cost involved in money market operations is the difference between the investment and the borrowing rate. The bid-ask spread is the cost involved in conversion of currencies. The deviations from the IRP have to exceed these costs in order to make dealing in the foreign markets (both currency markets and money markets) profitable. Hence, the presence of these costs allow deviations up to the costs involved.

The arbitrage process discussed earlier, also referred to as the round-trip arbitrage, allows the maximum deviations from the parity. This is because the arbitrageur has to bear the bid-ask spread as well as the money market costs. The arbitrageur borrows in one market to invest in the other. While he has to pay the higher interest applicable to borrowings, he receives the lower interest rate applicable to investments. After borrowing one currency, he converts it into the other currency, and reconverts the currency on maturity. In the process, he receives the lower 'bid' rate while selling, and has to pay the higher 'ask' rate while buying a currency. These costs, together, allow a huge deviation from IRP.

Yet, the process of round about arbitrage imposes certain limits on these deviations. Let us see how. Let the investment rate in currency A be r_A^I and that in currency B be r_B^I . Let the borrowing rate in the two currencies be denoted by r_A^B and r_B^B respectively. Assuming that the arbitrageur borrows in currency A and invests in currency B, the arbitrage process would be as follows. The arbitrageur would borrow one unit of currency A. This one unit would fetch him

$$\frac{1}{S(A/B)_{\text{ask}}} \text{ units of B.}$$

The arbitrageur would invest these units at r_B^I , let's say for one year. At the end of the year he would get

$$\frac{1}{S(A/B)_{\text{ask}}} \times (1 + r_B^I) \text{ units of B.}$$

In the forward market, this would fetch

$$\frac{F(A/B)_{bid}}{S(A/B)_{ask}} \times (1 + r_B^I) \text{ units of A.}$$

Since the arbitrageur would borrow at r_A^B , he would have to repay

$$(1 + r_A^B) \text{ units of A.}$$

The no-arbitrage condition would be where the arbitrageur cannot make any profit out of the process, i.e. where

$$1 + r_A^B \geq \frac{F(A/B)_{bid}}{S(A/B)_{ask}} \times (1 + r_B^I)$$

This can be rewritten as:

$$r_A^B \geq r_B^I + \left[\frac{R(A/B)_{bid} - S(A/B)_{ask}}{S(A/B)_{ask}} \right] (1 + r_B^I) \quad \text{Eq. (26)}$$

Now suppose that the arbitrageur borrows in currency B and invests in currency A. For every one unit of currency B borrowed, he will get,

$$S(A/B)_{bid} \text{ units of A}$$

When invested in currency A at r_A^I , it will fetch

$$S(A/B)_{bid} \times (1 + r_A^I) \text{ units of A.}$$

Converted in the forward market it will yield

$$\frac{S(A/B)_{bid}}{F(A/B)_{ask}} \times (1 + r_A^I) \text{ units of B.}$$

Since the arbitrageur borrowed in currency B at r_B^B , he will have to repay

$$(1 + r_B^B) \text{ units of B.}$$

Again, the no arbitrage condition would be where the arbitrageur cannot make any profits, i.e. where

$$\frac{S(A/B)_{bid}}{F(A/B)_{ask}} \times (1 + r_A^I) \leq (1 + r_B^B)$$

$$\Rightarrow 1 + r_A^I \leq \frac{F(A/B)_{ask}}{S(A/B)_{bid}} \times (1 + r_B^B)$$

This can be rewritten as:

$$r_A^I \leq r_B^B + \left[\frac{F(A/B)_{ask} - S(A/B)_{bid}}{S(A/B)_{bid}} \right] (1 + r_B^B) \quad \text{(Eq. 27)}$$

Let us see an example. Suppose

$$S(\text{Rs./\$}) = 45.40/45.65$$

$$1 - \text{yr } F(\text{Rs./\$}) = 49.65/50.15$$

$$r_{\text{Rs}}^I = 10\%$$

$$r_{\text{Rs}}^B = 15\%$$

$$r_{\$}^I = 4\%$$

$$r_{\$}^B = 6\%$$

The covered cost on dollar borrowing would be:

$$0.06 + \left[\frac{50.15 - 45.40}{45.40} \right] (1 + 0.06) \\ = 0.1709 = 17.09\%$$

As r_{Rs}^I at 10%, is less than the cost of borrowing dollar funds, no arbitrage opportunity exists.

The covered yield on dollar deposits would be:

$$0.04 + \left[\frac{49.65 - 45.65}{45.65} \right] (1 + 0.04) \\ = 0.1311 = 13.11\%.$$

Again, as the covered yield on dollar deposits is less than the cost of rupee borrowings (15%), no arbitrage opportunity exists.

Investors and borrowers face a lower cost, in that their decision is affected only by the bid-ask spread. Whichever currency they choose to invest in, investors will receive the rate applicable to investments, which makes the presence of money market costs irrelevant for them. Similarly, the choice of currency is not affected by the money market cost for borrowers, as they have to invariably pay the interest rate applicable to borrowings. Both investors and borrowers are, however, affected by bid-ask spreads. If an investor chooses to invest in a foreign currency, he will first have to convert his domestic currency holdings into foreign currency, and enter into an opposite transaction at maturity. This reduces his net returns by the bid-ask spread he has to face. If a borrower decides to borrow in a foreign currency, he has to first convert it into his domestic currency, and then buy it at maturity. This increases his cost by the bid-ask margin. Hence, the deviation from the parity has to be more than the bid-ask spread, in order to provide a profitable opportunity to the players in these two classes. The deviation allowed by the presence of these players is lesser than that allowed by the round-trip arbitrage process.

The limits imposed by these transactions on the possible deviations can be worked out in the following manner. If an investor decides to invest one unit in currency A, he would get

$$(1 + r_A^I) \text{ units of A.}$$

If, instead, he would like to invest in currency A, he would first have to convert his holdings into currency B. For every unit of currency A, he would get

$$\frac{1}{S(A/B)_{ask}} \text{ units of B.}$$

When invested at r_B^I , this would yield

$$\frac{1}{S(A/B)_{ask}} \times (1 + r_B^I) \text{ units of B.}$$

Converted in the forward market, it would be equal to

$$\frac{F(A/B)_{bid}}{S(A/B)_{ask}} \times (1 + r_B^I) \text{ units of A.}$$

The market forces would force the two yields to equality. Hence,

$$1 + r_A^I = \frac{F(A/B)_{bid}}{S(A/B)_{ask}} \times (1 + r_B^I) \quad (\text{Eq. 28})$$

Similarly, the borrowing activities of the market players would force the following equality:

$$1 + r_A^B = \frac{F(A/B)_{ask}}{S(A/B)_{bid}} \times (1 + r_B^B) \quad (\text{Eq. 29})$$

As we see, the money market costs are no longer relevant, but deviations from Eq. 14 are still possible due to the bid-ask spread in the forex markets.

One more kind of process is possible in these markets. It involves players who have a pre-set need to convert one currency into another, sometime in the future. Suppose a person has foreign currency receivables in the future. He has two choices. One is that he can convert them in the forward market at the forward bid rate. The other option open to him, is to borrow in the foreign currency for a period which matches the maturity of the original receivable (at the foreign currency borrowing rate), convert the proceeds at the spot bid rate, invest the domestic currency equivalent in the domestic money markets at the domestic investment rate, and use the proceeds of the receivable to pay-off the foreign currency borrowing. The arbitrageur will, in this case, not face the bid-ask spread, in that he will be converting at the bid rate, whether he converts spot or forward. He will, however, face the money market cost. Similarly, a person having a foreign currency payable in the future may either lock-in his cost through the forward market, or borrow in the domestic markets, convert the proceeds at the spot ask rate, invest in the foreign currency markets, and pay-off the payable from the realizations of the investment. He will, thus, face only the money market costs. Hence, the deviations from the parity have to exceed the money market costs, to present profitable opportunities to the players. This deviation is again lesser than the one allowed by two-way arbitrage.

The tightest conditions are imposed by the process of one-way arbitrage. This involves the players who need to convert a present holding of the domestic currency into foreign currency in the future, or a future holding of a foreign currency into a domestic currency holding in the present (or vice versa). Let us understand the process in an elaborate manner.

If a person is holding currency A at time t_0 , and needs currency B at time t_1 , there are two ways in which he can make the conversion. He can either invest in currency A (at the investment rate) for the required maturity and lock-in the conversion rate at the forward ask rate for currency B, or can convert at the spot ask rate and invest the proceeds in currency B denominated securities (at the investment rate). Going by the first method, for every unit of currency A held and invested at time t_0 , the investor gets

$(1 + r_A^I)$ units of A at time t_1

Where r_A^I is the investment rate for currency A

These units will be converted into

$$\frac{(1 + r_A^I)}{F(A/B)_{ask}} \text{ units of B.} \quad (\text{Eq. 30})$$

By the second method, each unit of A will get converted into

$1/S(A/B)_{ask}$ units of B at time t_0

These units, when invested, will yield

$$\frac{1}{S(A/B)_{ask}} \times (1 + r_B^I) \quad (\text{Eq. 31})$$

The market forces will drive Eq. 30 and Eq. 31 to equality. Hence,

$$\begin{aligned} \frac{(1 + r_A^I)}{F(A/B)_{ask}} &= \frac{(1 + r_B^I)}{S(A/B)_{ask}} \\ \Rightarrow (1 + r_A^I) &= \frac{F(A/B)_{ask}}{S(A/B)_{ask}} \times (1 + r_B^I) \end{aligned} \quad (\text{Eq. 32})$$

If the bid-ask spread in the spot and forward market were the same, Eq. 32 would become equivalent to Eq. 14. The transaction costs would become irrelevant, as

the investor would have to bear the same cost in the conversion of currencies, whether he uses the spot market or the forward market. As he pays the ask rate both the ways, the cost would become irrelevant, if both the margins were equal. The money market costs also become irrelevant since the investor earns the investment rate, whichever market he invests in. Hence, the transaction costs become irrelevant and IRP holds precisely due to the presence of these players.

In reality, however, the bid-ask spread increases with maturity (as observed in the previous chapter). This results in the transaction costs not getting canceled out totally, and leaves scope for a possible deviation from the parity.

We shall now evaluate the other possibility, i.e. a person (e.g., an exporter) expects to receive currency B at time t_1 and needs currency A at time t_0 . There are again two ways to do the conversion. The market player can borrow in the foreign market and convert in the spot market, using the receipts in B at t_1 to pay-off the borrowing. Otherwise, he can borrow in the domestic market and convert the receipts using the forward market, paying off the borrowings from the proceeds. The first way, for every unit of currency A needed at t_0 , he will have to borrow

$$1/S(A/B)_{\text{bid}} \text{ units of B}$$

At t_1 , he will have to repay

$$\frac{(1+r_B^B)}{S(A/B)_{\text{bid}}} \text{ units of B} \quad (\text{Eq. 33})$$

The second way, for every unit of A borrowed at t^0 , the arbitrageur will have to pay at t_1

$$(1+r_A^B) \text{ units of A}$$

This will require

$$\frac{(1+r_A^B)}{F(A/B)_{\text{bid}}} \text{ units of B} \quad (\text{Eq. 34})$$

Again, market forces will drive Eq. 33 and Eq. 34 to equality. So,

$$\frac{(1+r_A^B)}{F(A/B)_{\text{bid}}} = \frac{(1+r_B^B)}{S(A/B)_{\text{bid}}} \quad (\text{Eq. 35})$$

Again, the money market costs become irrelevant as the borrowing rate has to be paid irrespective of the market borrowed in. Similarly, the forex market costs would no longer be relevant if the bid-ask spreads in the spot and the forward market were the same. In such a situation, Eq. 35 would become equivalent to Eq. 14, and interest parity would hold perfectly. But as we have seen, the spreads increase with maturity, making it possible for the variables to move a bit away from the parity equation, without leaving any scope for arbitrage. However, the departures allowed by these activities are very small, compared to those allowed by round-trip arbitrage or the investment or borrowing processes.

In this way, transaction costs allow for departures from the interest rate parity.

Political Risks

Investment in a foreign currency denominated security can be made in two ways. One is, investing directly in securities issued in the country to which the currency belongs. For example a US citizen may invest in T-bills issued by the Government of India. The other way is to invest in deposits denominated in the foreign currency held domestically, or in some third country. For example a French citizen may hold a dollar deposit with a London bank. In the second case, the investor faces only the currency risk. In the first case, the investor faces the political risk as well. It is the risk of any change in the foreign country's laws or policies that affect

the returns on the investment. It may take the form of a change in the tax structure, or a restriction on repatriation of proceeds of the investment, or a sudden confiscation of all foreign assets, among other things. This additional risk makes the investors require a higher return on foreign investments than warranted by the interest parity. This factor allows deviations from the parity to take place.

While generally it is the foreign investment which has a higher political risk attached to it and hence requires a higher return, sometimes it is the other way round. Residents of a country which is politically very unstable may like to invest in a relatively stable country, even when there is an interest disadvantage. This would again allow deviations from the IRP, this time on the other side.

Despite the presence of additional political risk in foreign investments, the presence of third country investors may push the variables towards the parity. This would happen due to the fact that they may perceive the additional risk as equal between the two countries, and would have to take it on irrespective of which of the two countries they invest in. Hence, they may require an equal risk premium on either side of the parity, thus disallowing any variation from it.

The factor of political risk generally affects only the investment decisions, as no country is likely to change its laws or policies in a way which would make it difficult for the borrower to repay his obligations. Yet, it is a strong enough factor to allow deviations from the parity line.

Taxes

Taxes can affect the parity in two ways – through withholding taxes, and through differential tax rates on capital gains and interest income. The following section analyzes these factors.

Withholding Taxes

Generally, any resident making a payment to a foreign resident is required to withhold a part of that payment as taxes, and pass it on to the tax authority of his country. To that extent, foreign currency earnings of an investor stand reduced, permitting a deviation from the interest parity up to the extent of the tax withheld. Normally, this factor gets canceled out if the investor receives a tax credit from his government for the amount paid as withholding taxes. Hence, it affects the parity only if the tax credit is not given, or if it is less than the amount paid as withholding taxes.

Differential Tax Rate

Deviations from the interest parity are possible if the earnings on account of transactions in foreign currency are treated as capital gains, and hence are taxed at rates different from the rates applicable to interest income. Suppose an investor pays tax on capital gains at the tax rate t_c , and on normal income at t_y . Then, for that investor the interest parity line will be given by

$$r_A - r_B = \frac{1 - t_c}{1 - t_y} \left[\frac{F(A/B) - S(A/B)}{S(A/B)} \right] \times (1 + r_B) \quad (\text{Eq. 36})$$

Hence, if

$$\frac{1 - t_c}{1 - t_y} > 1$$

i.e., the capital gains tax rate is lower than the income tax rate, then there would be a premium attached to investing in those foreign currencies which are at a premium. Also, borrowers would like to borrow in a foreign currency which is at a discount.

The differential tax structure normally changes the parity line for only those players who need to convert currencies occasionally. The major players in the forex markets, i.e. the banks, do not face this differential tax rate as they frequently deal in the market, and hence any earnings on account of a change in the exchange

rates is taken as a normal business income for them and taxed accordingly. Hence, the IRP is not affected by this factor. As a result, the infrequent players get an arbitrage opportunity which is not available to the major players. They get a chance to benefit by denominating their investments and borrowings in the currency that provides them the tax advantage.

Liquidity Preference

An asset's liquidity is measured by the quickness with which it can be converted into cash, at the least possible cost. While the time that is taken to liquidate a foreign investment may be the same as that taken for liquidating a domestic investment, the costs involved are different. Suppose an investment is liquidated before maturity. There will be some costs involved in the process which are likely to be the same for both kinds of investments. But there is an additional cost involved in liquidating covered foreign investments before maturity. It is the cost of canceling the cover (i.e., canceling the forward contract), which was explained in the previous chapter.

The presence of this cost makes the investors require a premium over the interest parity for making foreign investments. The amount of this premium would depend on the liquidity needs of the investors. The higher the expectation that the investment may have to be liquidated before maturity, the higher will be the required premium. The possibility of raising short-term finance from alternate sources also has an effect on the required premium. If such alternate sources are available, it is likely to reduce the premium demanded by the investors.

Capital Controls

The factors mentioned above are likely to cause only small deviations from covered interest parity. The most important cause of large deviations from the parity is the presence of capital controls. Capital controls include restrictions on investing or borrowing abroad and on repatriation of investments made by foreign residents. It also includes restrictions on conversion of currencies. These controls restrict the market forces from bringing the interest rates and exchange rates in line with the parity. As a result of these controls, the interest rates in the euro-market (where these regulations do not apply) are more in line with the parity, than the domestic interest rates in different countries.

SUMMARY

- Though the market forces, if left free, have the potential to bring the prices of various commodities (including money) in line internationally, various practical factors impede the process.
- As a result, prices, interest rates and exchange rates are observed across countries, which do not fall in line with the parity conditions. Despite these factors, a long-term trend is observed whereby the various variables are generally seen moving towards the parities. Hence, these parities are also considered along with other factors by the market players, while trying to forecast exchange rates.
- The more formal models of exchange rate forecasting form the substance of the next chapter.

Chapter VIII

Exchange Rate Forecasting

After reading this chapter, you will be conversant with:

- Forward Rate as a Predictor
- The Demand-Supply Approach
- The Monetary Approach
- The Asset Approach
- Portfolio Balance Approach
- Role of a News as a Determinant
- Technical Analysis

A plethora of factors affect the levels of, and movements in exchange rates, often in a conflicting manner. A number of theories were propounded to explain these effects. Though a consistent prediction of the exact level of future exchange rates is impossible, these theories help in forecasting the possible direction of the movement. Such forecasting is very important for players in the international markets, as the exchange rates have a great impact on their profits. Another set of players for whom correct exchange rate forecasting is vital, are the speculators. Their forecast about the movement in exchange rates propels them to undertake speculative activities, especially when their expectations are against those of the market. Though speculators are generally ill-known for the destabilizing effects of their activities on financial markets, they are actually the liquidity providers of the markets. Also, as their views are generally opposite to the market's views, they stabilize the markets by forming the other (than the market's) side of the demand-supply forces.

The following models of exchange rate forecasting are being covered in this chapter:

Forward rate as an unbiased predictor of future spot rates

- The demand-supply approach
- The monetary approach
- The asset approach
- The portfolio balance approach
- News as the determinant of exchange rates
- Technical analysis.

FORWARD RATE AS A PREDICTOR

As discussed in chapter 6, forward rate is expected to be an unbiased predictor of the future exchange rate. There are two criteria for judging the effectiveness of a forecasting tool – its accuracy and its unbiasedness. A forecasting tool is said to be accurate if the forecast generated proves to be in accordance with the actual future values of the concerned variable, with minor forecasting errors. An unbiased estimate is, where the probability of an overestimate is the same as the probability of an underestimate. This makes the forecast accurate on an average.

Various empirical studies have concluded that forward rates are indeed unbiased predictors of future spot rates, where the markets are competitive. For the market to be competitive, the concerned currencies should be freely floating and heavily traded. The presence of central bank intervention reduces the efficiency of the market. There is no evidence to support that the forward rates are accurate predictors of future rates. One possible reason for the inaccuracy of the forward rates is, that at any point of time, the forward rate reflects expected developments in the variables affecting the exchange rates. On the other hand, the actual future spot rates are affected by all the expected and unexpected developments. As the unexpected developments cannot be factored in the forward rates, the estimates based on these are normally inaccurate. Due to this, the shorter the time gap, the more accurate the forecast based on forward rates is expected to be. Further, a speculator who takes a forward position runs the risk of losing if the actual spot rate turns out to be adverse. Hence, the risk undertaken tends to be compensated with a risk premium.

THE DEMAND-SUPPLY APPROACH

It has been mentioned in the previous chapters that a currency's exchange rate is determined by the overall supply of and demand for that currency. According to this view, changes in exchange rates can be forecasted by analyzing the factors that affect the demand and supply of a currency. Since these factors are listed out in the balance of payments account, this approach is also referred to as the balance-of-payments approach.

When the exchange rates are fixed, the effect of other factors is balanced by official demand or supply, which helps in preventing the movement of the exchange rate. In case of a flexible exchange rate regime, however, any change in other factors results in a movement in the exchange rate. Since it is the flow of payments into and out of a country caused by these factors which is recorded in the BoP account, a forecast of exchange rate movements based on this approach takes into account the flow of demand and supply of currencies. Let us now see how exchange rate movements can be forecasted in accordance with this approach.

The demand curve of a currency is mainly derived from the country's supply curve of exports. The supply of a currency is derived mainly from the country's imports. Other factors affecting the value of a currency are trade in services, income flows (i.e. flows on account of interest, dividends, rents and profits), transfer payments and foreign investments. While an exogenous increase in exports has the effect of appreciating the domestic currency, an exogenous increase in imports results in depreciating the local currency. A change in the level of trade in services has a similar effect.

As mentioned previously, income flows depend on past investments and the current rate of return that can be earned on these investments. Hence, an expected change in the rate of returns can be used to predict the direction of exchange rates. Any change resulting in a reduction of an inflow would depreciate a currency, while a reduction of an outflow would appreciate the domestic currency.

Similarly, an increase in net transfers out of the country result in a depreciation of the currency and vice versa. An increase in the net inflows on account of foreign investments has two effects. While the domestic currency appreciates at the time of the inflow, its supply increases in the future periods on account of the interest, dividends, profits or rent earned by that investment and repatriated. The two factors affect the forecast of the exchange rates in the relevant periods accordingly. Another important factor needed to be considered here is the expected change in earnings from foreign investments. Earnings from foreign investments have two components – the interest rate or the income out of the investment itself, and the expected income arising from a change in the value of the currency (which would be realized at the time of liquidation of the investment). The second component is affected by any expected change in the value of the currency. Hence, if a country's currency is expected to appreciate in the future, it is likely to attract more foreign investment, thus resulting in the currency's appreciation now. So a future expectation of a change in the currency's value gets reflected in a current change in its value.

Let us now understand how other economic variables are expected to influence the exchange rate. One of the most important economic variables affecting exchange rates is the relative price levels in the respective countries. According to this approach, a relatively higher inflation affects the relative prices of that country's exports and imports. This results in the exports coming down and the imports increasing, thus depreciating the currency. This approach, thus, supports the PPP. This approach also supports the IRP, as it says that an increase in domestic interest rates would attract more foreign investments, and thus result in an appreciation of the currency.

An increase in the national income or the GNP increases the spending capacity of the residents of a country. This results in an increased demand, both for domestically produced goods and imports. With exports remaining at the same level, the current account worsens. This makes the currency of that country depreciate.

According to this theory, money supply increase also has a negative effect on the value of a currency. An increase in money supply will mean that more money will be chasing the same amount of goods (as the increase in the production of goods will not take place in the short run). This would cause the price level to increase. A higher inflation will depreciate the local currency.

An important aspect of this theory is, that the mechanism employed to explain exchange rate changes implies that any change in the value of a currency is only an instrument to correct the temporary imbalance in the system. For example, if a currency depreciates due to the country experiencing a relatively higher inflation than its trading partners, the depreciation reduces the foreign currency price of the country's exports and thereby restores the competitiveness of the exports. At the same time, the imported goods are made more expensive by the depreciation, thereby reducing imports. This improves the current account balance. But sometimes it is observed that this does not happen. Despite a depreciation, the current account balance continues to worsen. This results in instability in the exchange markets as well. This phenomenon is called the J-curve effect. According to this, when both imports and exports are price inelastic in the short run but price elastic in the long run, volume of exports and imports do not immediately respond to the change in relative prices of exports and imports, caused by depreciation of home currency. This leads to deterioration in the Balance of Trade (and hence, BoP) for the home country. This makes the currency depreciate further. This happens because it takes people some time to adjust to the change in relative prices. Despite a higher price of imports, people change-over to import substitutes only after a time lag. Similarly, it takes time for the producers of exported goods to increase their production of these goods, and for the foreign consumers to start consuming more of these goods. Till such time that the exports go up and the imports come down, the trade balance continues to worsen and the domestic currency continues to depreciate. After this time lag, the current account balance improves and the exchange rate stabilizes. Inelasticities of export supply and import demand curves also explain the opposite phenomenon – the trade balance continuing to become stronger despite an appreciation of the currency. These two conditions are shown in figure 1 and figure 2. As can be observed, the path followed by the trade balance forms a J (an inverse J in the latter case), thus giving its name to this phenomenon.

Figure 1: The J Curve after Depreciation

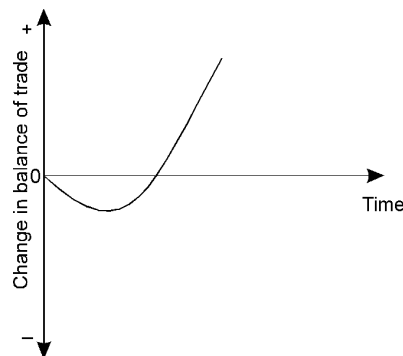
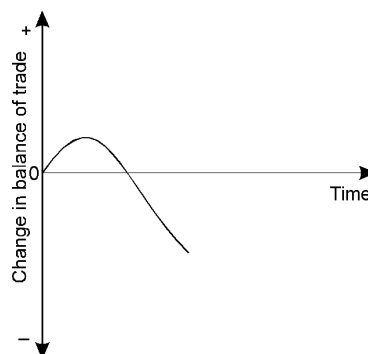


Figure 2: The J Curve after Appreciation



When the import demand and the export supply curves behave in the manner as implied by these figures, the supply curve of the currency becomes downward sloping (instead of the upward sloping curve). This introduces instability in the exchange markets. Let us see how. Consider figure 3. The S_{RS} and the D_{RS} represent the supply and demand for rupee against the dollar, with the equilibrium exchange rate between the dollar and the rupee being represented by $S^e(\$/Rs)$. According to this figure, any small appreciation in the value of the rupee (i.e. an upward movement of the exchange rate from the equilibrium exchange rate) results in the demand for rupees exceeding the supply, and hence a further appreciation of rupee. Similarly, any small depreciation of rupee sees a higher supply of rupee than the demand, and hence a further depreciation. This makes the exchange markets extremely unstable. Now consider figure 4. Here, despite the supply curve being downward sloping, any movement of the exchange rate away from the equilibrium results in the market forces forcing it back to equilibrium point. An appreciation of the rupee sees a higher supply than demand, thus lowering the exchange rate. A depreciation faces a higher demand, forcing the exchange rate to move up. In this figure, the forex markets are stable despite a downward sloping supply curve of the currency. This is so because in figure 4, the demand curve is flatter, and hence more elastic than the supply curve. It is the opposite case in figure 3. It follows that for the exchange markets to be unstable, the demand curve for a currency has to be relatively less elastic than the supply curve, with the supply curve being downward sloping. This happens when the import demand curve is inelastic, with the export supply curve being even more inelastic. If the export supply curve is less inelastic than the import demand curve, the increase in the value of exports would more than compensate the short run increase in the value of imports (with the value of imports increasing due to the increase in price of imports more than offsetting the decrease in the quantity of imports due to the inelasticity). In the opposite case, the increase in the value of the exports would not be able to compensate the increase in the value of imports, thus giving rise to the J-curve and instability in the exchange markets. When represented in terms of elasticities of export supply and import demand curves, the conditions state that the two elasticities should together be greater than one to avoid exchange market instability. This is called the Marshall-Lerner condition.

Figure 3: Unstable Market

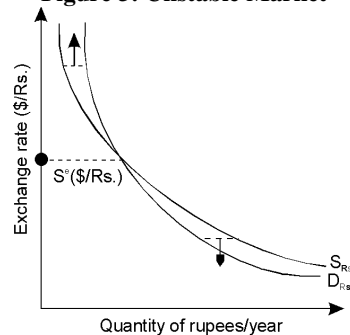
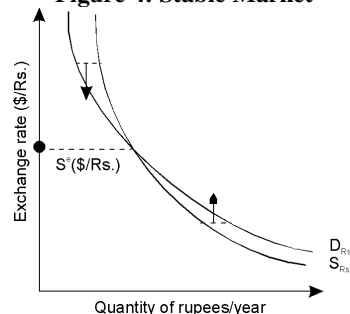


Figure 4: Stable Market



As we know from observing the actual happenings in the markets, all market movements are not observed to be in accordance with the demand-supply view. A few of the divergences are explained by the following theories. These theories state that the value of a currency is determined by its stock and the desire of people to hold this stock, in place of other goods. These theories differ in the other goods being considered by them. We start by discussing the monetary approach.

THE MONETARY APPROACH

The monetary approach assumes that PPP holds good, i.e. an increase in the price level results in the depreciation of a country's currency and vice versa. Using this assumption, this theory arrives at a few results that are diametrically opposite to that given by the demand-supply approach.

Let us start with an increase in the real GNP (the real product) of a country. As the real product increases, so do the transactions and the demand for money needed to be held for making purchases. Hence, an increase in the real GNP results in an increase in the real money demand. Due to this, lesser money is left for purchase of goods, services and bonds. With no change in the money supply, this brings down the price levels. With a reduction in the demand for bonds, the bond prices also go down, resulting in an increase in the nominal interest rates. Since this approach assumes PPP to hold good, a reduction in the price levels brings about an appreciation of the currency. Hence, an increase in the real GNP brings about an appreciation of the currency. This is in contrast with the predictions of the demand-supply theory.

The theory also outlines the correction mechanism in the system. With a fall in the price level, the real money demand stands reduced. At the same time, an increase in the interest rates increases the opportunity cost of holding money, thus reducing the real demand for money. This leaves people with more money to spend on goods and services, thus increasing the price levels. This makes the currency appreciate.

There is another route through which a growth in real GNP affects the exchange rate. As we have seen, an increase in the real GNP increases the real demand for money. As much of this increased demand, as is not satisfied through an increase in the money supply, is satisfied through a current account surplus. This makes the currency appreciate.

Let us see the effect of an increase in money supply. Such an increase induces people to spend more on goods and bonds. This increases the price levels and reduces the nominal interest rates. The higher price level makes the currency depreciate.

The predictions of the monetary theory can be summarized as follows:

- An increase in the real GNP of a country causes its currency to appreciate. It follows that out of two countries, the country having a higher growth in the GNP will see its currency appreciating against the other country's currency.
- An increase in real money demand makes the currency appreciate.
- An increase in nominal interest rates causes the currency to depreciate (as seen in the correction mechanism). This again goes against the predictions of the demand-supply approach.
- An increase in the money supply causes the currency to depreciate.

This theory also analyzes the effects of expected inflation. Expected inflation leads to higher nominal interest rates (since the nominal interest rate includes a premium for inflation). This causes a depreciation of the currency. The PPP says that inflation causes a currency to depreciate. According to the monetary approach, the effect on the exchange rates is immediate, rather than happening after the inflation takes place.

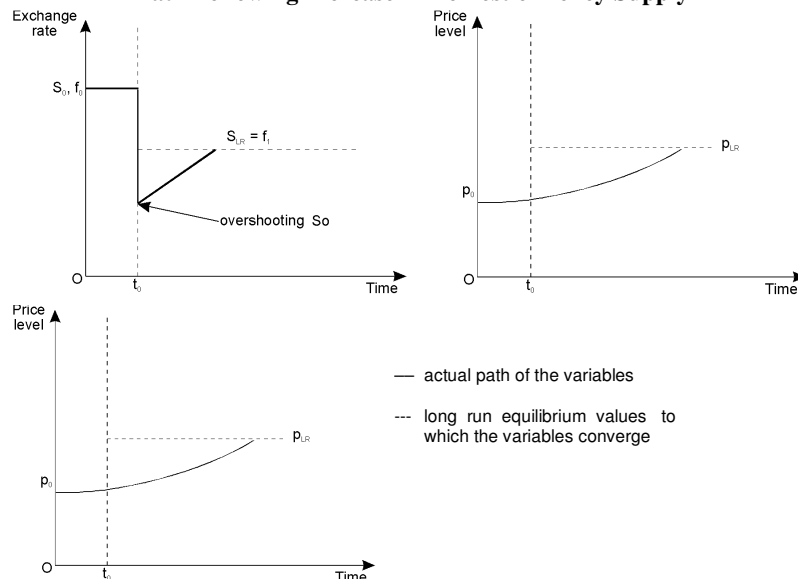
Exchange Rate Volatility

An important phenomenon observed is that of overshooting of exchange rates, i.e. exchange rates changing more than that required by a change in an economic variable and later coming back to the new equilibrium. This phenomenon is explained by the Dornbusch Sticky-Price Theory.

Suppose there is an increase in the money supply. This should increase the price level in the economy and the currency should depreciate accordingly. But it is often observed that the immediate depreciation in the currency is much more than that warranted by the models, with the currency appreciating after some time to reach the new equilibrium level. According to this theory, this happens due to the stickiness of the price of some goods. This theory states that while the price of traded goods changes quickly in accordance with the change in the money supply, the price of non-traded goods are sticky in the short run and take some time to adjust. Since the prices of all the goods do not change up to the required level, the demand for money does not increase enough to become equal to the supply of money. Hence, in order to restore equilibrium to the money markets, the interest rates fall. This leads to an increase in the money demand and restores equilibrium.

The falling of the interest rates has an interesting effect on the exchange rates. According to the interest rate parity, a fall in interest rate is accompanied by a corresponding fall in the forward premium/discount on a currency. This can happen either through the forward rate or through the spot rate. As the prices of the non-traded goods are expected to rise in the long run, the future spot rates are expected to weaken in accordance with PPP. This expected change in the future spot rate gets reflected in a weaker current forward rate for the currency. With the premium on a currency (given by $f - s$) having to fall and the forward rate weakening (represented by a higher f), the spot rate would have to weaken more than the forward rate (i.e. s will have to increase by more than the increase in f). This results in the spot rate depreciating by more than that required, and hence overshooting. Later, as the prices of non-traded goods change in accordance with the increase in the money supply, the demand for money rises and the interest rates fall. This makes the spot rate appreciate towards the equilibrium level, eventually reaching it. This phenomenon is reflected in figure 5.

Figure 5: Forward and Spot Exchange Rates, Interest Rate and Price Level Path Following Increase in Domestic Money Supply



Source: *Multinational Finance* by Adrian Buckley.

THE ASSET APPROACH

This approach is also referred to as the efficient market hypothesis approach. It does not talk about the effect of changes in the basic economic variables on the exchange rates. According to this approach, whatever changes are expected to occur in the value of a currency in future (whether based on the monetary theory or the demand-supply theory or any other approach), gets reflected in the exchange rates immediately. That is, any expected change gets absorbed immediately. Hence, the current exchange rate is the reflection of the expectations of the market as a whole.

This theory states that new information about the factors likely to affect exchange rates, comes to the market in a random manner. This news is quickly absorbed by the market. The efficient working of the market assumes that there are a large number of participants in the market whose aim is to maximize their profits. Through their profit-maximizing activities, the participants ensure that all available information is quickly absorbed by the market. There is one category of players in the currency markets, though, whose aim is not to maximize profits from currency movements. They are the central banks. The presence of central banks comes in the way of existing exchange rates reflecting the expected values of currencies truly.

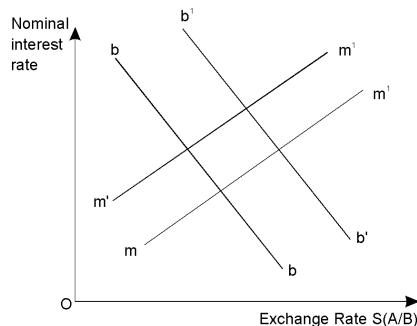
This approach explains the implications of fiscal and monetary policy on exchange rates. Since a fiscal deficit is expected to increase the money supply levels sometime in the future, an increasing fiscal deficit is likely to trigger off an immediate depreciation of the currency, even without an immediate increase in the money supply. Similarly, an expected increase in the money supply through the monetary policy would cause the currency to depreciate immediately.

PORTFOLIO BALANCE APPROACH

The portfolio balance approach states that the value of a currency is determined by two factors – the relative demand and supply of money and the relative demand and supply of bonds. According to this approach, people can hold assets across different countries, denominated in different currencies (mainly in the form of currencies and bonds). Hence, any change in exchange rates changes the wealth of the holders of these assets, which becomes an instrument for maintaining equilibrium in money and bond markets.

According to this theory, interest rates and exchange rates are linked in the manner as shown by figure 6.

Figure 6: Portfolio Balance Model



A – Home currency; B – Foreign Currency

In figure 6, interest rates are shown on the y-axis, and the exchange rate on the x-axis, with a movement towards the right reflecting depreciation of the home currency. Curve bb represents the combinations of interest rates and exchange rates for which the bond market is in equilibrium, with curve mm representing those combinations for which the money markets are in equilibrium. As interest rates rise, the demand for bonds increases. With the supply of bonds not changing, this results in an excess demand. This demand can be reduced by reducing the wealth of the portfolio holders. A reduction in the wealth would induce portfolio holders to demand less of everything, including bonds. This is achieved through an

appreciation of the domestic currency. The appreciation reduces the real wealth of the portfolio holders in domestic currency terms. Hence, appreciation of the domestic currency accompanies an increase in interest rates, in order to maintain the equilibrium in the bond market. This makes curve 'bb' downward sloping. At the same time, an increase in interest rates means a lower demand for money. With money supply being constant, this results in an excess supply of money. To bring the money markets back to equilibrium, the demand for money needs to be increased. This can happen if the real wealth of portfolio holders increases through a depreciation of the domestic currency. The increase in the wealth induces higher demand for everything, including money. Hence, depreciation of the domestic currency accompanies an increase in the interest rates, to maintain the equilibrium in the money markets. This makes curve 'mm' upward sloping.

The equilibrium level of interest rates and exchange rate are determined by the interplay of money market and bonds market, represented by the two curves in the figure. The theory goes on to assume that any change in money supply is effected via open-market operations by the government (or the central bank), thus changing the supply of bonds. Suppose there is a reduction in the money supply. This would be done by the government selling bonds in the market. The reduced money supply would shift the 'mm' curve upwards to since the interest rate would increase for every level of exchange rate. The increase in the bonds' supply would shift curve 'bb' to the right to as at every level of exchange rate, portfolio holders would require increased interest rate. While this reduction in the money supply will definitely result in an increase in interest rates, the effect on exchange rates would depend upon the degree to which the two curves would shift, and hence could be in any direction. If curve 'bb' shifts more than curve 'mm' (which is the case in fig. 8.5), then there would be a depreciation of the currency. If, however, the opposite is true, the currency will appreciate. In any case, the appreciation in the currency will be less than that predicted by the monetary approach, i.e. the one arrived at without considering the bond markets.

If the money supply increases through a purchase of bonds by the government, the 'mm' curve will shift downwards and the 'bb' curve will shift to its left. This will be because the increased money supply and the reduced supply of bonds will reduce the interest rates at every level of exchange rates. If 'mm' curve shifts more than 'bb' curve, the currency will depreciate. In the other case, the currency will appreciate. In any case, the depreciation will be less than that predicted by the monetary approach.

Next, the theory provides an explanation for a change in the value of a currency arising from a change in the real GNP. A higher real GNP results in a higher demand for both money and bonds. The higher demand for money increases interest rates and hence, shifts mm curve upwards. The higher demand for bonds reduces the interest rates and hence, shifts curve 'bb' to the left. Both the shifts result in an appreciation of the currency, which is higher than that predicted by the monetary theory. But here, the effect on interest rates is ambiguous and depends on the quantum by which the two curves shift.

ROLE OF NEWS AS A DETERMINANT

The models discussed above show how expected changes are factored into exchange rate forecasts. Despite an understanding of these models, exchange rate forecasting is not very easy, often because of the conflicting interpretations provided by these approaches. One more factor that contributes to unpredictability of exchange rates, is news. News, as per its definition, is something unexpected. Unexpected happenings keep on occurring, as we notice in our day-to-day lives. Since these events are unexpected, so is their effect on exchange rates. As many of the events can often not be forecasted, so are the associated changes in exchange rates.

News also explains why PPP does not always hold good. As an unexpected event occurs, the forex markets quickly absorb it and change accordingly. But the real markets are slow to absorb the news, and hence, there is a divergence from PPP till the real markets adjust. In periods when a lot of unexpected events take place, this divergence becomes quite ambiguous.

TECHNICAL ANALYSIS

Forecasting future exchange rates with the use of past exchange rate movements is called technical analysis. The forecasters are called technicians. A pure technician is he, who believes that clues in the past movements lead him to the future. Economic factors such as inflation rates, interest rates, balance of payments and political stability are ignored by pure technicians. A technician believes that exchange rate movements are predictable by using the data on historical movements, the contention being that irrespective of factors that contribute, the impact of all such factors is finally reflected in prices. Technicians develop their own forecasts about future currency values and each technician has his individual method. There are many methods used by technicians such as sophisticated statistical models, charts of past exchange rate movements, etc. Some technicians give simple recommendations about future forex movements. Most technicians use historical data for primary analysis and then make a forecast by keeping in view the economic and political factors.

Evaluation of Technical Forecasts

Economists do not like technical analysis as it does not obey the principles of economics. The logical explanation given by economists in support of their view is that according to efficient market hypothesis, prices reflect all available information. In an efficient forex market, the impact of available information is already reflected in the present rates. Therefore, historical data does not help develop accurate forecasts. Technical analysts are viewed by these economists as astrologers of market place though they are often able to give more accurate predictions than those given by any economic forecasting model or highly sophisticated statistical model of exchange rate forecasting.

Economic research indicates that forex movements follow a pattern of random walk which implies that a specific present change is unrelated to past changes and is, therefore, unforecastable. The explanation given by economists is that current exchange rates change with the unforceable events in the market and the present rates reflect all forceable events. The unforceable events occur in a random fashion and hence exchange rate changes follow a random pattern. Technical analysts assert that their approach works and it is very difficult to disapprove their assertions. To prove the efficiency of technical analysis, it is necessary to prove that technical analysis yields better forecasts than forward market forecasts and no known technical forecast till date meets this standard. Technical forecasts are often used in conjunction with economic model based forecasts, but technical forecasts are widely used by speculators in the forex markets to book quick profits since technical forecasts emphasize on short-term exchange rates.

SUMMARY

- Different models of exchange rate determination predict different effects of changes in various economic variables on the exchange rates. Though conflicting, all these effects are observed in real-life situations.
- The final effect of a change in an economic variable is a combination of the predictions of the various theories, and is also dependent on the situation of the moment.
- Though this makes exchange rate forecasting a Herculean task, the theories discussed in the chapter do provide some guidance, and hence make essential reading for a student of international finance.
- In the end, it is fair to say that forecasts made by using economic indicators do help in having a long-term view, which is supplemented by technical analysis which helps in having a short-term view.

Part III – Exchange Risk Management

Chapter IX

Introduction to Exchange Risk

After reading this chapter, you will be conversant with:

- Foreign Exchange Exposure
- Foreign Exchange Risk
- Types of Exposure

In the introductory chapter it was mentioned that corporates, whether operating domestically or internationally, are exposed to risks of adverse movements in their profits resulting from unexpected movements in exchange rates. Foreign exchange exposure results in foreign exchange risk due to the unanticipated variability in exchange rates. Variability of exchange rates gives rise to foreign exchange exposure and foreign exchange risk. Though these two terms are often used interchangeably, in reality they represent two different, yet closely related, concepts. Let us first understand these two terms.

FOREIGN EXCHANGE EXPOSURE

Adler and Dumas define foreign exchange exposure as 'the sensitivity of changes in the real domestic currency value of assets and liabilities or operating incomes to unanticipated changes in exchange rates'.

To understand the concept of exposure, we need to analyze this definition in detail. The first important point is that both foreign and domestic assets and liabilities could be exposed to effects of exchange rate movements. Example, if an Indian resident holds a dollar deposit and the dollar's value vis-à-vis the rupee changes, the value of the deposit in terms of rupees changes automatically. This makes the dollar deposit exposed to exchange rate changes. On the other hand, if a person is holding a debenture in an Indian company, the value of the debenture may change due to an increase in general interest rates, which in turn may be the effect of a depreciating rupee. Thus, even though no conversion from one currency to another is involved, a domestic asset can be exposed to movements in the exchange rates, albeit indirectly.

The second important point is that not only assets and liabilities, but even operating incomes can be exposed to exchange rate movements. A very simple example would be of a firm exporting its products. Any change in the exchange rates is likely to result in a change in the firm's revenue in domestic currency terms.

Thirdly, exposure measures the sensitivity of changes in real domestic-currency value of assets, liabilities and operating incomes. That is, it is the inflation adjusted values expressed in domestic currency terms that is relevant. Though this is theoretically a sound way of looking at exposure, practically it is very difficult to measure and incorporate inflation in the calculations. Hence, in reality, the nominal figures are taken into account, though it does not always present the true picture.

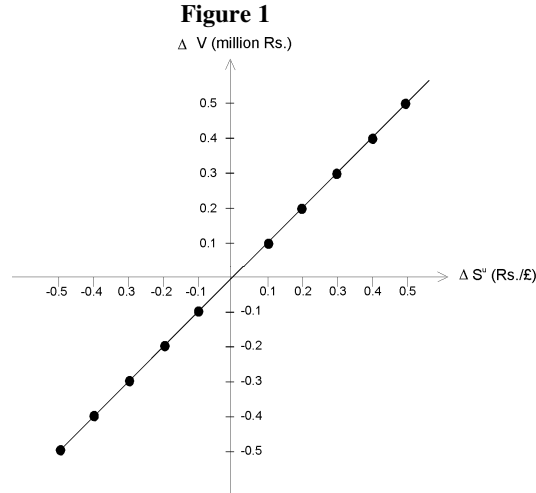
The last point to be noted is that exposure measures the responses only to the unexpected changes in the exchange rate as the expected changes are already discounted by the market.

What does this definition mean? In simple terms, it means that exposure is the amount of assets, liabilities and operating income that is at risk from unexpected changes in exchange rates. (We shall later see how this is different from foreign exchange risk.) The way it has been defined by Adler and Dumas helps us in measuring exposure. As we know, sensitivity can be measured by the slope of the regression equation between two variables. Here, the two variables are the unexpected changes in the exchange rates and the resultant change in the domestic-currency value of assets, liabilities and operating incomes. The second variable can be divided into four categories for the purpose of measurement of exposure. These are,

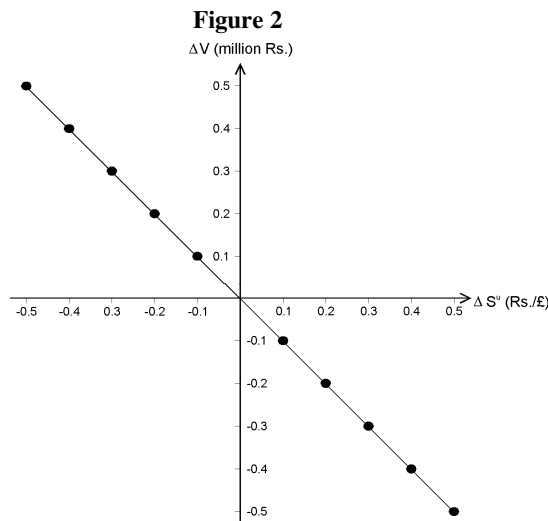
- Foreign currency assets and liabilities which have fixed foreign-currency values.
- Foreign currency assets and liabilities with foreign-currency values that change with an unexpected change in the exchange rate.
- Domestic currency assets and liabilities.
- Operating incomes.

Exposure When Assets and Liabilities Have Fixed Foreign Currency Values

The measurement of exposure for the first category is comparatively simpler than for the remaining three. Let us see an example to understand the process of measurement. Assume that an Indian resident is holding a £1 million deposit. The change in the rupee-value of the deposit due to unexpected changes in the Rs./£ rate have been plotted in figure 1.



In this graph, the unexpected changes in the exchange rate [$\Delta S_u(\text{Rs./£})$] are represented on the X-axis, with a positive value denoting an appreciation in the foreign currency. The Y-axis represents the change in the rupee-value of the deposit (V). As the pound appreciates by Rs.0.10, the value of the deposit also increases by Rs.0.1 million. With an unexpected appreciation of Rs.0.20 in the pound's value, the deposit's value increases by Rs.0.2 million. Similarly, an unexpected depreciation of the pound by Rs.0.10 will reduce the value of the deposit by Rs.0.1 million, while a depreciation of Rs.0.2 will reduce the deposit's value by Rs.0.2 million. This gives us an upward sloping exposure line. On the other hand, if there were a foreign liability which had its value fixed in terms of the foreign currency, it would give a downward sloping exposure line. There may be a few assets or liabilities where the combinations of the two variables may not lie exactly on a straight line. In such a case, the exposure line would be the line of best fit. (See figure 2).



Whether the points fall exactly on the exposure line or not, there is one thing common among the assets and liabilities discussed above. The common factor is that the quantum of change in the foreign-currency value of these assets and liabilities is predictable to a high degree. This predictability of the change in value makes it more convenient to draw a regression line and hence, to measure exposure.

As was mentioned earlier, exposure can be measured as the slope of the regression equation between unexpected changes in the exchange rate and the resultant changes in the domestic value of assets and liabilities. We can express the regression equation as

$$\Delta V = a \times \Delta S^u + e$$

Where,

- ΔV = Change in the domestic value of assets and liabilities
- a = The slope of the regression line
- ΔS^u = Unexpected change in the exchange rate
- e = Random error, the presence of which allows for small variations in the value of V from those given by the regression line.

The exposure is given by 'a' in the above equation. For graph 1, the exposure can be measured in the following way. As all the points fall exactly on the exposure line, the value of the random error 'e' is equal to zero. Hence, the regression equation stands reduced to

$$\begin{aligned}\Delta V &= a \times \Delta S^u \\ \Rightarrow a &= \frac{\Delta V}{\Delta S^u} \\ &= \frac{-\text{Rs.1,00,000}}{\text{Rs.0.10/£}} \\ &= \text{£1,000,000.}\end{aligned}$$

Even when the exposure line is a downward sloping line (as will be in case of a liability), the exposure can again be measured in the same way as outlined above. Assuming the same figures as used in the above example, an unexpected appreciation of the pound by Rs.0.10/£ will result in an increase in the liability by Rs.1,00,000, thus making V equal to (–)1,00,000. Thus the exposure will be:

$$\begin{aligned}a &= \frac{\Delta V}{\Delta S^u} \\ &= \frac{-\text{Rs.1,00,000}}{\text{Rs.0.10/£}} \\ &= -\text{£1,000,000.}\end{aligned}$$

A few points need to be noted from the above calculation:

- When the foreign currency value of an asset or liability does not change with a change in the exchange rate, the exposure is equal to the foreign currency value.
- When the slope of the exposure line is negative, the exposure appears with a negative sign. While an exposure with a positive sign is referred to as a long exposure, the one with a negative sign is referred to as a short exposure.
- The unit of measurement of exposure is the foreign currency in which the asset or liability is expressed. This is because while calculating exposure, the domestic currency gets canceled in the numerator and the denominator, leaving the foreign currency as the unit. In the above example, the rupee in the numerator gets canceled with that in the denominator, leaving the pound as the unit of exposure.

- While calculating exposure in this way, we are assuming that all the change in the exchange rate is unexpected. In real life, the unexpected change can be calculated using the forward rate. As we know, the forward rate can be used as the unbiased estimate of the future spot rate. Hence, in retrospective, the forward rate for a particular maturity can be compared to the actual spot rate as on the date of the maturity. The difference between the two will be the unexpected change in exchange rate.

Exposure When the Foreign-Currency Value of Assets and Liabilities Changes with a Change in the Exchange Rate

A change in the exchange rate may be accompanied by a change in the foreign-currency value of an asset or liability. Though the change in the foreign currency value may not be directly attributable to the movement in the exchange rate, the link between the two is certainly there due to the common underlying factors. For example, inflation in a country, denoting a general increase in price levels would result in the value of any asset like real estate going up. At the same time, it would also result in a depreciation of the currency. Though the change in the asset's value is not directly a result of the change in the exchange rate, it may be possible to establish a relationship between the two. In such a case, the degree of exposure would depend on the response of the exchange rate and of the asset's (or liability's) value to the change in the underlying variable. Sometimes, the exchange rate movement does affect the foreign-currency value of the foreign asset or liability, albeit in an indirect way. Example, if there is a depreciation of the foreign currency, the foreign central bank may consider it imperative to increase the interest rates in the economy in order to defend its currency. In such a situation, the value of an asset in the form of an interest bearing security would stand reduced. In such cases also, the degree of exposure would depend on the movement of the two variables and the predictability of the movement in the asset's or liability's value. Depending on these movements, the exposure may be equal to, lower than, or higher than the foreign-currency value of the asset or liability. Let us see a few examples.

Suppose there is a foreign asset whose value is \$2,500,000 with the exchange rate ruling at Rs.43.50/\$. At this point its domestic-currency value equals Rs.108.75 million. The US economy is facing an inflation rate of 4%, due to which the asset's price increases to \$2,600,000. At the same time, the dollar depreciates to Rs.41.8269/\$. The new value of the asset is again Rs.108.75 million. If with every change in the exchange rate, the asset's value changes in the same way, the two will be having a predictable relationship. In that situation, the exposure can again be calculated as the slope of the regression equation between these two variables. In the example given above, the exposure will be equal to

$$\begin{aligned} a &= \frac{\Delta V}{\Delta S^u} \\ &= \frac{\text{Rs.0}}{-\text{Rs.1.6731}/\$} \\ &= 0 \end{aligned}$$

Here, we can observe that though the exchange rate is variable, the exposure is nil. This is because in response to the exchange rate movements, the foreign-currency value of the asset is changing in such a way as to leave the domestic-currency value of the asset unchanged. Without any movement in the domestic-currency value of the asset, the exposure on the asset becomes zero.

Though a zero exposure may be an ideal condition, it would be quite difficult to find such assets and liabilities. Generally, the foreign-currency values of assets and liabilities move in the manner outlined above, but not to the same extent. Even if the prices of assets change as above, such change may not occur simultaneously having an exposure. Say, in the above example, the value of the asset may increase only to \$2,550,000 in response to the depreciation of the dollar. This would result in a rupee value of Rs.106,658,595. Again, if this value changes in a similar predictable manner every time there is a dollar appreciation or depreciation, the exposure would be equal to

$$\begin{aligned} a &= \frac{\Delta V}{\Delta S^u} \\ &= \frac{-\text{Rs.}2,09,405}{-\text{Rs.}1.6731/\$} \\ &= \$1,250,018. \end{aligned}$$

It can be observed that the exposure is less than the value of the asset (i.e. \$2.5 million). If, on the other hand, the value of the asset had become \$2.7 million, the exposure would have been:

$$\begin{aligned} a &= \frac{\Delta V}{\Delta S^u} \\ &= \frac{\text{Rs.}4,182,630}{-\text{Rs.}1.6731/\$} \\ &= -\$2,499,928. \end{aligned}$$

This makes the exposure almost equal to the value of the asset. If the value of the asset had instead moved to \$2.75 million, the exposure would have been higher than the value of the asset, i.e. \$3,749,910. From these examples we can observe that the exposure on an asset or liability whose foreign-currency value changes with a change in the exchange rate, could be nil or equal to, less than, or more than the value of the asset/liability.

In all the examples considered above, the foreign-currency value of the asset was changing in such a way, as to make the relationship between the movement in the domestic-currency value of the asset and a change in the exchange rate a predictable one. In many situations, however, it may be very difficult to establish a regression line, and hence, a predictable relationship, or even impossible to do so. In such cases, though the asset or liability may be exposed to exchange rate movements, the measurement of exposure may become impossible.

EXPOSURE ON DOMESTIC ASSETS AND LIABILITIES

Domestic assets and liabilities are not directly exposed to exchange rate movements, as no conversion from a foreign currency to the domestic currency is involved. Yet, as explained in the beginning of the chapter, even these assets and liabilities may be indirectly affected through interest rates. In the case of these assets and liabilities, the possibility of measurement of exposure and the degree of exposure would again depend on the predictability of the change in the domestic prices. The calculation of exposure would also be done in the same way as for foreign assets and liabilities whose value change with a change in the exchange rate. However, it needs to be mentioned that the exercise is more difficult in this case than in the previous one.

OPERATING INCOMES

Measurement of exposure on operating profits is the most difficult of all. Let us examine the case of an export oriented company. A depreciation of the foreign currency may or may not result in a lower price quoted by the company in the international market, depending on a number of factors like the number of suppliers in the international market, their cost competitiveness, any product differentiation enjoyed by the company, price elasticity of international demand for the product, number of consumers, and even the attractiveness of the international market vis-à-vis the domestic market. Then again, the company's changing or not changing the price may or may not have an effect on the quantity demanded. The new price and the new quantity demanded would together determine the operating profit of the company. The presence of so many variables, with the change in the majority being unpredictable, makes it extremely difficult, if not impossible, to predict the effect of a change in the exchange rate on the operating profits of an export firm.

Let us now observe the case of a company using imported raw materials, whether it is selling its products in the domestic market or the international market. Let us say there is an appreciation of the foreign currency. Firstly, whether the domestic price of the imported raw material will increase or not will depend on the response of the seller. The international price may or may not get reduced, depending upon the conditions prevailing in the international market. Even if we assume that the international price is not reduced and hence, the domestic currency price of the raw material increases, the effect on the operating profits is not easily predictable. Though the quantity of raw material the company wants to buy at the increased price (and hence, the raw material costs) would appear to be in its own hands, in reality it is dependent on a number of factors. These include availability and the price of the same or substitute raw materials in the domestic market, the possible response of the consumers in case the company tries to pass on the increased costs to them (which would, in turn, depend upon the domestic/international market conditions) etc. All this makes the measurement of the exposure extremely difficult.

Even companies which do not operate in the international markets, either as exporters or as importers, may be exposed to exchange rate changes. This could be due to the presence of, or the possibility of appearance of competitors. One way exchange rate movements may affect such players is by affecting the production costs and/or prices of their competitor. This may result in a change in the domestic firm's operating profits either by changing the quantity demanded by its consumers, or by forcing it to change the price at which it sells its products, or both. Another way exchange rate changes may affect the domestic companies is by making its foreign competitor's operations more, or less profitable, thereby either driving it out of the market, or by acting as an inducement for more competitors to enter the market.

Again, as we can notice, the measurement of exposure of operating profits is nearly impossible.

FOREIGN EXCHANGE RISK

Maurice D Levi describes foreign exchange risk as "the variance of the domestic-currency value of an asset, liability, or operating income that is attributable to unanticipated changes in exchange rates".

According to this definition, foreign-exchange risk results when the domestic-currency value of assets, liabilities or operating incomes, becomes variable in response to unexpected changes in exchange rates. Hence, for exchange rate risk to be present, the presence of two factors are essential. One is the variability of exchange rates, and the second is exposure. If an asset, liability or operating income is not exposed to exchange rate changes, variability of exchange rate does not create any exchange rate risk. Similarly, variability of domestic-currency value of an asset, liability or operating income which is not linked to exchange rate movements, or where the changes in exchange rates are perfectly predictable, does not create any exchange rate risk.

Where exposure is measurable in terms of the slope of a regression equation between exchange rate movements and changes in the values of assets or liabilities, exchange rate risk can be expressed as a function of exposure and variance of exchange rate. We recall that the regression equation can be written as

$$\Delta V = a \times \Delta S^u$$

This equation can be rewritten as:

$$\text{var}(\Delta V) = \text{var}[a \times \Delta S^u]$$

or,

$$\text{var}(\Delta V) = a^2 \times \text{var}(\Delta S^u)$$

Where, $\text{var}(\Delta V)$ = exchange rate risk.

This is in conformity to our statement that exchange rate risk is dependent on both exposure and unexpected changes in exchange rates.

TYPES OF EXPOSURE

Exposure can be classified into three kinds on the basis of the nature of item that is exposed, measurability of the exposure and the timing of estimation of exposure. These are:

- Transaction exposure
- Translation exposure
- Operating exposure.

Transaction Exposure

Transaction exposure is the exposure that arises from foreign currency denominated transactions which an entity is committed to complete. In other words, it arises from contractual, foreign currency, future cash flows. For example, if a firm has entered into a contract to sell computers to a foreign customer at a fixed price denominated in a foreign currency, the firm would be exposed to exchange rate movements till it receives the payment and converts the receipts into the domestic currency. The exposure of a company in a particular currency is measured in net terms, i.e. after netting off potential cash inflows with outflows.

Translation Exposure

Translation exposure is the exposure that arises from the need to convert values of assets and liabilities denominated in a foreign currency, into the domestic currency. For example, a company having a foreign currency deposit would need to translate its value into its domestic currency for the purpose of reporting at the time of preparation of its financial statements. Any exposure arising out of exchange rate movement and the resultant change in the domestic-currency value of the deposit would classify as translation exposure. It needs to be noted that this exposure is mostly notional, as there is no real gain or loss due to exchange rate movements since the asset or liability does not stand liquidated at the time of reporting. Hence, it is also referred to as *accounting exposure*. This fact makes the measurement of translation exposure dependent on the accounting policies followed for the purpose of converting the foreign-currency values of assets and liabilities into the domestic currency.

At the time of the initial transaction, an asset or liability is recorded at a particular rate in accordance with company policy. At a later date, when the need to translate the value of the asset or liability arises, it may be translated either at the historical rate (which was the rate used at the time of the initial transaction) or at some other rate, which would again depend either on company policy, or on accounting

standards, or on both. We know that for an asset to be considered as exposed, there needs to be a change in its domestic currency value in response to a change in the exchange rate. Hence, those assets whose values are translated at a historical exchange rate do not result in translation exposure. Only the assets whose values are translated at the current (or post-event) exchange rate contribute to translation exposure. Again, like transaction exposure, translation exposure is measured as the difference between exposed assets and exposed liabilities.

Operating Exposure

Operating exposure is defined by Alan Shapiro as “the extent to which the value of a firm stands exposed to exchange rate movements, the firm’s value being measured by the present value of its expected cash flows”. Operating exposure is a result of economic consequences (rather than accounting consequences, as in the case of transaction and translation exposure) of exchange rate movements on the value of a firm, and hence, is also known as economic exposure. In an earlier section, we had discussed the exposure faced by an export firm on account of changes in exchange rates. That is one example of economic exposure.

As we saw in the preceding sections, transaction and translation exposure cover the risk of the current profits of the firm being affected by a movement in exchange rates. On the other hand, operating exposure describes the risk of future cash flows of a firm changing due to a change in the exchange rate.

The exposure arising out of contractually fixed cash flows can be managed using various techniques, but where the exposure arises out of cash flows that are not fixed contractually, or where the change in the domestic-currency value as a result of exchange rate movements cannot be predicted exactly, these techniques become ineffective. Due to this difficulty in managing such exposure with the traditional techniques, it is also referred to as the residual exposure.

The future cash flows of a firm are dependent not only on the exchange rate movements, but also on the relative rates of inflation prevailing in different countries. The interplay of these two forces determine the future cash flows and their variability, and hence, the operating exposure faced by a firm. If the change in the exchange rates is matched by an equal change in the price levels, i.e. Relative PPP is maintained (or in other words, the real exchange rate remains unchanged), the relative competitive positions of domestic and foreign firms will not change, and hence, there will be no change in the cash flows of the domestic firm due to exchange rates. Hence, there will be no economic exposure. On the other hand, in case of a change in the real exchange rate, the relative prices (i.e. the ratio of the domestic goods’ prices to the prices of foreign goods) will change, resulting in a change in the domestic firm’s cash flows. Hence, it follows that in case relative PPP holds good, even a widely fluctuating and unpredictable exchange rate will not result in operating exposure. On the other hand, even a relative stable exchange rate can result in operating exposure if it is not matched by appropriate changes in the price levels. The hidden dangers of a fixed or stable exchange rate become clear from the above discussion. Hence, we can say that a real appreciation of a currency harms the domestic exporting and import-competing industries, while a real depreciation has the opposite effect.

A change in the real exchange rate getting translated into a change in a firm’s cash flow is dependent upon the price flexibility enjoyed by it. When the domestic currency experiences a real appreciation, for an export-oriented firm the flexibility gets reflected in whether it can increase its foreign-currency prices proportionately, and in case of a firm competing with imported goods, it gets reflected in whether the company can maintain its domestic prices at the existing level in face of the lower price of the imported goods without losing sales.

The price flexibility enjoyed by a firm is largely a factor of the price elasticity of demand. Price flexibility is negatively correlated to price elasticity, i.e. the more price elastic the demand, the less flexibility the firm enjoys to change the foreign-currency price (or keep the domestic price unchanged, in case of a firm facing competition from imported goods) of its product. The price elasticity of demand, in turn, is dependent on a number of factors. These are:

- Degree of competition.
- Location of competitors.
- Degree of product differentiation.

DEGREE OF COMPETITION

A large number of competitors restrict the flexibility of prices enjoyed by a firm. This is so because with a large number of suppliers, it will be very easy for the consumers to change from one product to another. Hence, lower the competition faced by a firm, higher the price flexibility.

LOCATION OF COMPETITORS

If most of the competitors are located in the same country as the exporting firm, all of them will face the same changes in costs and pressures on profits as a result of a change in the real exchange rate. This will enable them to change the foreign-currency price of their product collectively, without having any effect on their competitiveness.

DEGREE OF PRODUCT DIFFERENTIATION

A firm's product being unique and different in some way from its competitors' products, helps it charge a premium on it. The higher the product differentiation, the more price flexibility the firm enjoys.

A firm's exposure is also a factor of the flexibility it enjoys to shift its production centers and the sources of its raw materials. An MNC having production centers in different countries is less exposed to exchange rate movements as it can increase the production in a country whose currency has depreciated and decrease production where the currency has appreciated. Also, having a production center in the country where the goods are to be sold reduces the exposure by matching the currency of costs and revenue.

There is an important relationship between transaction and translation exposure. A translation exposure may get converted into transaction exposure. This would happen when an asset or liability is liquidated. In the same way, a transaction exposure may result in a translation exposure. This would happen when there is some transaction exposure outstanding at the time of preparation of financial statements. For example, a receivable on account of an export transaction would need to be converted into the domestic currency if the financial statements are prepared before the receivable is realized. On the other hand, there is an important difference between transaction and translation exposure on one hand, and operating exposure on the other. While the former are the result of transactions already entered into or assets and liabilities already on hand, the latter is more forward looking and takes into account the effects on future cash flows. The techniques/tools used for managing transaction or translation exposure are more operational in nature whereas the approach adopted for managing economic exposure is more strategic in nature.

SUMMARY

- This chapter explained the difference between the exchange risk and exposure. It also introduced the different kinds of exposure.
- There are various kinds of instruments that are available to a firm to hedge itself against these exposures. These instruments are together called derivatives.
- The next chapter focuses on the management of exchange risk.

Chapter X

Management of Exchange Risk

After reading this chapter, you will be conversant with:

- Management of Transaction and Translation Exposures
- Management of Economic Exposure

The preceding chapters gave us adequate knowledge of the various derivative tools. They also illustrated how these tools can be used to hedge exchange risk. In this chapter we will see how these and other tools can be used to hedge the different kinds of exposure.

MANAGEMENT OF TRANSACTION AND TRANSLATION EXPOSURES

Transaction exposure introduces variability in a firm's profits. For example, the price received in rupee terms by an Indian exporter for goods exported by him will not be known till he actually converts the foreign currency receipts into rupees. This price varies with changes in the exchange rate. While transaction exposure arises out of the day-to-day activities of a firm, translation exposure arises due to the need to translate the foreign currency values of assets and liabilities into the domestic currency.

These differences in the two types of exposures result in some basic differences in the way they are required to be managed. Management of transaction exposure is essentially a day-to-day operation carried out by the treasurer. It involves continuous monitoring of exchange rates and the firm's exposure, along with an evaluation of the effectiveness of the hedging techniques employed. On the other hand, management of translation exposure is a periodic affair, coming into the picture at the time of preparation of financial statements. This makes the management of translation exposure more of a policy decision, rather than a day-to-day issue to be handled by the treasurer.

Management of exposure essentially means reduction or elimination of exchange rate risk through hedging. It involves taking a position in the forex/and or the money market which cancels out the outstanding position. Though the frequency at which the need to manage transaction and translation exposure arises, differs, the basic instruments that can be used are the same. These instruments can broadly be classified as internal and external instruments. Internal instruments are those which are a part of the day-to-day operations of a company, while external instruments are the ones which are not a part of the day-to-day activities and are especially undertaken for the purpose of hedging exchange rate risk. Here, it needs to be noted that the term internal does not denote that no external party is involved. It only denotes that it is a normal activity for the company.

The various internal hedging techniques are:

- Exposure netting,
- Leading and lagging,
- Hedging by choosing the currency of invoice, and
- Hedging through sourcing.

Exposure Netting

Exposure netting involves creating exposures in the normal course of business which offset the existing exposures. The exposures so created may be in the same currency as the existing exposures, or in any other currency, but the effect should be that any movement in exchange rates that results in a loss on the original exposure should result in a gain on the new exposure. This may be achieved by creating an opposite exposure in the same currency or a currency which moves in tandem with the currency of the original exposure. It may also be achieved by creating a similar exposure in a currency which moves in the opposite direction to the currency of the original exposure.

Leading and Lagging

Leading and lagging can also be used to hedge exposures. Leading involves advancing a payment, i.e. making a payment before it is due. Lagging, on the other hand, refers to postponing a payment. A company can lead payments required to be made in a currency that is likely to appreciate, and lag the payments that it needs to make in a currency that is likely to depreciate.

Hedging by Choosing the Currency of Invoicing

One very simple way of eliminating transaction and translation exposure is to invoice all receivables and payables in the domestic currency. However, only one of the parties involved can hedge itself in this manner. It will still leave the other party exposed as it will be dealing in a foreign currency. Also, as the other party needs to cover its exposure, it is likely to build in the cost of doing so in the price it quotes/it is willing to accept.

Another way of using the choice of invoicing currency as a hedging tool relates to the outlook of a firm about various currencies. This involves invoicing exports in a hard currency and imports in a soft currency. The currency so chosen may not be the domestic currency for either of the parties involved, and may be selected because of its stability (like the dollar, which serves as an international currency).

Another way the parties involved in international transactions may hedge exposures is by sharing the risk. This may be achieved by denominating the transaction partly in each of the domestic currencies of the parties involved. This way, the exposure for both the parties gets reduced.

Hedging through Sourcing

Sourcing is a specific way of exposure netting. It involves a firm buying the raw materials in the same currency in which it sells its products. This results in netting of the exposure, at least to some extent. This technique has its own disadvantages. A company may have to buy raw material which is costlier or of lower quality than it can otherwise buy, if it restricts the possible sources in this manner. Due to this, this technique is not used very extensively by firms.

The various external hedging techniques are:

- Forwards
- Futures,
- Options, and
- Money markets.

HEDGING THROUGH THE FORWARD MARKET

In order to hedge its transaction exposure, a company having a long position in a currency (having a receivable) will sell the currency forward, i.e., go short in the forward market, and a company having a short position in a currency (having a payable) will buy the currency forward, i.e. go long in the forward market.

The idea behind buying or selling a currency in the forward market is to lock the rate at which the foreign currency transaction takes place, and hence, the costs or profits. For example, if an Indian firm is importing computers from the USA and needs to pay \$1,00,000 after 3 months to the exporter, it can book a 3-month forward contract to buy \$1,00,000. If the 3-month forward rate is Rs.42.50/\$, the cost to the Indian firm will be locked at Rs.42,50,000. Whatever be the actual spot price at the end of three months, the firm needs to pay only the forward rate. Thus, a forward contract eliminates transaction exposure completely.

Most of the times, when the transaction exposure is hedged, the translation exposure gets automatically hedged. In the above example, the translation exposure gets automatically hedged as any loss/gain on the outstanding payable gets set-off by the gain/loss on the forward contract. But there may be situations where the translation exposure may need to be hedged, either because the underlying transaction exposure has not been hedged or because the translation exposure arises due to the company holding some long-term asset or liability. In such situations also, forward contracts may be used to hedge the exposure. The firm would need to determine its net exposure in a currency and then book an opposite forward contract, thus nullifying its exposure. For example, if a firm has a net positive exposure of \$1,00,000, it will sell \$1,00,000 forward so that any loss

by exchange rate movements on account of the main exposure will be canceled off by the gain on the forward contract, and vice versa. However, the gain/loss on the underlying exposure will be notional while the loss/gain on the forward contract will be real and involve cash outlay.

The cost of a forward hedge can be measured by the opportunity cost, which depends on the expected spot rate at which the currency needs to be bought or sold in the absence of the forward contract. Hence, the cost of a forward hedge is measured as the difference between the forward rate and the expected spot rate for the relevant maturity. In an efficient market, as mentioned earlier, the forward rate is an unbiased predictor of the future spot rate. The process equating these two requires the speculators to be risk-neutral. Hence, when the markets are efficient and the speculators are risk-averse, the cost of hedging through the forward market will be nil.

HEDGING THROUGH FUTURES

The second way to hedge exposure is through futures. The rule is the same as in the forward market, i.e. go short in futures if you are long in the currency and vice versa. Hence, if an importer needs to pay \$2,50,000 after four months, he can buy dollar futures for the required sum and maturity. Futures can be similarly used for hedging translation exposure. Hedging through futures has an effect similar to hedging through forward contracts. As the gain/loss on the futures contract gets canceled by the loss/gain on the underlying transaction, the exposure gets almost eliminated. Here it is assumed that basis remains constant. Only a small part of the exposure is left due to the mark-to-market risk on the futures contract. The main difference between hedging through forwards and through futures is that while under a forward contract the whole receipt/payment takes place at the time of maturity of the contract, in case of futures, there has to be an initial payment of margin money, and further payments/receipts during the tenure of the contract on the basis of market movements.

HEDGING THROUGH OPTIONS

Options can prove to be a useful and flexible tool for hedging transaction and translation exposure. A firm having a foreign currency receivable can buy a put option on the currency, having the same maturity as the receivable. Conversely, a firm having a foreign currency payable can buy a call option on the currency with the same maturity.

Hedging through options has an advantage over hedging through forwards or futures. While the latter fixes the price at which the currency will be bought or sold, options limit the downside loss without limiting the upside potential. That is, since the firm has the right to buy or sell the foreign currency but not the obligation, it can let the option expire by not exercising its right in case the exchange rates move in its favor, thereby making the profits it would not have made had it hedged through forwards or futures. But this advantage does not come free. Because of this feature, options generally cost more than the other tools of hedging.

Another advantage offered by options is flexibility. There is only one exchange rate at which a currency can be bought or sold under a forward or a futures contract. On the other hand, options are available at different exchange rates. Depending on the firm's outlook about the future and its risk-taking capacity, it can buy a suitable contract.

An option has a strike price and premium. Premium is the price paid for the option. Importers as well as exporters can use these options to hedge their risk.

HEDGING THROUGH THE MONEY MARKETS

Money markets can also be used for hedging foreign currency receivables or payables. Let us say, a firm has a dollar payable after three months. It can borrow in the domestic currency now, convert it at the spot rate into dollars, invest those dollars in the money markets, and use the proceeds to pay the payable after three

months. (This process has been described in detail in Chapter The Foreign Exchange Market). This process locks the exchange rate at which the firm needs to buy dollars. At the same time, it knows its total cost in advance in the form of the principal and interest it needs to repay in the domestic markets.

We have seen in Chapter Exchange Rate Determination that in the absence of transaction costs, the exchange rate arrived at in this manner will be the same as the forward rate. It needs to be added that in the presence of transaction costs, the forward market gives a better rate than the money market.

Let us see a few comprehensive illustrations.

Illustration 1

An Indian firm exports jeans to America. Currently it sells 20,000 pieces at \$30 per piece. Its cost per piece of jeans is Rs.300. In addition, it needs to import certain raw material which costs \$10 per piece. The fixed costs of the company are Rs.2,000,000. The current spot rate is Rs.44.00/\$. Suppose that the rupee appreciates to Rs.40/\$. By how many units should the company's sales increase for its profits to remain unchanged?

Solution

The company's existing profits can be calculated as follows:

	(in Rs.)
Sales (20,000 x 30 x 44)	26,400,000
Variable costs:	
300 x 20,000	= 6,000,000
10 x 44 x 20,000	= <u>8,800,000</u>
	14,800,000
Fixed costs	<u>2,000,000</u>
	16,800,000
Profit	<u>9,600,000</u>

After the rupee appreciation, the company's profits will be

	(in Rs.)
Sales (20,000 x 30 x 40)	24,000,000
Variable costs:	
300 x 20,000	= 6,000,000
10 x 40 x 20,000	= <u>8,000,000</u>
	14,000,000
Fixed costs	<u>2,000,000</u>
	<u>16,000,000</u>
Profit	<u>8,000,000</u>

As a result of the appreciation of the domestic currency, the profits of the company have come down despite it selling the same number of units at the same dollar price, as existed before the appreciation. Let the number of units that need to be sold for keeping the profits at the pre-appreciation level be 'X'. Here, we are assuming that the company can sell unlimited quantity at the existing dollar price. Then,

$$\begin{aligned}
 9,600,000 &= (40 \times 30 \times X) - [(300 \times X) + (10 \times 40 \times X) + 2,000,000] \\
 9,600,000 &= 1,200 X - 700 X - 2,000,000 \\
 11,600,000 &= 500 X \\
 X &= 11,600,000 / 500 = 23,200 \text{ units.}
 \end{aligned}$$

Hence, the firm needs to increase its sales by 3,200 units to maintain its pre-appreciation profits.

While using these hedging techniques to hedge transaction exposure, it needs to be remembered that their use may not necessarily result in hedging the economic exposure arising out of the transaction being hedged. Take the example of an importer who imports shirts and sells them in the local market. There are other competitors in the market who do the same thing. Let us suppose this importer locks-in the domestic-currency price of his imports by buying forward contract, while his competitors do not. In such a case, if the domestic currency appreciates, his competitors would be able to reduce the price of the shirts, which he would not be able to do due to his fixed costs. Thus, his competitors would be successful in taking away his business and profits. On the other hand, in case of a depreciation of the domestic currency, he would be able to sell the shirts at a much cheaper rate than his competitors, thereby increasing his sales and profits. Thus, though the domestic-currency costs of the producer are hedged, the variability of his profits arising out of economic exposure are not. Management of economic exposure requires the use of specific techniques which are discussed in the following section.

Management of Economic Exposure

As was mentioned previously, economic exposure cannot be managed by the traditional hedging techniques due to the unpredictability of the changes in the cash flows. Rather, it requires various marketing, production and financial management strategies to cope with the risks.

Changes in real exchange rate may either bring about losses, or create an opportunity to increase the profits for an exposed firm, by changing the relative prices, and hence, the competitiveness of the firm. Depending on the duration for which the change in the exchange rate is expected to last, an appropriate strategy can be adopted. For example, if an appreciation of the domestic currency is not expected to last long, the firm may decide not to increase the foreign-currency price of its product if it considers the cost of regaining the lost market share to be too high. On the other hand, if the exchange rate change is likely to last for a longer period, the cost of regaining the market share may become lower than the profit that would be lost if the price is not increased. This may persuade the firm to increase the foreign-currency price even at the cost of losing market share (again, depending on the volume of market share that will be lost, which will be dependent on the price elasticity of demand). If the change is expected to last for a very long time, the firm may even consider shifting its production capacities to a country whose currency has depreciated.

Illustration 2

Vinod Textiles exports leather jackets to France. For the year ended March 31, 2005 the company exported 25,000 pieces at an average price of € 25 per piece. The average cost of producing each piece for the company is Rs.1,250. The price elasticity of demand for company's product in the French market is 1.50. Prevailing rupee-euro exchange rate during the last year was Rs.56. In the current year, rupee-euro exchange rate is expected to be at 58.

You are **required** to compute

- The change in profit due to transaction exposure.
- The change in profit due to economic exposure, if the company passes on the benefit of depreciation to the buyer.

Solution

- Current profit at exchange rate of Rs.56/€

$$= \text{Rs.}25,000 \times (25 \times 56 - 1,250)$$

$$= \text{Rs.}37.50 \text{ lakh}$$

Profit if rupee depreciates to Rs.58/ε

$$= \text{Rs.}25,000 \times (25 \times 58 - 1250)$$

$$= \text{Rs.}50.00 \text{ lakh}$$

∴ Increase in profit due to depreciation of rupee (transaction exposure)

$$= \text{Rs.}50 - 37.50$$

$$= \text{Rs.}12.50 \text{ lakh}$$

b. Selling price of each garment in rupee term = Rs.25 × 56 = Rs.1,400

$$\text{Price in dollar terms after depreciation of rupee} = \frac{1400}{58} = \text{ε } 24.1379$$

∴ Decrease in price of each piece = 3.45%

∴ Change in quantity demanded = $-1.5 \times (-3.45)\% = 5.18\%$

∴ Number of pieces to be sold = $25,000 \times (1 + 0.0518) = 26,295$

$$\text{Profit} = \text{Rs.}26,295 \times (1400 - 1250)$$

$$= \text{Rs.}39,44,250$$

∴ Increase in profit due to economic exposure = Rs.(39,44,250 – 37,50,000)

$$= \text{Rs.}1,94,250.$$

MARKETING STRATEGIES

The marketing manager needs to analyze the effect of a change in the exchange rate and evaluate the strategy required to manage the exposure. The four strategies available to him are:

- Market selection,
- Pricing strategy,
- Promotional strategy, and
- Product strategy.

Market Selection

This strategy is useful when the actual or anticipated change in the real exchange rate is likely to persist for a long time. It involves selection of the markets in which the firm wishes to market its products and providing relevant services to provide the firm an edge in these markets. This may translate into pulling out of the markets which have become unprofitable due to the depreciation of the currency of that market, or entering those markets that have become attractive as a result of currency appreciation in that market.

Knowledge about *market segmentation* is a very important input for the decision about market selection. Before pulling out of a market, the effect of the change in the exchange rate on the cash flows of the firm needs to be analyzed. The cash flows of a firm selling a highly differentiated product to high-income customers may not be affected by the exchange rate movement, hence not requiring the firm to pull out of the market. Similarly, a company that does not aim at the low-price mass market, may be able to access that market as a result of a depreciation of the domestic currency. In both the cases, the decision about market selection gets affected by market segmentation.

Pricing Strategy

There are two main issues involved in developing a pricing strategy – the choice between market share and profits, and the frequency of price adjustments.

Market Share vs. Profit Margin: When the domestic currency appreciates, a firm can either reduce its domestic currency prices, thus maintaining the foreign currency prices at the pre-appreciation level, or maintain the domestic currency prices which would result in an increase in the foreign currency price. While the

former would result in the profit margins coming down, the latter may result in a fall in the market share, which would again affect the profits of the firm. On the other hand, a firm facing a depreciation of the domestic currency may either increase the domestic currency price which would result in the profit margin going up (called *price skimming*), or maintain them at the pre-depreciation level, thus reducing the foreign currency price to increase its market share (called *penetration pricing*).

A company facing competition from imported goods faces a similar dilemma. In the face of a domestic currency appreciation, it can either let the price of its product remain unchanged, thus risking a reduction in the market share, and hence, overall profits, or it can reduce the price, thus reducing the profit margin.

As mentioned earlier, the final decision would depend on the price elasticity of demand. The greater the price elasticity, the higher the incentive to take a hit on profit margins rather than on market share. An important point that needs to be kept in mind while taking the decision is that it may not always be possible to regain lost market share subsequently. Even if it is possible, the cost may be prohibitive. This brings the expected duration of the change in the exchange rate into the picture. Longer the expected duration, lesser the importance of lost sales.

Another factor that needs to be considered is economies of scale faced by the company. In case of large economies of scale, it may make more sense to forego larger profit margins and to try to make up the lost profit through higher volumes. Lower the economies of scale, more important defending the profit margins becomes.

Frequency of price adjustments: While a firm may decide to change the price of its products with a change in the exchange rates, it would still need to decide upon the frequency of such price changes. As we know, exchange rates move even on a minute-to-minute basis. A firm's sales may get affected by frequent price changes, because of the resultant risk faced by its consumers. On the other hand, a firm may lose on account of unfavorable exchange rate movements if it delays the change in the price of its product. Finally, a balance between the two needs to be arrived at, based on the level of uncertainty the firm's customers are ready to face, the duration for which the exchange rate movement is likely to persist and the loss expected to be incurred by not changing the prices.

Promotional Strategy

The promotional strategy deciding the amount that the firm desires to spend in various markets in promoting its products, needs to take the exchange rate movements into consideration. A change in the exchange rate would change the domestic-currency cost of overseas promotion. The effect of exchange rate movements on promotional costs is also in the form of the expected revenues that can be generated per unit of expenditure on promotion. For example, a devaluation of the domestic currency may improve the competitive position of an exporting firm, thus increasing the expected revenue per unit of promotional cost. This may persuade the firm to increase the promotional expenditure in those markets. When the promotional strategy takes these factors into consideration on a pro-active basis rather than on a reactive basis, the benefits are expected to be more.

Product Strategy

A firm can use product strategy to respond to exchange rate movements. It may involve timing of introduction of new products, making product-line decisions and product innovations. The best time for a company to introduce a new product would be when it has a price advantage (for example, in case of an exporting firm, when the domestic currency has depreciated). The firm may need to hold back the products from the market when the conditions are not favorable. It is easier to establish a new product in international markets with a favorable pricing scenario, than with an unfavorable one. Product-line decisions refer to the company having to change its products in accordance with the exchange rate movements. As

outlined in market selection, it involves according preference to producing high-end products at the time of an appreciation in the domestic currency, and producing mass products at the time of a depreciation. It may even involve an effort to improve the quality of the product by using new technology or through more R&D. While market selection refers to marketing the right product in the right market, product-line decisions involve changing the product-mix. The third component of this strategy is product innovations. In the face of an appreciating domestic currency and extremely competitive conditions in the international market, the firm may be able to protect its cash flows by regularly coming up with innovative products. Thus, by offering differentiated product to its customers, the firm may be able to protect its foreign currency price, and hence, its profits.

PRODUCTION STRATEGIES

Sometimes, exchange rate movements are too large and long lasting to be handled by marketing strategies. In these situations, the production manager may need to step in, to take long-term decisions to protect the firm from harmful effects of an unfavorable exchange rate movement, or to help it take advantage of favorable movements. The following strategies would be available to the production manager:

- Input mix,
- Product sourcing,
- Plant location, and
- Raising productivity.

Input Mix

The pressures on the profits of an exporting firm caused by an appreciating domestic currency can be countered by buying more inputs in the international markets than in the domestic market. This would reduce the costs at the time of reducing revenues, thus protecting the profits, at least to a certain extent. Another way of achieving the same objective is to outsource the intermediated inputs, either from producers in the country where the firm is selling its final product, or from producers of a country whose currency is closely linked to that of the country in which it markets its products. At the same time, it would create pressure on the domestic producers of the intermediate inputs and force them to become more competitive, thus proving advantageous to the exporting firm.

Inversely, a firm which has production capacities in other countries can benefit from a depreciating domestic currency by sourcing more of its inputs from the domestic market. However, while taking such a decision, the firm would need to observe the price behavior of the domestically produced inputs. In the wake of a domestic currency depreciation, the domestic prices of tradable goods, or those using imported inputs are likely to go up, reducing the price advantage of sourcing the inputs from the domestic market. On the other hand, the prices of non-tradable goods and goods using little imported inputs is likely to remain stable.

To enable these changes, the technology used by the firm for production should be flexible and capable of adjusting to inputs sourced from different producers. This requires making a comparison between the costs of making the technology flexible, and the expected reduction in profits in case the input mix is not changed. The final decision has to be based on comparative costs.

Product Sourcing

One of the ways of countering exposure is to shift production among different production centers. This strategy presupposes the presence of production facilities in more than one country. As a response to exchange rate movements, the firm can reallocate production to increase the quantity produced in the country whose currency has depreciated, and reducing production in countries whose currency has appreciated. Due to this flexibility, an MNC faces less economic exposure than a company having production facilities in only one country.

Practically, there may be a number of problems coming in the way of such adjustments. For example, availability of an important raw material in a particular country, protest by labor unions to shifting of production (as it is likely to result in redundancies), etc. It may not always be possible to overcome such problems.

Another problem is that establishment of multiple production facilities may result in economies of scale not being utilized resulting in higher per unit cost, excess capacities, and higher fixed costs in times of low production requirements. These costs have to be weighed against the benefits of production flexibility provided by the presence of multiple production facilities. These additional costs can be seen as the cost of an option to produce goods at an alternative location, whose value increases with an increase in exchange rate volatility.

Plant Location

Companies which do not have multiple production facilities may be forced to set up such facilities abroad as a response to exchange rate movements which change the relative cost advantages of countries. Firms may even decide to set up production facilities in third-world countries for labor-intensive products due to the low labor cost there, without there being any specific advantage due to exchange rate movements.

Such decisions have to be taken after giving due consideration to the duration for which such production facilities are likely to enjoy cost advantages. Since these commitments are long-term in nature, the benefits should be expected to continue for a substantially long period, for such investment to be justified. The underlying economic factors of the country where the setting up of production facilities is being contemplated, need to be evaluated thoroughly before the decision is made. Sometimes the root cause of the depreciation of that currency (which gives the country its cost advantage) may be such as to make the cost advantage last only for a short-term (e.g. inflation). In such cases it may be advisable not to make the investment.

The advantages accruing from the setting up of these facilities also need to be weighed against factors like the loss over quality control, distance from suppliers of crucial inputs, the political environment in that country resulting in additional risks. The decision should be taken after all these relevant factors have been duly considered.

Raising Productivity

An appreciation of the domestic currency results in increasing the costs of an exporting firm in terms of the foreign currency, thus making the product uncompetitive in the international market, forcing the firm either to bear a cut in the profit margin or to lose market share. This problem may be resolved by the firm making an effort to reduce the domestic currency cost of its product in the wake of a domestic currency appreciation. While this may happen automatically in case imported raw materials or intermediate inputs being used. When this is not the case the firm may have to resort to other measures like attempting to increase the productivity of the various factors of production. It may entail modernizing the machinery and the technology, renegotiating wage agreements, closing inefficient plants, pruning the product line, etc.

FINANCIAL MANAGEMENT STRATEGIES

The production and marketing strategies detailed above generally take some time to be implemented. The focus of the financial management strategies is to control the damage caused by unfavorable exchange rate movements while the above strategies are being implemented. The major financial management strategy is to create liabilities in the currency to which the firm's earnings are exposed to a large extent, thus creating a natural hedge. Any loss of operating profits caused due to exchange rate movements would then be made up at least partially by reduction of debt-servicing costs.

It has to be kept in mind that while this strategy can be used for managing large exposures in currencies, it can neither be used to hedge exposures perfectly, nor for managing exposures in all the currencies. A comparative analysis of the exposures in various currencies needs to be done before deciding on the final strategy.

SUMMARY

- As we have seen, there are a number of ways in which transaction and translation exposures can be managed. Though there is no perfect method, each one has its own features, advantages and disadvantages which make it suitable for particular situations. Finally, the selection of the suitable method depends upon the firm's expectations regarding the future movement of exchange rates and the degree of risk that is acceptable to the management.
- The strategies for managing operating exposure outlined above would prove to be more effective if the exchange rate movements and their effects on operating profits could be predicted. But managing exposure is all about managing unpredictable exchange rate movements and their unpredictable effects on the operating profits of a company. This requires advance planning by the firm which involves a study of the possible exchange rate scenarios and the probability that could be attached to them. It further involves estimating the effect of each scenario on the firm's operating profits and planning the possible corrective actions (in terms of the production or marketing strategies) that would need to be taken in such scenarios. With the presence of such plans, acting quickly would become possible when the exchange rate movements actually take place, which is the best, a firm can do to manage its operating exposure.
- We have seen that the decisions that are required to be taken for managing operating exposure do not necessarily fall within the purview of the treasurer. It is the top management which is more involved and responsible for managing the operating exposure. Another important point that needs to be noted is that implementing a policy for hedging operating exposure is extremely difficult in practice due to the continuously changing exchange rates, the difficulty in predicting their effect on a firm's operating profits, and the costs involved in making the analysis that goes in as an input to the decision-making process. These high costs and difficulties in implementation, which sometimes make the expected returns from these activities very small, make it imperative that these activities should be undertaken only when the cost of leaving the firm exposed to exchange rate movements are expected to be large.

Part IV – International Projects

Chapter XI

International Project Appraisal

After reading this chapter, you will be conversant with:

- Reasons for Foreign Direct Investment (FDI)
- Appraisal for Foreign Direct Investment (FDI)
- The Adjusted Present Value (APV) Criteria

Foreign Direct Investment (FDI) is the investment made in physical assets like plant and machinery in a foreign country, with the management control being retained by the domestic investor. It differs from international portfolio investments in two aspects. Firstly, while portfolio investments are made in financial assets, FDI is made in physical assets. Secondly, portfolio investment does not result in a managerial control over the company whose securities are bought, whereas FDI usually results in managerial control over the operations of the foreign entity. FDI can be done in a number of ways:

- By establishing a new corporate in the foreign country, either as a branch or a subsidiary. A business enterprise can set-up a subsidiary either on its own or as a joint venture with an existing foreign entity;
- By making further investments in an existing foreign branch or subsidiary;
- By acquiring an existing foreign business enterprise or purchasing its assets.

REASONS FOR FDI

Companies invest in foreign physical assets for a number of reasons. The important ones are:

- Economies of scale
- Need to get around trade barriers
- Comparative advantage
- Vertical diversification
- General diversification benefits
- Attacking foreign competition
- Extension of existing international operations
- Product life cycle
- Non-transferable knowledge
- Brand Equity
- Protection of Brand Equity
- Following its clients.

Economies of Scale

As the domestic market saturates for a company's products, it starts viewing overseas markets as a potential source of growth. Continuous growth is essential for achieving further economies of scale, which is necessary for any business enterprise to survive in a competitive market.

Need to Get Around Trade Barriers

Despite the growing importance of international trade, trade barriers continue to be in place in most of the countries due to various economic, political and social reasons. The need to get around these trade barriers prompts corporates to make FDI in order to expand the market for its products.

Comparative Advantage

The locational advantages offered by a country by way of lower costs serve as an important incentive for a corporate to start production facilities abroad.

Vertical Diversification

Companies going for vertical diversification may sometimes need to expand overseas due to non-availability of opportunities in the domestic market. Example, if a foreign country has abundant supplies of an essential raw material, the company may like to diversify by investing in that market, thus ensuring smooth supply of the raw material. Similarly, if there is a flourishing industry abroad which can serve as a captive consumer of a company's final product, the company may like to establish its presence there.

General Diversification Benefits

A corporate may like to invest overseas for the benefits of diversification across various markets. As in the case of portfolio investments, investment in physical assets when spread over various countries, is expected to give a steadier or a higher stream of income.

Attacking Foreign Competition

Companies being challenged by foreign competitors in their home country may have an incentive in establishing production bases in the competitors' countries. The incentive may be two-fold. On one hand, it may provide them with the same cost advantages as their competitors. At the same time, the competitors' attention may get diverted as they start concentrating on protecting their market shares in the home market.

Extension of Existing International Operations

For a corporate involved in exporting goods to other countries, establishing a foreign subsidiary may appear a natural extension. Starting with a sales subsidiary, the corporate may graduate to having licensing agreements, and finally overseas production capacities.

Product Life Cycle

As a product moves to the maturity stage (as explained by the product life cycle theory in the Chapter "Theories of International Trade"), its production process becomes more standardized and producers from developing countries become interested in producing it. As the developing country producers enjoy a cost advantage at this stage (mainly due to cheap labor), the producers of the country where the innovation took place need to shift their production facilities to the developing countries in order to be able to compete. This requires foreign direct investment.

Non-transferable Knowledge

Certain types of knowledge (e.g., the experience in manufacturing and marketing a particular product) cannot be transferred to foreign producers for a price (unlike a trade mark or a patent), and hence the need to set-up overseas operations to fulfill the desire to exploit a company's existing knowledge in foreign markets. Sometimes the knowledge may become non-transferable due to the reluctance of the company to share its secrets, again promoting FDI. Example, the Coca-Cola company has to set-up its own operations everywhere due to its reluctance to share the secret formula of its soft drinks.

Brand Equity

Some brands enjoy international reputation. The popularity of these brands act as an incentive for their producers to expand overseas. Example, Levi's set-up operations in India to exploit its international reputation as a producer of good quality denim clothes.

Protection of Brand Equity

Though a company can exploit foreign markets by licensing the use of their brand names, the fear that the licensee may not be able to live up to the company's strict quality standards, may push the company to set-up its own manufacturing unit abroad.

Following its Clients

Some service firms may find it both attractive and necessary to expand along with their clients. Example, the major auditing firms generally extend their operations to countries where their clients are headed due to their clients' need to have a single audit firm across the globe. This sort of expansion becomes necessary due to the possibility of losing business to a competitor having international presence.

APPRAISAL FOR FDI

Before making any investment, it is imperative that an estimate is made as to the expected returns from that investment. This requires the investment to be judged both for the cash flows it is expected to generate, as well as for the associated risk. Since foreign direct investment entails ownership of physical assets which are to be employed for specified uses, the process is reduced to analyzing a project, albeit with an important difference. Here, the cash flows are expected to be in a foreign currency (as the investment is made in a foreign country), with the attendant economic, political and social environment (and hence the risks) being different from those applicable to home country projects.

The economic viability of a home country project can be measured using various tools like NPV, IRR, payback period, accounting rate of return etc. However, in an international project there are certain issues involved which affect both the cash flows and the discount rate and thus make these frameworks insufficient. The issues are:

- Blocked funds
- Effect on the cash flows of other divisions
- Restrictions on repatriation
- Taxability of cash flows
- Exchange rate movements
- Subsidized loans by the foreign government.

Blocked Funds

Sometimes, a company may have funds which are blocked in another country due to restrictions on their being remitted. If these funds can be activated and be invested in the new project, the initial outlay for the new project stands reduced accordingly. Suppose the funds were blocked completely and could not be repatriated at all. In that case, the full amount of the activated funds would be deducted from the amount of initial investment. If it is possible to recover a part of the blocked funds (after paying withholding taxes etc.), then that part of the funds which cannot be recovered will be treated as activated funds and deducted from the initial investment. This is so because investing the recoverable part of the funds would be equivalent to recovering and reinvesting them.

Effect on the Cash Flows of Other Divisions

One of the basic principles of financial management is that while evaluating a project, only the incremental cash flows to the corporate as a whole should be taken into consideration. This has to be borne in mind even while evaluating foreign projects. The sales from the new project may reduce the sales of other existing divisions in the same or another country, which cater to the same market. On the other hand, the new project may increase the cash flows of an existing division by serving as a captive customer for its products, or by supplying it raw materials at better rates. All these factors should be considered while estimating the cash flows of the new project.

Restrictions on Repatriation

A number of countries impose restrictions on the profit or the capital that can be repatriated by a company to its foreign parent company. As all the cash flows generated by the foreign subsidiary would not be available to the parent company in the presence of such restrictions, they cannot be considered for evaluating the worth of the project. In such a scenario, only those cash flows which can be repatriated (irrespective of whether they are actually repatriated or not) should be considered.

There are a number of legal ways to circumvent restrictions on profit repatriations. These should also be accounted for, especially as some of them involve the way the project is to be financed. Some of these ways are discussed below:

- Transfer pricing
- Royalties
- Leading and lagging
- Financing structure
- Inter-company loans
- Currency of invoicing
- Re invoicing centers
- Countertrade.

Transfer Pricing

Transfer pricing refers to the policy of invoicing purchase and sale transactions between a parent company and its foreign subsidiary on terms which are favorable to the parent company, thus shifting a part of the subsidiary's rightful profits to the parent. As this method of circumventing repatriation restrictions is very common, authorities are generally very alert as to the price at which transfers are made.

Royalties

The foreign subsidiary may use the parent company's trademarks and copyrights and pay royalties as compensation. As this is not a transfer of profit, the normal restrictions on profit repatriation do not cover these payments.

Leading and Lagging

Leading and lagging payments between the parent company and the subsidiary, based on expected movements in exchange rates can help in transferring profits from the latter to the former. Suppose the subsidiary has to pay its parent company a sum which is denominated in a currency that is expected to harden. The subsidiary lags (delays) the payment so that a part of the subsidiary's profits get transferred to the parent company. In the event of such a payment being denominated in a currency that is expected to depreciate, the subsidiary leads (advances) the payment, again with the same effect.

Financing Structure

An overseas project can be funded solely through equity investments, or through a mixture of equity and debt. In cases where there are restrictions on repatriation of profits and repayment of capital, part of the project can be funded through loans from the parent company to the foreign subsidiary. Generally, there are fewer restrictions on payment of interest and repayment of loans than on profit repatriation. Also, interest payments are tax deductible for the subsidiary whereas dividend payments are not (for the parent company both are taxable). There is another tax incentive involved as repayment of loans is non-taxable in the hands of the parent company, whereas funds transferred as dividends are. This way, repatriation restrictions can be maneuvered around, along with getting additional tax advantages, by extension of loans to the subsidiary by the parent company, instead of making direct equity investments.

Inter-company Loans

The methods mentioned above are fairly common ways of getting around regulations in a legal manner. Over a period of time, authorities have become aware of them and frown upon payments to a foreign parent company, under whatever disguise. Hence, the danger of the subsidiaries being disallowed from making such payments always looms large. To get around these problems, companies can resort to inter-company loans. The simplest way is that two

companies make parallel loans to each others subsidiaries, with the amounts and timing of the loans and the interest payment as also the loan repayment matching. This can be refined if each of the subsidiary companies is based in the same country as the other's parent company. In that case, the loans come totally out of the ambit of exchange control regulations as both the loans are made within the countries involved. The only drawback of this method is that the holding company cannot set-off the loan which it has extended against the loan that its subsidiary has received (which would be possible in quite a few countries if it were a direct loan to its own subsidiary) as a part of consolidation of accounts, and the loans would appear both as an asset as well a liability on its books.

Another way of extending such loans without the parent getting directly involved is a back-to-back loan involving a major multinational bank or a financial institution. Under this method, the parent corporation makes a loan to the bank/FI, with the bank/FI extending an equivalent loan to the foreign subsidiary. For the bank, the loan is risk-free as it is backed by the parent company's loan. From the parent company's point of view there is a lesser political risk involved, as in case of exchange controls being imposed, it is less likely that interest payments and loan repayments to a multinational bank/FI would be restricted than if the payments were to be made directly to the parent company.

Currency of Invoicing

Choice of currency in which intra-group trade is invoiced is an important tool for transferring profits within different companies of the same group. Exchange controls are generally imposed to prevent the local currency from depreciating. If the currency is expected to depreciate despite the controls, the exports from the subsidiary based in that country to other group companies can be invoiced in that country's currency. Also, the imports of that subsidiary from other group companies can be invoiced in some hard currency (one that is expected to appreciate). As the country's currency depreciates, the subsidiary's profits will fall from what they would have been otherwise, and the profits of other group companies will increase. The other group companies which benefit from this should be based in countries which have either lesser or non-existent exchange controls, or a lower tax rate or a hard currency. This way, the overall profit repatriable to the parent company increases.

Reinvoicing Centers

Trades between companies in the same group can be routed through a reinvoicing center. Reinvoicing centers act as an intermediary by buying from one company and selling them on to the other. The margin between the buying and the selling rates is the amount of profit transferred from the subsidiary to the reinvoicing center. Such centers are mainly used for the management of exposures, but can also be used for converting non-repatriable cash flows into repatriable cash flows, when set-up in countries with lesser capital controls. In addition to such conversion, setting up of such reinvoicing centers in tax havens can reduce the overall taxes, and hence increase the after-tax cash flows.

Countertrade

Countertrade involves the parent company and the subsidiary buying from and selling to each other. The most common form taken is barter trade. While the goods transferred from the subsidiary (the value of which may be very high compared to the value of goods received by it) may not be useful for the parent company directly, it can sell them to some third party, with the proceeds serving as an indirect transfer of the subsidiary's profits.

Taxability of Cash Flows

The profits of a foreign subsidiary are first taxed in the foreign country. This does not pose any problem as far as evaluation of a project is concerned, as the cash flows considered are post-tax, in accordance with financial management principles. The issue that comes up when the subsidiary is based in a foreign country, is that of taxes on repatriated profits. When the subsidiary repatriates its profits to its parent company, there is generally a withholding tax levied by the foreign government. These profits, when received by the parent company, are again taxed in the domestic country as dividends received. To avoid such problems, countries generally enter into double-taxation agreements, whereby these taxes become payable only in one country (or partly in one and partly in another). Even in the absence of such agreements, the parent company generally receives a tax credit for the withholding taxes paid by the subsidiary. As the tax credit cannot exceed the tax to be levied by the domestic tax authorities, if the foreign withholding tax rate is higher than the domestic dividend tax rate, the corporation as a whole ends up paying the higher tax rate. Due to this, the tax rate that is considered while evaluating such projects is the higher of the domestic and the foreign rates.

Exchange Rate Movement

The volatility of exchange rates is a well-known fact. The rate at which the initial investment is converted into the foreign currency need not be the same as the exchange rate prevailing at the time of repatriation of profits. Since the relevant cash flows are those from the point of view of the parent company, the cash flows to the subsidiary need to be converted into the domestic currency of the parent company, at rates expected to prevail in the future.

Subsidized Loans by the Foreign Government

The foreign government may sometimes extend concessional loans to a company setting up operations in its country in order to encourage FDI or to promote economic activity. This reduces the cost of funds for the project. Yet, this reduction of cost of funds may not get reflected as a lower discount rate in the traditional models, because this concession is not directly available to the company's investors.

It is quite difficult to build these factors into the frameworks used for evaluating domestic projects. These hurdles can be at least partially overcome by using the Adjusted Present Value (APV) approach. This approach is an extension of the Modigliani-Miller approach to valuation of a company. It first measures the present value of the basic cash flows of a project using the all-equity rate of discounting, and then tackles the above mentioned issues one by one. By breaking up the evaluation in this manner, it provides scope for analyzing an indefinite number of additional factors which may affect an international project.

THE APV CRITERIA

The adjusted present value of a foreign project is given by:

$$\begin{aligned} \text{APV} = & -S_0(C_0 - A_0) + \sum_{t=1}^n \frac{(S_t^*C_t^* + E_t^*)(1-T)}{(1+k_e)^t} + \sum_{t=1}^n \frac{D_t T}{(1+k_d)^t} + \sum_{t=1}^n \frac{rB_0 T}{(1+k_b)^t} \\ & + S_0 \left[CL_0 - \sum_{t=1}^n \frac{R_t}{(1+k_c)^t} \right] + \sum_{t=1}^n \frac{P_t^* T}{(1+k_p)^t} + \sum_{t=1}^n \frac{I_t}{(1+k_i)^t} \end{aligned}$$

.... (Eq. 1)

Where,

APV = Adjusted Present Value.

S_0 = Current exchange rate.

C_0 = Initial cash outlay in foreign currency terms.

A_0 = Activated funds.

S_t^* = Expected exchange rate at time 't'.

n = Life of the project.

C_t^* = Expected cash flow at time 't', in foreign currency terms.

E_t^* = Expected effect on the cash flows of other divisions at time 't', expressed in domestic currency terms; can be either positive or negative.

T = Domestic or foreign tax rate, whichever is higher.

D_t = Depreciation in home currency terms at time 't'. (If the depreciation is not allowed to be set-off by the parent company against its own profits, it needs to be defined in foreign currency terms with its present value being converted at S_0 into domestic currency terms).

B_0 = Contribution of the project to borrowing capacity of the parent firm.

r = Domestic interest rate.

CL_0 = Amount of concessional loan received in foreign currency.

R_t = Repayment of concessional loan at time 't'.

p_t^* = Expected savings at time 't' from inter-subsidiary transfer pricing.

I_t = Illegally repatriated cash flows at time 't'.

k_e = All-equity discount rate, reflecting all systematic risks, including country risk and exchange-rate risk.

k_d = Discount rate for depreciation allowances.

k_b = Discount rate for tax savings from generation of borrowing capacity.

k_c = Discount rate for savings due to concessional loans, generally the interest rate in the absence of concessional loans.

k_p = Discount rate for savings through transfer pricing.

k_i = Discount rate for illegal transfers.

The last term in the equation requires some explanation. A project may be unviable despite the use of all the possible ways of legally repatriating a subsidiary's profits. Under such conditions, the parent company may resort to use illegal ways of remitting these profits. In such a situation, these illegal cash flows should also be taken into account while evaluating the project.

THE DISCOUNT RATE

As previously mentioned, k_e is the all-equity discount rate, reflecting a premium for all systematic risks, including country-risk and exchange-risk. The discount rate also reflects the risk reduction due to the portfolio effect, i.e., due to the imperfect correlation between returns from the various markets.

An important factor that needs to be considered is inflation. The presence of inflation makes the choice between the real and the nominal rate of discount, crucial. It becomes important to match nominal cash flows with a nominal discount rate, and real cash flows with a real discount rate.

To match cash flows with the appropriate discount rate, it becomes essential to analyze the nature of the cash flow. If the future cash flow is predetermined, or contractual in nature (e.g., depreciation allowance, or pre-contracted sales at a pre-determined price), then the nominal discount rate should be used as the cash flows would be expressed in nominal terms. If the future cash flows need to be estimated, then either real cash flows can be estimated and discounted at the real discount rate, or the inflation estimates can be built into the cash flows which would then be discounted at nominal discount rates. Let us now analyze the various discounting factors one by one.

- k_e : This rate should be the nominal discount rate for contractual cash flows. As the cash flows have been converted to the domestic currency, it should be the domestic nominal discount rate. For non-contractual cash flows, if expressed in nominal terms, this should be the nominal rate.
- k_d : Since the depreciation charge is based on the historical cost of assets and is hence contractual, the discount rate should be the domestic nominal rate. If there is a strong probability of positive cash flows being generated, and hence of the depreciation tax shield being availed, then the risk-premium may be negligible, and the domestic nominal risk-free rate may be used.
- k_b : Since the borrowing capacity would be measured in nominal terms, this should be the nominal rate. Again, if the probability of positive cash flows is strong, the domestic nominal risk-free rate may be used.
- k_c : As the nominal foreign-currency interest rate would have had to be paid in the absence of the concessionary loan, that rate should be used as the discount rate for calculating the present value of the repayments of the concessionary loan.
- k_p & k_i : If the relevant cash flows are expressed in domestic, nominal terms, the discount rate should be the domestic nominal rate. As there should be a risk-premium to reflect the possibility of these cash flows not getting remitted, it is suggested that this rate be equal to k_e .

Illustration 1

Hitech Ltd. is an Indian company manufacturing computers. It plans to set-up a manufacturing unit in Switzerland.

The following details are available for the proposed project:

The project outlay is estimated to be SFr 1,00,000. The company currently has SFr 50,000 blocked in Switzerland, out of which it can activate SFr 10,000 for the current project. The life of the project is estimated to be 5 years.

Hitech Ltd. is expecting to receive the following cash flows from the project in the coming years:

Year	Cash flow (SFr)
1	30,000
2	35,000
3	50,000
4	45,000
5	30,000

Currently, Hitech Ltd. is exporting computers to Switzerland from its domestic manufacturing unit. The loss of cash flows from this operation due to the new manufacturing unit is expected to be:

Year 1 = Rs.3,00,000

Year 2 = Rs.2,00,000

Year 3 = Rs.1,50,000

The Indian tax rate is 30%, while the Swiss tax rate is 20%. Depreciation is to be provided on the basis of Straight Line Method. The contribution of the project to the borrowing capacity of the firm is Rs.15 lakh.

The Swiss government extends a concessionary loan of SFr 20,000 to Hitech Ltd. at the rate of 10% p.a. The loan has to be repaid in 5 equal annual installments over the life of the project.

The company expects to save Rs.1,00,000 p.a. on taxes over the next five years through transfer pricing.

The spot rate is Rs./SFr 30.80, and the Swiss franc is expected to appreciate against the rupee @ 5% p.a. for the next 5 years.

The all-equity discount rate is 20%, while the domestic nominal risk-free rate is 10%. The domestic interest rate is ruling at 18%, the Swiss interest rates are ruling at 15%.

The company expects zero salvage value at the end of 5 years. Calculate the APV of the project.

Solution

$$S_0 (C_0 - A_0) = 30.8 (100,000 - 10,000) = \text{Rs.}2,772,000$$

Expected exchange rate at the end of

$$\text{Year 1} = 30.80 \times 1.05 = \text{Rs.}32.34/\text{SFr}$$

$$\text{Year 2} = 32.34 \times 1.05 = \text{Rs.}33.96/\text{SFr}$$

$$\text{Year 3} = 33.96 \times 1.05 = \text{Rs.}35.66/\text{SFr}$$

$$\text{Year 4} = 35.66 \times 1.05 = \text{Rs.}37.44/\text{SFr}$$

$$\text{Year 5} = 37.44 \times 1.05 = \text{Rs.}39.31/\text{SFr}$$

The present value of the cash flows received by Hitech Ltd. from the project would be

$$\begin{aligned} &= \sum_{t=1}^n \frac{(S^* C_t^* + E_t^*)(1-T)}{(1+k_e)^t} \\ &= \frac{(32.34 \times 30,000 - 3,00,000)(1-0.3)}{(1.2)^1} + \frac{(33.96 \times 35,000 - 2,00,000)(0.7)}{(1.2)^2} \\ &\quad + \frac{(35.66 \times 50,000 - 1,50,000)(0.7)}{(1.2)^3} + \frac{(37.44 \times 45,000)(0.7)}{(1.2)^4} \\ &\quad + \frac{(39.31 \times 30,000)(0.7)}{(1.2)^5} \end{aligned}$$

$$= 3,90,950 + 4,80,569.44 + 6,61,516.20 + 5,68,750 + 3,31,753.95 = \text{Rs.}2,43,3539.59$$

$$D_t = \frac{30.8 \times 1,00,000}{5} = \text{Rs.}616,000$$

The present value of the depreciation tax shield

$$\begin{aligned} &= \sum_{t=1}^n \frac{D_t T}{(1+k_d)^t} \\ &= 616,000 \times 0.3 \times \text{PVIFA}_{(10\%, 5)} \\ &= \text{Rs.}700,537. \end{aligned}$$

The present value of interest tax shield on the borrowing capacity generated by the firm

$$\begin{aligned}
 &= \sum_{t=1}^n \frac{rB_0 T}{(1+k_b)^t} \\
 &= 15,00,000 \times 0.18 \times 0.3 \times \text{PVIFA}_{(10\%, 5)} \\
 &= \text{Rs.} 3,07,054.
 \end{aligned}$$

The annual repayment of concessionary loan

$$= 20,000/5 = \text{SFr } 4,000.$$

The present value of repayment of concessional loan

$$\begin{aligned}
 &= \sum_{t=1}^n \frac{R_t}{(1+k_c)^t} = 4,000 \times \text{PVIFA}_{(15\%, 5)} \\
 &= 4,000 \times 3.3522 \\
 &= \text{SFr } 13,409.
 \end{aligned}$$

The benefit of the concessionary loan

$$\begin{aligned}
 &= S_0 \left[CL_0 - \sum_{t=1}^n \frac{R_t}{(1+k_c)^t} \right] \\
 &= 30.8 [20,000 - 13,409] \\
 &= \text{Rs.} 2,03,003.
 \end{aligned}$$

The present value of the expected tax savings due to transfer pricing

$$\begin{aligned}
 &= \sum_{t=1}^n \frac{P_t^* T}{(1+k_p)^t} = 1,00,000 \times \text{PVIFA}_{(20\%, 5)} \\
 &= \text{Rs.} 2,99,061.
 \end{aligned}$$

Note: Here, the all-equity discount rate has been used to discount the expected tax savings.

$$\begin{aligned}
 \text{APV} &= -2,772,000 + 24,33,539.59 + 7,00,537 + 3,07,054 + 2,03,003 + 2,99,061 \\
 &= \text{Rs.} 11,71,194.59
 \end{aligned}$$

Let us now calculate the NPV for the same set of data, and compare it to the APV figure.

The cash flows for NPV would be:

$$\begin{aligned}
 C_0 &= 30.8 (1,00,000 - 10,000) = \text{Rs.} 2,772,000 \\
 C_1 \text{ to } C_5 &= (S^* C_t^* + E_t^*) (1 - T) + D_t T + P_t^* T \\
 C_1 &= 6,70,200 (1 - 0.3) + 6,16,000 (0.3) + 1,00,000 = \text{Rs.} 7,53,940 \\
 C_2 &= 9,88,600 (0.7) + 6,16,000 (0.3) + 1,00,000 = \text{Rs.} 9,76,820 \\
 C_3 &= 16,33,000 (0.7) + 6,16,000 (0.3) + 1,00,000 = \text{Rs.} 14,27,900 \\
 C_4 &= 16,84,800 (0.7) + 6,16,000 (0.3) + 1,00,000 = \text{Rs.} 14,64,160 \\
 C_5 &= 11,79,300 (0.7) + 6,16,000 (0.3) + 1,00,000 = \text{Rs.} 1,10,310.
 \end{aligned}$$

The project would be financed from various sources as follows:

$$\text{Domestic debt} = \text{Rs.} 15,00,000$$

Concessional loan from foreign government = 20,000 x 30.8 = Rs.616,000

Equity = 27,72,000 – (15,00,000 + 6,16,000) = Rs.6,56,000

$$\begin{aligned} \text{WACC} &= 20\left(\frac{656,000}{2,772}\right) + 18(0.3) \times \left(\frac{1,500,000}{2,772,000}\right) + 10\left(\frac{6,16,000}{27,72,000}\right) \\ &= 13.77\%. \end{aligned}$$

$$\begin{aligned} \text{NPV} &= -27,72,000 + \frac{7,53,940}{1.1377} + \frac{9,76,820}{(1.1377)^2} + \frac{14,27,900}{(1.1377)^3} + \frac{14,64,160}{(1.377)^4} + \frac{11,10,310}{(1.1377)^5} \\ &= \text{Rs.}10,71,455. \end{aligned}$$

As we can see, the APV criteria gives a value higher to the NPV figure by Rs.99,739. This difference occurs due to the different discount rates used in the two methods, as well as the difference in cash flows. Though this does not have a major effect on the decision in this case as both the figures are positive, using the NPV criteria may lead to wrong decisions in marginal cases. Even if it does not result in an erroneous decision, in all likelihood it will give a return which is different from the return arrived at through the APV method. The use of the APV method assumes that it is possible to identify the various discount rates used in the process. In situations where these discount rates cannot be accurately arrived at, it may be better to use the NPV criteria, as use of inappropriate discount rates may distort the present value figure more than it would be were the NPV criteria used.

The profitability of a project sometimes gets affected by the priorities and the economic policies of the foreign government. Suppose that two projects are similar in all respects, except the initial investment. Assuming that the profitability of the two projects (in percentage terms) is also the same, the project with a higher initial investment would have higher cash inflows in subsequent years, leading to a higher APV. If, in addition, the foreign government is trying to attract FDI, it may favor the bigger project, which may get reflected in a larger concessional loan or more activated funds. This would result in an even higher APV.

Let us now analyze the effect of governmental priorities on other factors affecting the APV of a project. A project being in a sector which is a high priority area for the foreign government may result in one or more of the following:

- A higher amount of blocked funds getting activated.
- More profits being allowed to be repatriated to the foreign parent company.
- Lower taxes (which would affect the profitability of a project only if these rates are still higher than the domestic tax rates faced by the parent company).
- A higher depreciation allowance leading to a higher depreciation tax shield.
- A larger concessional loan and/or a lower interest rate charged on the loan.

Such treatment would result in an increase in the APV, and hence, the economic viability of a project. In such a scenario, if two different projects with similar commercial viability are being considered by a firm, the fact that one of them is in a sector which is a priority sector for the foreign government, may tilt the decision in its favor. Here, the importance of the choice of the discount factors comes to the fore. Suppose the non-priority sector project is one which enjoys a higher depreciation than the priority-sector project. Also, suppose that this higher depreciation is exactly offset by an annual benefit through lower interest payments due to a concessional loan being extended to the latter by the foreign government. The APV of the former project may still be higher than that of the latter, if the discount rate applied to depreciation tax shields is lower than that applied to repayments of the concessional loan. Hence, the choice of discount rates may make the non-priority sector project more attractive, despite the foreign government extending a concessional loan to the priority-sector project. This highlights the importance of choosing appropriate discount rates for calculating the adjusted present value of the various components of the cash flow.

Till now, we have been evaluating international projects only from the financial angle. However, in addition to these quantitative aspects, there are a number of qualitative aspects which need to be considered, especially before undertaking an international project. Some of these are:

THE ECONOMIC SCENARIO

The current and the future economic scenario of the country in which the project would be based, is very crucial for the profitability of the project. A few of the economic factors which could affect the project's performance are the projected GDP growth rate, the income level in the economy, the projected growth rate of various sectors of the economy, the prevalent and projected interest rates, the inflation rate, the degree of development of financial markets, budget deficit, unemployment rate etc.

THE POLITICAL SCENARIO

The political ideology of the present government and that of the likely future governments affects an international project's performance in more than one way. The most important factor is the government's general outlook towards FDI. A project in a country which is hostile towards foreign capital is less likely to succeed than one based in a country which welcomes foreign capital. The political ideology of the government is also likely to determine the sectors open to FDI. The government's commitment to introduce and continue with economic reforms also depends on its political ideology. Many economic factors like the budget deficit, money supply, etc., also get directly affected by the government's policies. Lastly, the political stability or its absence in a country affects the chances of continuity of all the economic policies affecting FDI.

Financing Aspects

Sometimes it becomes very difficult to obtain financing for an international project due to the risks involved. Hence, the availability of finance from domestic and foreign sources becomes an important factor that needs to be considered before such a project can be undertaken.

SUMMARY

- Investing money in projects based in foreign countries through FDI can be a very risky and challenging affair, but one having its own rewards. It is essentially a long-term decision, which needs to be taken after a lot of careful deliberation.
- While the quantitative evaluation of such a project involves an analysis which considers a number of factors in addition to those considered by the more commonly used appraisal criteria, the qualitative evaluation of the project becomes equally important due to the complexities involved.
- A project undertaken after a thorough analysis of both these factors can prove to be a highly rewarding experience.

Appendix 1

RBI/2005 - 06/05

Master Circular No. / 05 /2005-06

July 1, 2005

Master Circular – Foreign Investments in India *

INDEX

Part - I

1. Foreign Investments in India

Foreign Investments in India attract provisions of Section 6 of Foreign Exchange Management Act (FEMA), 1999 and is subject to the Regulations issued by Reserve Bank of India under FEMA, 1999. The Regulations have been notified vide Notification No.FEMA 20/2000-RB dated May 3, 2000, and amended from time to time vide various Notifications listed in Appendix. An Indian entity cannot issue any security to a person resident outside India or record in its books any transfer of security from or to such person except as provided in the Act or Rules or Regulations or with the specific permission of the Reserve Bank.

2. Prohibition on investment into India

No person resident outside India can make investment in a company or a partnership firm or a proprietary concern or any entity, whether incorporated or not which is engaged or proposes to engage in the following activities.

- i. Business of chit fund, or
- ii. Nidhi Company, or
- iii. Agricultural or plantation activities, or
- iv. Real estate business, or construction of farm houses,
- v. Trading in Transferable Development Rights (TDRs).

It is clarified that Real Estate Business does not include development in townships, construction of residential/commercial premises, roads or bridges.

In addition to the above activities, the FDI is also prohibited in certain activities, a list of which is given in Annex-1 (Item B).

3. Permitted Investments in India

In other cases investments can be made either with the specific prior approval of the Government of India, the Secretariat for Industrial Assistance/Foreign Investment Promotion Board (SIA/FIPB) or under the Automatic route (Annex-1). The list of the activities requiring the approval of the Government is given in Annexure-A (A) to Schedule 1 to FEMA Notification No. 94 and details of the activities/sectors which are covered under the automatic route is given as Annexure-B to the said Schedule. The Automatic Route is not open in the following cases and as such require specific approval of FIPB i.e. (i) where the non-resident investors who have/had a previous financial/technical/ trademark collaboration in an existing domestic company engaged in the same or allied activity, (ii) if the activity or manufacturing item of the issuer company requires an Industrial License under the provisions of the Industries (Development and Regulation) Act, 1951 or under the locational policy notified by Government of India under the Industrial Policy Resolution, 1991 and (iii) the investment is sought in excess of the prescribed sectoral limits Automatic Route.

While the nature of investment activities have been prescribed in the FEMA Regulations, the scope of these activities especially regarding the investments by non-residents under the Government approval route have been detailed in

* Source: www.rbi.org.in

the Government Manual on Investing in India, Foreign Direct Investment, Policy & Procedures. This is a document which is available in the public domain and can be downloaded from the website of DIPP, Ministry of Commerce and Industry.

4. Eligibility for Investing in India

A person resident outside India (other than a citizen of Pakistan or Bangladesh) or an incorporated entity outside India, (other than an entity incorporated in Bangladesh or Pakistan) has the general permission to purchase shares or convertible debentures or preference shares of an Indian company subject to certain terms and conditions.

5. Nature of Investments

5.1 The Indian companies have general permission to issue equity/preference/convertible preference shares and convertible debentures subject to certain conditions.

5.2 Investment in a trading company incorporated in India is permitted under automatic route with FDI up to 51% provided the Indian company is primarily engaged in export activities, and the undertaking is an export house/trading house/super trading house/star trading house. Government also permits certain trading activities under FIPB route, as mentioned in Annexure 'B' to Notification No. FEMA 94/2003-RB dated 18th June, 2003. (Annex-2 Item No.9)

5.3 A company which is a small scale industrial unit and which is not engaged in any activity or in manufacture of items included in Annexure A (A) to Notification No.94, may issue shares or convertible debentures to a non-resident, to the extent of 24% of its paid-up capital. Such a company may issue shares in excess of 24% of its paid-up capital if,

- a. It has given up its small scale status,
- b. It is not engaged or does not propose to engage in manufacture of items reserved for small scale sector, and
- c. It complies with the ceilings specified in Annexure B to Notification No.94.

5.4 An Export Oriented Unit or a unit in Free Trade Zone or in Export Processing Zone or in a Software Technology Park or in an Electronic Hardware Technology Park may issue shares or convertible debentures to a person resident outside India in excess of 24% provided it conforms to the ceilings specified in Annexure B to Notification No.94 as annexed at Annex-2.

6. General Permissions granted under the Regulations.

6.1 Issue of Rights/Bonus shares

General permission is also available to Indian companies to issue Right/Bonus shares to existing non-resident shareholders, subject to adherence to sectoral cap and consequential offer on right basis is made at a price not lower than that at which offer is made to resident shareholder. As clarified in terms of AP (DIR Series) Circular No.14 dated 16th September 2003, entitlement of rights shares is not automatically available to investors who have been allotted such shares as OCBs. Such issuing companies would have to seek specific permission from RBI, Foreign Exchange Department, Foreign Investment Division, Central Office, Mumbai for issue of shares on

right basis to erstwhile OCBs. However, bonus shares can be issued to OCBs.

6.2 Acquisition of shares under Scheme of Amalgamation/merger

Where a Scheme of merger or amalgamation of two or more Indian companies has been approved by a court in India, the transferee company may issue shares to the shareholders of the transferor company, resident outside India subject to ensuring that the percentage of shareholding of persons resident outside India in the transferee or new company does not exceed the percentage specified in the approval granted by the Central Government or the Reserve Bank. The transferor company or the transferee or new company should not be engaged in activities prohibited in terms of FDI policy viz agriculture, plantation or real estate business or trading in TDRs, etc.

6.3 Issue of shares under Employees Stock Option Scheme

A company may issue shares under the Employees Stock Option Scheme, to its employees or employees of its joint venture or wholly owned subsidiary abroad who are resident outside India, other than citizens of Pakistan, directly or through a Trust subject to the condition that the scheme has been drawn in terms of relevant regulations issued by the Securities Exchange Board of India; and face value of the shares to be allotted under the scheme to the non-resident employees does not exceed 5% of the paid-up capital of the issuing company. The issuing company is required to report the details and submit certificate stipulated to Reserve Bank, within 30 days from the date of issue of shares.

8. Issue of shares by Indian companies under ADR/GDR

8.1 An Indian corporate can raise foreign currency resources abroad through the issue of American Depositary Receipts (ADRs) or Global Depositary Receipts (GDRs). Regulation 4 of Schedule I of FEMA Notification no.20 allows an Indian company to issue its Rupee denominated shares to a person resident outside India being a depository for the purpose of issuing Global Depositary Receipts (GDRs) and/or American Depositary Receipts (ADRs), subject to the conditions that:

- the ADRs/GDRs are issued in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993 and guidelines issued by the Central Government thereunder from time to time.
- The Indian company issuing such shares has an approval from the Ministry of Finance, Government of India to issue such ADRs and/or GDRs or is eligible to issue ADRs/GDRs in terms of the relevant scheme in force or notification issued by the Ministry of Finance, and
- Is not otherwise ineligible to issue shares to persons resident outside India in terms of these Regulations.

These instruments are issued by a Depository abroad and listed in the overseas stock exchanges like NASDAQ. The proceeds so raised have to be kept abroad till actually required in India. There are no end-use restrictions except for a ban on deployment/Investment of these funds in Real Estate and the Stock Market. There is no monetary limit up to which an Indian company can raise ADRs/GDRs. However, the Indian company has to be otherwise eligible to raise foreign equity under the extant FDI policy and the foreign shareholding after issue should be in compliance with the FDI policy.

- 8.2 The ADR/GDR can be issued on the basis of the ratio worked out by the Indian company in consultation with the Lead Manager of the issue. The Indian company will issue its rupee denominated shares in the name of the Overseas Depository and will keep in the custody of the domestic Custodian in India. On the basis of the ratio worked out and the rupee shares kept with the domestic Custodian, the Depository will issue ADRs/GDRs abroad.
- 8.3 A limited Two-way Fungibility scheme has been put in place by the Government of India for ADRs/GDRs. Under this scheme, a stock broker in India, registered with SEBI, can purchase the shares from the market for conversion into ADRs/GDR. Re-issuance of ADRs/GDR would be permitted to the extent of ADRs/GDRs which have been redeemed into underlying shares and sold in the domestic market.
- 8.4 An Indian company can also sponsor an issue of ADR/GDR. Under this mechanism, the company offers its resident shareholders a choice to submit their shares back to the company so that on the basis of such shares, ADRs/GDRs can be issued abroad. The proceeds of the ADR/GDR issue is remitted back to India and distributed among the resident investors who had offered their rupee denominated shares for conversion. These proceeds can be kept in Resident Foreign Currency (Domestic) accounts in India by the shareholders who have tendered such shares for conversion into ADR/GDR.
- 8.5 The ADR/GDR/FCCB proceeds may be utilised in the first stage acquisition of shares in the disinvestment process and also in the mandatory second stage offer to the public in view of their strategic importance.

ADs have been permitted to allow Indian companies to prepay the existing FCCB subject to certain conditions.

8.6 Reporting of such Issues

The Indian company issuing shares shall furnish to the Reserve Bank, full details of such issue in the form specified in Annexure C to Notification No.FEMA 20/2000-RB dated May 3, 2000 within 30 days from the date of closing of the issue. The company should also furnish a quarterly return in the form specified in Annexure D to Reserve Bank within 15 days of the close of the calendar quarter.

9. Issue Price

Price of shares issued to persons resident outside India under Schedule-I (i.e. under the FDI Scheme), would be worked out on the basis of SEBI guidelines in case of listed shares. In other cases valuation of shares would be done by a Chartered Accountant in accordance with the guidelines issued by the erstwhile Controller of Capital Issues.

10. Permission for retaining share subscription money received from persons resident outside India in a foreign currency account

Reserve Bank may, permit an Indian company issuing shares to persons resident outside India under Schedule I to FEMA Notification No.20 (i.e. under the FDI scheme), to retain the subscription amount in a foreign currency account, subject to such terms and conditions as it may stipulate.

11.4 Investments by NRIs

- 11.4.1 In the case of NRIs under PIS it is to be ensured that the paid-up value of shares/convertible debentures purchased by an NRI on repatriation and non-repatriation basis under PIS route should not exceed 5% of the paid-up capital/paid-up value of each series of debentures. The aggregate paid-up value of shares/convertible debentures purchased by all NRIs should not exceed 10% of the

paid-up capital of the company/paid-up value of series of debentures of the company. The aggregate ceiling of 10% can be raised to 24%, if the General Body of the Indian company concerned passes a special resolution to that effect. The NRI investor should take delivery of the shares purchased and give delivery of shares sold. Payment for purchase of shares and/or debentures is made by inward remittance in foreign exchange through normal banking channels or out of funds held in NRE/FCNR account maintained in India if the shares are purchased on repatriation basis and by inward remittance or out of funds held in NRE/FCNR/NRO account of the NRI concerned, maintained in India where shares/debentures are purchased on non-repatriation basis. Under PIS, NRIs are not permitted to invest in Print Media Sector.

- 11.4.2 The link office of the designated branch of an AD shall furnish to the Chief General Manager, Reserve Bank of India, Foreign Exchange Department, Central Office, Mumbai a report on a daily basis on PIS transactions undertaken by it, such report should be furnished on-line or on a floppy in a format supplied by RBI.
- 11.4.3 Shares purchased by NRIs on the stock exchange under PIS cannot be transferred by way of sale under private arrangement of gift to a person resident India or outside India without prior approval of RBI.
- 11.4.4 NRI may invest in Exchange Trade Derivative Contracts approved by SEBI from time to time out of INR funds held in India on non-repatriation basis subject to the limits prescribed by SEBI.

12. Investments by Overseas Corporate Bodies (OCBs)

- 12.1 With effect from November 29, 2001, OCBs are not permitted to invest under the PIS in India. Further, the OCBs that have already made investments under the Portfolio Investment Scheme, may continue to hold such shares/convertible debentures till such time these are sold on the stock exchange.
- 12.2 OCBs have been derecognised as a class of investor entity in India with effect from September 16, 2003. However, requests from such entities which are incorporated and not under the adverse notice of RBI/SEBI will be considered for undertaking fresh investments under FDI scheme with prior approval of Government if the investment is under Government route and with the prior approval of RBI if the investment is under automatic route.

15. Investments by Venture Capital Funds

A SEBI registered Foreign Venture Capital Investor (FVCI) with general permission from RBI under FEMA Regulations can invest in Indian Venture Capital Undertaking (IVCU) or in a Venture Capital Fund (VCF) or in a Scheme floated by such VCFs subject to the condition that the VCF should also be registered with SEBI. They can purchase equity/equity linked instruments/debt/debt instruments, debentures of an IVCU or of a VCF through initial public offer or private placement or in units of schemes/funds set up by a VCF. RBI, on application, may permit a FVCI to open a foreign currency account or rupee account with a designated branch of an authorised dealer. The purchase/sale of shares, debentures, units can be at a price that is mutually acceptable to the buyer and the seller/issuer. ADs are also authorised to offer forward cover to FVCIs to the extent of total inward remittance net of investments liquidated.

16. Conversion of ECB/Lumpsum Fee/Royalty into Equity

16.1 General permission has been granted for conversion of ECB into equity, subject to certain conditions and reporting requirements. It is also clarified that the conversion facility is available for ECBs availed either with general permission or specific permission of Reserve Bank. This would also be applicable to ECBs irrespective of whether due for payment or not, as well as secured/unsecured loans availed from non-resident collaborators. However, import payables, deemed as ECBs would not be eligible for conversion.

16.2 General permission is also available for issue of shares against lump-sum technical know-how fee, royalty, under automatic route or SIA/FIPB route, subject to pricing guidelines of Reserve Bank/SEBI and compliance with applicable tax laws.

17. Remittance of sale proceeds

Remittance of sale proceeds of an Indian Security held by a person resident outside India is permissible subject to conditions stipulated in relevant Schedules to the Notification No.FEMA.20/2000-RB dated May 3, 2000, as amended from time to time. An authorised dealer can allow the remittance of sale proceeds of a security (net of applicable taxes) to the seller of shares resident outside India, provided the security has been held on repatriation basis, the sale of security has been made in accordance with the prescribed guidelines and NOC / tax clearance certificate has been produced.

Table
Investments Facilities in Brief

Avenues of Investment	Nature of Instruments	Category of Investors
Public /Private Limited Companies	Shares/Convertible Debentures/Preference shares	Non-Resident Indians/Non-residents/Non-Resident Incorporated Entities/Foreign Institutional Investors
Public Limited Companies	NCDs	NRI
Trading Companies	Shares/Convertible Debentures/Preference Shares	Non-residents
SSI Units	Shares/Convertible Debentures/Preference Shares	Non-residents
EOU or Unit in Free Trade Zone or in Export Processing Zone	Shares/Convertible Debentures/Preference Shares	Non-residents
Public/Private Ltd. Companies	Right Share	Existing shareholders / Renounces
Under Scheme of amalgamation/ merger	Shares/Convertible Debentures/Preference Shares	Existing shareholders
Employees Stock Option	Shares/Convertible Debentures/Preference Shares	Employees resident outside India
ADR/GDR	Receipts	Non-residents
Portfolio Investment Scheme	Shares/Convertible Debentures	FII & NRI
Investment in Derivatives	Exchange Traded Derivatives	FII (on repatriation basis) & NRI (on non-repatriation basis)
Govt. Securities	Govt. dated Securities/Treasury Bills, Units of Domestic Mutual Funds, Bonds issued by PSUs and shares of Public Sector Enterprises being divested	NRI & FII
Indian VCU or VCF or in a Scheme floated by VCF	SEBI Registered VCF/VC Units	SEBI Registered Foreign Venture Capital Investor

Part III

Investment in Partnership Firm/Proprietary Concern

1. Investment in a firm or a proprietary concern in India by a person resident outside India

A non-resident Indian or a person of Indian origin resident outside India may invest by way of contribution to the capital of a firm or a proprietary concern in India on non-repatriation basis provided

- a. Amount is invested by inward remittance or out of NRE/FCNR/NRO account maintained with AD.
- b. The firm or proprietary concern is not engaged in any agricultural/plantation or real estate business (i.e. dealing in land and immovable property with a view to earning profit or earning income there from) or print media sector.
- c. Amount invested shall not be eligible for repatriation outside India.

2. Investment in sole proprietorship concern/partnership firm with repatriation benefits.

NRIs/PIO may seek prior permission of Reserve Bank for investment in sole proprietorship concerns/partnership firms with repatriation benefits.

3. Investment by non-residents other than NRIs/PIO

A person resident outside India other than NRIs/PIO may make an application and seek prior approval of Reserve bank for making investment by way of contribution to the capital of a firm or a proprietorship concern or any association of persons in India.

4. Restrictions

In terms of Regulation 4(b) and (e) of RBI Notification No.FEMA 24/2000-RB dated May 3, 2000 an NRI or PIO cannot invest in a firm or proprietorship concern engaged in any agricultural/plantation activity or real estate business or engaged in **Print Media**.

Annexure-1

Annexure A to Schedule I of FEMA Notification No. FEMA 20 /2000-RB dated May 3, 2000

(As amended vide Notification No. FEMA 94/2003-RB dated June 18, 2003)

(A) List of Activities for which Automatic Route of RBI for investment by person resident outside India is not available.

1. Petroleum Sector (except for private sector oil refining)/Natural Gas/LNG Pipelines
2. Investing companies in Infrastructure & Services Sector
3. Defence and Strategic Industries
4. Atomic Minerals
5. Print Media
6. Broadcasting
8. Postal services
9. Courier Services
10. Establishment and Operation of satellite
11. Development of Integrated Township*
12. Tea Sector.

* For more details, please refer to Government Manual on Investing in India, Foreign Direct Investment, Policy and Procedures. (www.dipp.nic.in)

(B) List of activities or items for which FDI is prohibited.

1. Retail Trading
2. Atomic Energy
3. Lottery Business
4. Gambling and Betting
5. Housing and Real Estate Business
6. Agriculture (**excluding** Floriculture, Horticulture, Development of Seeds, Animal Husbandry, Pisciculture and Cultivation of Vegetables, Mushrooms, etc. under controlled conditions and services related to agro and allied sectors) and Plantations (**Other than Tea plantations**).

Annexure-2

Annexure B to Schedule I of FEMA Notification No. FEMA 20/2000-RB dated May 3, 2000.

(As amended vide Notification No. FEMA 94/2003-RB dated June 18, 2003)

Sectoral cap on Investments by persons resident outside India

Sector	Investment Cap	Description of Activity/Items/Conditions
1. Private Sector Banking *	49%	Subject to guidelines issued by RBI from time to time
2. Non-Banking Financial Companies	100%	<p>FDI/NRI investments allowed in the following 19 NBFC activities shall be as per the levels indicated below:</p> <p>a) Activities covered:</p> <ol style="list-style-type: none"> 1. Merchant Banking 2. Underwriting 3. Portfolio Management Services 4. Investment Advisory Services 5. Financial Consultancy 6. Stock-broking 7. Asset Management 8. Venture Capital 9. Custodial Services 10. Factoring 11. Credit Reference Agencies 12. Credit Rating Agencies 13. Leasing & Finance 14. Housing Finance 15. Forex-broking 16. Credit Card Business 17. Money-changing Business 18. Micro-credit 19. Rural credit <p>b) Minimum Capitalisation norms for fund based NBFCs</p> <ol style="list-style-type: none"> i) For FDI up to 51%, US \$0.5 million to be brought in upfront ii) If the FDI is above 51% and up to 75%, US \$ 5 million to be brought upfront iii) If the FDI is above 75% and up to 100%, US \$ 50 million out of which \$ 7.5 million to be brought in upfront and the balance in 24 months <p>c) Minimum Capitalisation norms for non-fund based activities.</p> <p>Minimum Capitalisation norm of US\$0.5 million is applicable in respect of non-fund based NBFCs with foreign investment.</p>

Sector	Investment Cap	Description of Activity/Items/Conditions
		<p>d) Foreign investors can set up 100% operating subsidiaries without the condition to disinvest a minimum of 25% of its equity to Indian entities, subject to bringing in US \$50 million as at (b) (iii) above (without any restriction on number of operating subsidiaries without bringing in additional capital)</p> <p>e) Joint Venture operating NBFCs that have 75% or less than 75% foreign investment will also be allowed to set up subsidiaries for undertaking other NBFC activities, subject to the subsidiaries also complying with the applicable minimum capital inflow i.e, (b)(i) and (b)(ii) above.</p> <p>f) FDI in the NBFC sector is put on automatic route subject to compliance with guidelines of the Reserve Bank of India. RBI would issue appropriate guidelines in this regard.</p>
3. Insurance	26%	FDI up to 26% in the Insurance sector is allowed on the automatic route subject to obtaining licence from Insurance Regulatory & Development Authority (IRDA)
4. Telecommunications	49 %	<p>i. In basic, Cellular, Value Added Services, and Global Mobile Personal Communications by Satellite, FDI is limited to 49% subject to licencing and security requirements and adherence by the companies (who are investing and the companies in which the investment is being made) to the license conditions for foreign equity cap and lock-in period for transfer and addition of equity and other license provisions.</p> <p>ii. ISPs with gateways, radio paging and end-to-end bandwidth, FDI is permitted upto 74% with FDI, beyond 49% requiring Government approval. These services would be subject to licensing and security requirements</p> <p>i. No equity cap is applicable to manufacturing activities.</p> <p>ii. FDI up to 100% is allowed for the following activities in the telecom sector:</p> <ol style="list-style-type: none"> ISPs not providing gateways (both for satellite and submarine cables) Infrastructure Providers providing dark fibre (IP Category 1) Electronic Mail, and Voice Mail

International Finance and Trade

Sector	Investment Cap	Description of Activity/Items/Conditions
		<p>The above would be subject to the following conditions;</p> <p>FDI upto 100% is allowed subject to the condition that such companies would divest 26% of their equity in favour of Indian public in 5 years, if these companies are listed in other parts of the world.</p> <p>The above services would be subject to licencing and security requirements, wherever required.</p> <p>Proposal for FDI beyond 49% shall be considered by FIPB on case to case basis.</p>
5. (i) Petroleum Refining (Private Sector)	100%	FDI permitted up to 100 % in case of private Indian companies.
(ii) Petroleum Product Marketing	100%	Subject to the existing sectoral policy and regulatory framework in the oil marketing sector.
(iii) Oil Exploration in both Medium sized fields	100 %	<p>Subject to and under the policy of Government on private participation in -</p> <p>(a) exploration of oil; and</p> <p>(b) the discovered fields of national oil companies.</p> <p>Subject to and under the Government policy and regulations thereof.</p>
(iii) Petroleum product pipelines	100%	
6. Housing and Real Estate	100 %	<p>Only NRIs are allowed to invest up to 100 % in the areas listed below:</p> <p>a) Development of serviced plots and construction of built-up residential premises.</p> <p>b) Investment in real estate covering construction of residential and commercial premises including business centres and offices.</p> <p>c) Development of townships</p> <p>d) City and regional level urban infrastructure facilities, including both roads and bridges</p> <p>e) Investment in manufacture of building materials</p> <p>f) Investment in participatory ventures in (a) to (e) above</p> <p>g) Investment in Housing finance institutions which is also opened to FDI as an NBFC</p>
7. Coal & Lignite		<p>i) Private Indian companies setting up or operating power projects as well as coal and lignite mines for captive consumption are allowed FDI up to 100%.</p> <p>ii) 100% FDI is allowed for setting up coal processing plants subject to the condition that the company shall not do coal mining and shall not sell washed coal or sized coal from its coal processing plants in the open market</p>

Sector	Investment Cap	Description of Activity/Items/Conditions
		<p>and shall supply the washed or sized coal to those parties who are supplying raw coal to coal processing plants for washing or sizing.</p> <p>iii) FDI up to 74% is allowed for exploration or mining of coal or lignite for captive consumption.</p> <p>iv) In all the above cases, FDI is allowed up to 50% under the automatic route subject to the condition that such investment shall not exceed 49% of the equity of a PSU.</p>
8. Venture Capital Fund (VCF) and Venture Capital Company (VCC)		Offshore Venture Capital Funds/companies are allowed to invest in domestic venture capital undertaking as well as other companies through the automatic route, subject only to SEBI regulations and sector specific caps on FDI.
9. Trading		<p>Trading is permitted under automatic route with FDI upto 51% provided it is primarily export activities, and the undertaking is an export house/trading house/super trading house/star trading house. However, under the FIPB route:</p> <p>(i) 100% FDI is permitted in case of trading companies for the following activities:</p> <ol style="list-style-type: none"> exports; bulk imports with export/ex-bonded warehouse sales; cash and carry wholesale trading; other import of goods or services provided at least 75% is for procurement and sale of the same group and not for third party use or onward transfer/distribution/sales. <p>ii) The following kinds of trading are also permitted, subject to provisions of Exim Policy.</p> <ol style="list-style-type: none"> Companies for providing after sales services (that is not trading <i>per se</i>) Domestic trading of products of JVs is permitted at the wholesale level for such trading companies who wish to market manufactured products on behalf of their Joint ventures in which they have equity participation in India Trading of hi-tech items/items requiring specialised after sales service Trading of items for social sector Trading of hi-tech, medical and diagnostic items.

Sector	Investment Cap	Description of Activity/Items/Conditions
		<p>f) Trading of items sourced from the small scale sector under which, based on technology provided and laid down quality specifications, a company can market that item under its brand name</p> <p>g) Domestic sourcing of products for exports</p> <p>h) Test marketing of such items for which a company has approval for manufacture provided such test marketing facility will be for a period of two years, and investment in setting up manufacturing facilities commences simultaneously with test marketing.</p> <p>i) FDI up to 100% permitted for e-commerce activities subject to the condition that such companies would divest 26% of their equity in favour of the Indian public in five years, if these companies are listed in other parts of the world. Such companies would engage only in business to business (B2B) e-commerce and not in retail trading.</p>
10. Power	100%	FDI allowed up to 100% in respect of projects relating to electricity generation, transmission and distribution, other than atomic reactor power plants. There is no limit on the project cost and quantum of foreign direct investment.
11. Drugs & Pharmaceuticals	100 %	<p>FDI permitted upto 100 % for manufacture of drugs and pharmaceuticals provided the activity does not attract compulsory licensing or involve use of recombinant DNA technology and specific cell/tissue targeted formulations.</p> <p>FDI proposals for the manufacture of licensable drugs and pharmaceuticals and bulk drugs produced by recombinant DNA technology and specific cell/tissue targeted formulations will require prior Govt. approval.</p>
12. Road and highways, Ports and harbours	100%	In projects for construction and maintenance of roads, highways, vehicular bridges, toll roads, vehicular tunnels, ports and harbours.
13. Hotel&Tourism	100 %	The term hotels include restaurants, beach resorts and other tourist complexes providing accommodation and/or catering and food facilities to tourists. Tourism related industry include travel agencies, tour operating agencies and tourist transport operating agencies, units providing facilities for cultural, adventure and wild life experience to tourists, surface, air and water transport

Sector	Investment Cap	Description of Activity/Items/Conditions
		<p>facilities to tourists, leisure, entertainment, amusement, sports and health units for tourists and Convention/Seminar units and organisations.</p> <p>For foreign technology agreements, automatic approval is granted if</p> <p>(i) Up to 3% of the capital cost of the project is proposed to be paid for technical and consultancy services including fees for architects, design, supervision, etc.</p> <p>(ii) Up to 3% of the net turnover is payable for franchising and marketing/publicity support fee, and Up to 10% of gross operating profit is payable for management fee, including incentive fee.</p>
14. Mining	<p>74 %</p> <p>100 %</p>	<p>(i) For exploration and mining of diamonds and precious stones FDI is allowed up to 74% under automatic route</p> <p>(ii) For exploration and mining of gold and silver and minerals other than diamonds and precious stones, metallurgy and processing FDI is allowed up to 100% under automatic route</p> <p>(iii) Press Note 18 (1998 series) dated 14/12/98 would not be applicable for setting up 100% owned subsidiaries in so far as the mining sector is concerned, subject to a declaration from the applicant that he has no existing joint venture for the same area and/or the particular mineral.</p>
15. Advertising	100 %	<p>Advertising Sector</p> <p>FDI up to 100% allowed on the automatic route</p>
16. Films	100 %	<p>Film Sector</p> <p>(Film production, exhibition and distribution including related services/products)</p> <p>FDI up to 100% allowed on the automatic route with no entry-level condition</p>
17. Airports	74 %	Govt. approval required beyond 74%
18. Mass Rapid Transport Systems	100 %	FDI up to 100% is permitted on the automatic route in mass rapid transport system in all metros including associated real estate development

International Finance and Trade

Sector	Investment Cap	Description of Activity/Items/Conditions
19. Pollution Control & Management	100 %	In both manufacture of pollution control equipment and consultancy for integration of pollution control systems is permitted on the automatic route
20. Special Economic Zones	100 %	All manufacturing activities except: (i) Arms and ammunition, Explosives and allied items Of defence equipments, Defence aircrafts, and warships, (ii) Atomic substances, Narcotics and Psychotropic Substances and hazardous Chemicals, (iii) Distillation and brewing of Alcoholic drinks and (iv) Cigarette/cigars and manufactured tobacco substitutes.
21. Any other Sector/Activity (if not included in Annexure A)	100 %	
22. Air Transport Services	100% for NRIs 49% for others	No direct or indirect equity participation by foreign airlines is allowed.

* Govt of India vide Press Note No.2 (2004 Series) has raised the FDI limit in Private Sector banks from 49% to 74%. RBI is yet to issue Notification.

Chapter XII

International Financial Markets and Instruments

After reading this chapter, you will be conversant with:

- Origin of International Financial Markets
- Instruments Available in the International Financial Markets
- Players in the International Financial Markets.
- Resource Mobilization – The Decision Criteria
- Equity Instruments
- Debt Instruments
- Euro Credit Syndication
- Strategic Considerations

The gap between savings and investment is widening gradually in the developing countries. The growing demand for capital inflows in the developing countries forced them to depend on external sources for debt or equity capital.

The need for external borrowings in a country's economy can be gauged from the national income and balance of payment position. From the macro economic theories, the current account surplus or deficit in BoP of a country is nothing but the difference between the domestic savings and domestic investments. If the domestic savings exceed domestic investment a surplus in current account would result increasing the reserves of the country. A deficit in current account would emerge if the domestic savings is less than domestic investment.

To recall from the chapter on BoP, national income can be defined in the following formats.

$$Y = C + I + G + (X - M) \quad (\text{Eq. 1})$$

$$Y = C + S + T \quad (\text{Eq. 2})$$

Where,

Y	=	National Income	X : Exports
C	=	Consumption	M : Imports
I	=	Investment	S : Private savings
G	=	Government expenditure	T : Tax

By equating (1) and (2) we get

$$C + I + G + (X - M) = C + S + T$$

$$\text{i.e. } I + G + (X - M) = S + T$$

$$\text{i.e. } S + (T - G) = I + (X - M)$$

Since $(T - G)$ gives the public savings, we can write the above relationship as

$$\text{Private savings} + \text{Public savings} = I + (X - M) \quad (\text{Eq. 3})$$

If $(X - M)$ gives the net of foreign exchange inflows/outflows of the current account in BoP statement we can conclude in a broader perspective, that the gross domestic savings are equal to the sum of gross domestic capital formation and foreign investment.

Basing on BoP position of a country, the sources of external funds can be broadly classified into the following categories:

- i. External assistance in the form of aid.
- ii. Commercial borrowings.
- iii. Short-term credit.
- iv. Non-resident deposits.
- v. Foreign direct investment.

The flow of external funds into a country depends on various factors like the policy guidelines of the country on commercial borrowings by individual entities, the exchange control regulations of the country, the interest rate ceilings in the financial sector and the structure of taxation. The integration of financial markets across countries has opened up the international markets and large variety of financial instruments have emerged to suit the changing needs of the international investor. In this chapter, we briefly discuss various instruments that are available in international financial markets.

The financial markets across countries facilitate the financial intermediation/dis-intermediation and transfer of surplus funds from the savers to the deficit units. The gradual liberalization of the financial sector in the developing countries initiated in early '70s started providing multiple instruments to the savers and the issuers converging the needs of suppliers of the resources with that of the users of the resources.

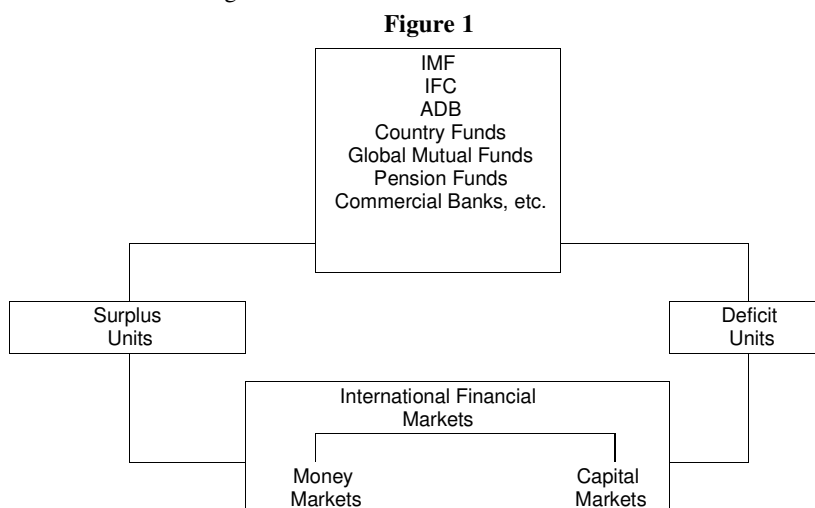
ORIGIN OF INTERNATIONAL FINANCIAL MARKETS

The genesis of the present international markets can be traced back to 1960s, when there was a real demand for high quality dollar-denominated bonds from wealthy Europeans (and others) who wished to hold their assets outside their home countries or in currencies other than their own. These investors were driven by the twin concerns of avoiding taxes in their home country and protecting themselves against the falling value of domestic currencies. The bonds which were then available for investment were subjected to withholding tax. Further, it was also necessary to register the ownership of the bonds. Dollar denominated Euro-bonds were designed to address these concerns. These were issued in bearer forms and so, there was no record of ownership and no tax was withheld.

Also, until 1970, the International Capital Market focused on debt financing and the equity finances were raised by the corporate entities primarily in the domestic markets. This was due to the restrictions on cross-border equity investments prevailing until then in many countries. Investors too preferred to invest in domestic equity issues due to perceived risks implied in foreign equity issues either related to foreign currency exposure or related to apprehensions of restrictions on such investments by the regulators.

Major changes have occurred since the '70s which have witnessed expanding and fluctuating trade volumes and patterns with various blocks experiencing extremes in fortunes in their exports/imports. This was the period which saw the removal of exchange controls by countries like the UK, France and Japan which gave a further boost to financial market operations. In addition to this, the application of new technology to financial services, the institutionalization of savings and the deregulation of markets have played an important role in channelizing the funds from surplus units to deficit units across the globe. The international capital markets also became a major source of external finance for nations with low internal savings. The markets were classified into Euro Market, American Market and Other Foreign Markets.

The following figure shows the various sources of external finance and various channels for accessing external funds.



India's presence in International Markets

India has made its presence felt in the international financial markets though to a very small extent. There has been a total turnaround in the market sentiment for Indian paper since 1991-1992 – albeit with a difference.

So far the traditional avenues for raising capital abroad have been through bank borrowings, syndicated loans, lines of credit, bonds and floating rate notes. Access to the international capital markets was only through debt instruments and was

mostly limited to financial institutions and public sector units, although there were a few cases of private companies also. With the downward revision of India's credit rating to the non-investment grade, borrowing in the international capital markets dried up with most of the lenders being off limits (crossing the exposure limit) on India. The picture has since changed. There were a variety of reasons for the international markets to view India differently, namely:

- Improved perception of India's economic reforms
- Improved export performance
- Modest to healthy economic indicators
- Inflation contained to single digit
- Improved forex reserves position
- Improved performance of Indian companies
- Improved confidence of the FIIs in the economy
- Lack of investment opportunities worldwide and
- Decline in rate of return on investments in developed markets.

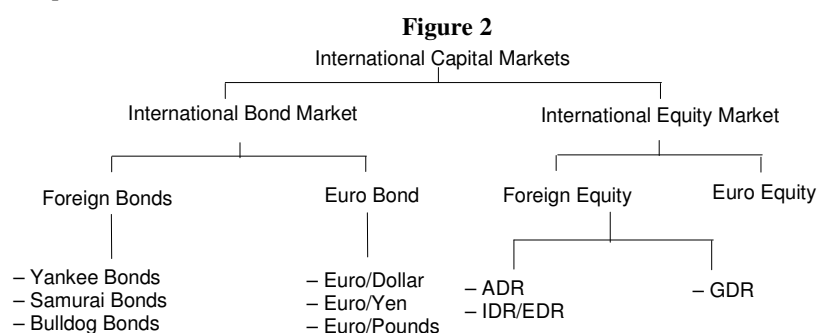
It was in March 1992, that the government first permitted a few Indian companies to tap the international equity market and till date a number of Indian companies have successfully taken the equity/equity-related route.

INSTRUMENTS AVAILABLE IN THE INTERNATIONAL FINANCIAL MARKETS

As in any domestic capital structuring we can segregate international financing into two broad categories. These are:

- i. Equity financing, and
- ii. Debt financing.

The various instruments used to raise funds abroad include: Equity, straight debt or hybrid instruments. The following figure shows the classification of international capital markets based on instruments used and market(s) accessed.



Debt Instruments

The issue of bonds to finance cross-border capital flows has a history of more than 150 years. In the 19th century, foreign issuers of bonds, mainly governments and railway companies, used the London market to raise funds.

International bonds are classified broadly under two categories:

Foreign Bonds: These are the bonds floated in the domestic market denominated in domestic currency by non-resident entities. Dollar denominated bonds issued in the US domestic markets by non-US companies are known as Yankee Bonds, Yen denominated bonds issued in Japanese domestic market by non-Japanese companies are known as Samurai Bonds and Pound denominated bonds issued in

the UK by non-UK companies are known as Bulldog Bonds. Similarly, currency sectors of other foreign bond markets have special names like Rambrandt Dutch Guilder, and Matador Spanish Peseta etc.

Eurobonds: The term 'Euro' originated in the fifties when the USA under the Marshall Plan was assisting the European nations in the rebuilding process after the devastation caused by the Second World War. The dollars that were in use outside the US came to be called as "Eurodollars". In this context, the term 'Euro' signifies a currency outside its home country. The term 'Eurobonds' thus refers to bonds issued and sold outside the home country of the currency. For example, a dollar denominated bond issued in the UK is a Euro (dollar) bond, similarly, a Yen denominated bond issued in the US is a Euro (Yen) bond.

The companies wishing to come out with shorter maturities have an option to issue Euronotes in the European Markets. The important ones being Commercial Paper (CP), Note Issuance Facilities (NIF) and Medium-Term Notes (MTNs).

Euro-Commercial Paper issued with maturity of up to one year, are not underwritten and are unsecured.

Note Issuance Facilities (NIFs) are underwritten and have a maturity of up to one year. Standby NIFs are those formally designated instruments which back Commercial Paper to raise short-term finances. A variation of NIF is the Multiple Component Facility (MCF), where a borrower is enabled to draw funds in a number of ways, as a part of overall NIF program. These options are referred to as short-term advances and banker's acceptances, and afford opportunities for choosing the maturity, currency and interest rate basis.

Medium-Term Notes, on the other hand, are non-underwritten and are issued for maturities of more than one year with several tranches depending upon the preferred maturities. It is to be noted that in similar circumstances, a typical CP program allows for a series of note issues having regard to the maturity of the overall program.

The borrowings in the international capital markets are in the form of Euro Loans which are basically loans from the bank to the companies which need long-term and medium-term funds. Broadly, two distinct practices of arranging syndicated credits have emerged in Euromarkets, club loans and syndicated loans. The Club Loan is a private arrangement between lending banks and a borrower. When the loan amounts are small and the parties are familiar with each other; lending banks form a club and advance a loan hence the name of club loan. Syndicated Eurocredit, however, has a full-fledged public arrangement for organizing a loan transaction. It is treated as an integral part of the financial market mechanism with a wide network of banks participating in the transaction over the globe. Typically, a syndicated loan is available for a maturity of seven years with shorter period transactions having a maturity of 3 to 5 years.

Equity Instruments

Until the end of 1970s, International Capital Markets focused on debt financing and the equity finances were raised by the corporate entities primarily in the domestic markets. This was due to restrictions on cross-border equity investments prevailing until then in many countries. Investors too preferred to invest in domestic equity issues due to perceived risks implied in foreign equity issue either related to foreign currency exposure or related to apprehensions of restrictions on such investments by the national authorities.

Early '80s witnessed liberalization of many domestic economies and globalization of the same. Issuers from developing countries, where issue of dollar/foreign currency denominated equity shares are not permitted, are now able to access international equity markets through the issue of an intermediate instrument called 'Depository Receipt'.

A Depositary Receipt (DR) is a negotiable certificate issued by a depository bank which represents the beneficial interest in shares issued by a company. These shares are deposited with a local 'custodian' appointed by the depository, which issues receipts against the deposit of shares.

According to the placements planned, DRs are referred to as (i) Global Depositary Receipts (GDRs) (ii) American Depositary Receipts (ADRs) and (iii) International Depositary Receipts (IDRs). Each of the Depositary Receipt represents a specified number of shares in the domestic markets. Usually, in countries with capital account convertibility, the GDRs and domestic shares are convertible (may be redeemed) mutually. This implies that, an equity shareholder may deposit the specified number of shares and obtain the GDR and vice versa. The holder of GDR is entitled to a dividend on the value of the underlying shares of the GDR (issued normally in the currency of the investor country). As far as Indian companies are concerned, the dividends are announced as a percentage of the value of GDR sans premium in rupee terms converted at the prevailing exchange rate.

However, until the Global Depositary Receipts (GDRs)/American Depositary Receipts (ADRs)/International Depositary Receipts (IDRs) are converted, the holder cannot claim any voting right and also, there is no foreign exchange risk for the company. These types of instruments are ideal for companies which prefer a large shareholder base and international presence. The company will be listed at the prescribed stock exchanges providing liquidity for the instrument.

Quasi-instruments

These instruments are considered as debt instruments for a time-frame and are converted into equity at the option of the investor (or at company's option) after the expiry of that particular time-frame. The examples of these are Warrants, Foreign Currency Convertible Bonds (FCCBs), etc. Warrants are normally issued along with other debt instruments so as to act as a 'sweetener'.

FCCBs have a fixed coupon rate with a legal payment obligation. It has greater flexibility with the conversion option – at the choice of the investor – to equity. The price of the conversion of FCCB closely resembles the trading price of the shares at the stock exchange. Also, the company may incorporate a 'call option' at the choice of the issuer to obtain FCCBs before maturity. This may be due to the adverse market conditions, changes in the shareholding pattern, changes of tax laws, etc.

A Euro Convertible Bond is issued for investment in Europe. It is a quasi-equity issue made outside the domestic market and provides the holder with an option to convert the instrument from debt to equity. An added feature now-a-days is to allow conversion of Euro Convertible Bond into GDR. Till conversion, interest is paid in US dollars and bond redemption is also done in US dollars, thus while the investor would prefer the convertible bond as an investment instrument, the issuing company tends to prefer a GDR. An investor can exercise the conversion option at any time or at specified points during the convertible life. The investor exchanges the convertible bond for a specified number of shares.

PLAYERS IN THE INTERNATIONAL FINANCIAL MARKETS

Borrowers/Issuers, Lenders/Investors and Intermediaries are the major players of the international markets. The role of these players is discussed below.

Borrowers/Issuers

These primarily are corporates, banks, financial institutions, government and quasi-government bodies and supranational organizations, which need forex funds for various reasons. The important reasons for corporate borrowings are, need for foreign currencies for operation in markets abroad, dull/saturated domestic market and expansion of operations into other countries.

Governments borrow in the global financial market for adjusting the balance of payments mismatches, to gain net capital investments abroad and to keep a sufficient inventory of foreign currency reserves for contingencies like supporting the domestic currency against speculative pressures.

Further, the supranational organizations like the International Monetary Fund (IMF), World Bank, International Finance Corporation, Asian Development Bank, etc., borrow usually, long-term funds to finance diversified financing, sometimes linked to swaps for hedging current/interest rate exposures. These supranationals are also typical examples of large entities appearing in the global markets as both issuers and borrowers.

Lenders/Investors

In case of Euro-loans, the lenders are mainly banks who possess inherent confidence on the credibility of the borrowing corporate or any other entity mentioned above. In case of a GDR, it is the institutional investors and high net worth individuals (referred as Belgian Dentists) who subscribe to the equity of the corporates. For an ADR, it is the institutional investor or the individual investor through the Qualified Institutional Buyer who puts in the money in the instrument depending on the statutory status attributed to the ADR as per the statutory requirements of the land.

Investors in the global markets come in a large range who invest to suit their own requirements, investment objectives, risk taking abilities and liabilities. The investor range includes private individuals investing through Swiss Banks, the IMF and the World Bank. The other major investors are insurance companies, professional pension fund managers and investment trusts. In the United Kingdom, with London still a major force in the international finance market, it is the pension fund and insurance companies which are the major investors in the equity markets and bond markets. In the USA and Japan, the private player has an important role in the equity markets. In Germany, on the other hand, commercial banks play a dominant role as investors.

Institutional investors can also be classified as:

Market Specific Investors: Specialize in specific instruments like equity, convertibles, fixed interest bonds, floating rate bonds, etc.

Time Specific Investors: Specialize in specific maturity instruments like long-term, medium-term, short-term, etc.

Industry Specific Investors: Specialize in specific industries like chemical, pharmaceutical, steel, automobiles, etc.

Intermediaries

The intermediaries involved in International Capital Markets include Lead managers/Co-lead Managers, Underwriters, Agents and Trustees, Lawyers and Auditors, Listing Agents and Stock Exchanges, Depository Banks and Custodians.

An overview of the functions performed by each of them is given below:

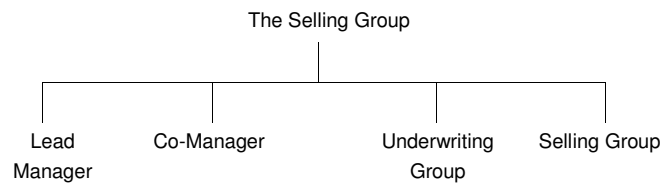
- i. **Lead and Co-managers:** The responsibilities of a Lead Manager include undertaking due diligence and preparing the offer circular, marketing the issues including arranging the roadshows. Lead manager, sometimes in consultation with the issuer, can choose to invite a syndicate of investment banks to buy some of the Bonds/DRs and help sell the remainder to other investors. 'Co-managers' are thus invited to join the deal, each of whom agrees to take a substantial portion of the issue to sell to their investor clients. Quite often there will be more than one lead manager as mandates are sometimes jointly won, or the investment bank which actually won the mandate from the issuer may decide that it needs another institution to ensure a successful launch.

Two or more managers may also reflect the fact that a geographical spread of placing power is required or deemed appropriate.

One of the lead manager will 'run the books' for the issue. This essentially involves arranging the whole issue, sending out invitation telexes, allotting Bonds/DRs, etc.

- ii. **Underwriters:** The lead manager(s) and co-managers act as underwriters for the issue, taking on the risk of interest rates/markets moving against them before they have placed Bonds/DRs. Lead manager(s) may also invite additional investment banks to act as sub-underwriters, thus forming a larger underwriting group. A third group of investment banks may also be invited to join the issue as members of selling group, but these institutions only receive a commission in respect of any Bonds/DRs sold and do not act as underwriters. The co-managers and the underwriters are also members of the selling group.

Figure 3



- iii. **Agents and Trustees:** These intermediaries are involved in the issue of bonds/convertibles. The issuer of bonds/convertibles, in association with the lead manager, must appoint 'paying agents' in different financial centers, who will arrange for the payment of interest and principal due to investors under the terms of the issue. These paying agents will be banks.
- iv. **Lawyers and Auditors:** The lead manager will appoint a prominent firm of solicitors to draw up documentations evidencing Bond/DRs issue. The various draft documents will be scrutinized by lawyers acting for the issuer and in due course by the co-managers and any other party signing a document related to the issue. Many of these documents are prepared in standard forms, but each needs to be reviewed carefully to ensure that all parties to the transactions are fully satisfied with the wording. The issuer will also appoint legal advisors to seek advice on matters pertaining to Indian/English/American law and to comment on necessary legal documentation. Auditors or reporting accountants will become involved as well, supplying financial information, summaries and an audit report which will be incorporated into the 'offering circular'. The auditors provide comfort letters to the lead manager on the financial health of the issuer. Further, they also provide a statement of difference between the UK and the Indian GAAP in case of GDR issue.
- v. **Listing Agents and Stock Exchanges:** The listing agent facilitates the documentation and listing process for listing on stock exchanges and keeps on file information regarding the issuer such as Annual Reports, Articles of Association, the Depository Agreement, etc.

The Stock Exchange (Luxembourg/London/AMEX/NYSE as the case may be) reviews the issuers application for listing of the Bonds/DRs and provides comments on offering circular prior to accepting the securities for listing.

- vi. **Depository Bank:** Depository Bank is involved only in the issue of DRs. It is responsible for issuing the actual DRs, disseminating information from the issuer to the DR holders, paying any dividends or other distributions and facilitating the exchange of DRs into underlying shares when presented for redemption.

- vii. **Custodian:** The custodian holds the shares underlying DRs on behalf of the Depository and is responsible for collecting rupee dividends on the underlying shares and repatriation of the same to the Depository in US dollars/foreign currency.
- viii. **Printers:** The printers are responsible for printing and delivery of the preliminary and final offering circulars as well as the DRs/Bond certificates.
See Appendix-IV for information about various intermediaries involved in international issues of SCICI Ltd. (Convertible Issue) and EID Parry Ltd. (GDR issue).

RESOURCE MOBILIZATION – THE DECISION CRITERIA

Resource mobilization at competitive cost is a critical issue which confronts every management. In the past, Indian companies could access only the domestic capital market. Liberalization process has opened new avenues for Indian companies in terms of markets and instruments.

For an Indian company, the choice between the domestic and international market would depend on a number of criteria, some of which are listed below:

- i. **Currency Requirements:** A decision has to be taken about the currency needs of the company, keeping in view the future expansion plans, capital imports, export earnings/potential export earnings. A conscious view on the exchange rate also needs to be taken.
- ii. **Pricing:** Pricing of an international issue would be a factor of interest rates and the value of the underlying stock in the domestic market. Based on these factors, the issue price conversion (for convertible) premium would be decided. Given the arbitrage available between interest rates in rupees and say, US dollars, and given the strength of the rupee, as well as the resilience a company can have in its operations against exchange fluctuation risk, due to export earnings, it is possible to take advantage of the low interest rates that are prevailing in the international markets. The above is possible without dilution of the value of the underlying stock. This is so, because, in the case of international issues, open pricing/book building is possible, which has the advantage of allowing the company to maximize the proceeds, enabling the foreign investors to set the premium ensuring transparency and creating price tension.
- iii. **Investment:** At present greater flexibility is available in structuring an international issue in terms of pure equity offering, a debt instrument or a hybrid instrument like Foreign Currency Convertible Bond (FCCB). Each company can take a view on instrument depending upon the financials of the company and its future plans.
- iv. **Depth of the Market:** Relatively larger issues can be floated, marketed and absorbed in international markets more easily than in the domestic markets.
- v. **International Positioning:** Planning for an international offering has to be a part of the long-term perspective of a company. An international issue positions the issuing company, for a much higher visibility and an international exposure. Besides, it opens up new avenues for further fund-raising activities.
- vi. **Regulatory Aspects:** For an international issue, approvals are required from the government of India and the Reserve Bank of India, whereas for a domestic issue the requirements to be satisfied are those of the SEBI and the stock exchanges.

- vii. **Disclosure Requirements:** The disclosure requirements for an international issue are more stringent as compared with a domestic issue. The requirements would, however, differ depending upon the market addressed and the place where listing is sought.
- viii. **Investment Climate:** The international offering would be affected by factors like the international liquidity and the country risk, which will not have an effect in a domestic issue. With the current country rating, companies have to depend on the strength of their balance sheets to raise funds at competitive rates in the international markets.

EQUITY INSTRUMENTS

Global Depository Receipts

The advent of GDRs in India has been mainly due to the balance of payments crisis in the early '90s. At this time India did not have enough foreign exchange balance even to meet the requirements of a fortnight's imports. International institutions were not willing to lend because of non-investment credit rating of India. Out of compulsions, rather than by choice, the government (accepting the World Bank suggestions on tiding over the financial predicament) gave the permission to allow fundamentally strong private corporates to raise funds in international capital markets through equity or equity-related instruments. The Foreign Exchange Regulation Act (FERA) was modified to facilitate investment by foreign investors up to 51% of the equity-capital of the companies. Investment even beyond this limit is also being permitted by the Government.

Prior to this, the companies in need of the foreign exchange component or resources for their projects had to rely on the government of India or otherwise rely partly on the government and partly on the financial institutions. These foreign currency loans utilized by the companies (whether through the financial institutions or through the government agency) were paid from the government allocation from the IMF, World Bank or other Governments credits. This, in turn, created liability for the remittance of interest and principal, in foreign currencies which was to be met by way of earnings through exports and other grants received by the government. However, with a rapid deterioration in the foreign exchange reserves consequent to Gulf War and its subsequent oil crisis, the companies were asked to get their own foreign currencies which led to the advent of the GDRs.

THE INSTRUMENT

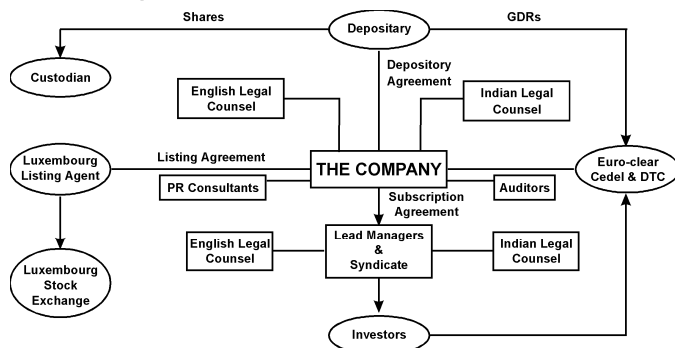
As mentioned earlier, GDRs are essentially those instruments which possess a certain number of underlying shares in the custodial domestic bank of the company. That is, a GDR is a negotiable instrument which represents publicly traded local-currency-equity share. By law, a GDR is any instrument in the form of a depository receipt or certificate created by the Overseas Depository Bank outside India and issued to non-resident investors against the issue of ordinary shares or foreign currency convertible bonds of the issuing company. Usually, a typical GDR is denominated in US dollars whereas the underlying shares would be denominated in the local currency of the Issuer. GDRs may be – at the request of the investor – converted into equity shares by cancelation of GDRs through the intermediation of the depository and the sale of underlying shares in the domestic market through the local custodian.

GDRs, per se, are considered as common equity of the issuing company and are entitled to dividends and voting rights since the date of its issuance. The company effectively transacts with only one entity – the Overseas Depository – for all the transactions. The voting rights of the shares are exercised by the Depository as per the understanding between the issuing company and the GDR holders.

THE PROCEDURE

The sequence of events to be followed for issue of GDR takes the same procedure and documentation as that of other equity instruments which are globally issued. The overall structure typically followed in an issue of GDR is given in the figure.

Figure 4: Structure for a GDR Transaction



ISSUANCE OF GDR

The following are the sequence of activities that take place during the issuance of GDRs:

- a. **Shareholder Approval Needed:** The issuance of an equity instrument like the GDR needs the mandate of the shareholders of the company issuing it. The terms of the issue will have to be decided before such a mandate is sought from the shareholders. There should be an authorization from the Board of Directors for floating a Euro-issue and for calling a general meeting for the purpose. A committee of directors is generally constituted and conferred with necessary powers for the approval of (i) the offering memorandum; (ii) fixation of issue price (iii) opening of bank account outside India and operation of the said account and (iv) for notifying the stock exchange about the date of the board meeting when the proposal will be considered and also inform it about the decisions taken.

After all this, the shareholders should approve the issue by a special resolution passed at a general meeting as per Section 81 of the Companies Act, 1956. It stipulates that, if a company proposes any issue of capital after two years from the formation of the company or at any time after one year from the allotment of shares that the company has made for the first time after its formation – whichever is earlier – the company has to offer such issues first to the shareholders of the company.

- b. **Appointment of Lead Manager:** Lead Manager is an important cog in the wheel of the Euro-issue and is the vital link between the government and investors with the issuers. Practically, it is the lead manager who is responsible for the eventual success or failure of a Euro-issue when all the other factors are same. Hence, the choice of a suitable lead manager is as significant as any other issue activity. An ideal lead manager is selected after preliminary meetings with merchant bankers. The merchant bankers are evaluated on various parameters such as (i) Marketing ability (ii) Marketing research capability (iii) Market making capability (iv) Track record (v) Competitive fee structure and (vi) Placement skills. A beauty parade, which is basically the presentations made by the various merchant bankers, is held by the company to help it decide on the final choice of the lead manager after they are filtered by the above parameters. The final appointment of lead manager is done after the approval by the government.

The lead manager advises the company in the following areas after taking into consideration the needs of the company, the industry in which the company is engaged, the international monetary and securities markets, the

general economic conditions and the terms of the issue viz., quantum of issue, type of security needed to be issued (GDR in this case), stages of conversion, price of equity, shares on conversion, rate of interest, redemption date, etc.

- c. **Finalization of Issue Structure:** On completion of the formalities of issue structure in consultation with the lead manager, the company should obtain the final approval from the government. For this purpose, the company should furnish the information about the entities involved in the GDR issue and the following parameters to the government.

i. Lead Manager	xii. Indian Custodian
ii. Co-Lead Manager	xiii. Issue structure and denomination of underlying shares represented by the GDRs
iii. Currency	xiv. Issue amount
iv. Issue Price (approximate range in case of GDR)	xv. Green Shoe option
v. Form and Denomination	xvi. Warrants attached, if any
vi. Negative pledge provisions	xvii. Listing modalities
vii. Taxation	xviii. Selling commission
viii. Commissions	xix. Underwriting commission
ix. Reimbursable expenses	xx. Legal expenses, printing expenses, depository fees, and other out-of-pocket expenses
x. Governing Laws	xxi. Taxation procedure
xi. Overseas Depository Institution	

The government, after considering all the above information will give a final approval for the issue – if satisfied.

Table 1

Bookrunners of International Bonds

Pos.	Manager or Group	Amt US\$ (bn)	Iss.	% Share
1.	Salomon Smith Barney International	172.75	490	10.27
2.	Deutsche Bank	144.05	576	8.56
3.	Morgan Stanley Dean Witter	137.83	593	8.19
4.	JP Morgan	131.76	427	7.83
5.	Merrill Lynch & Co	126.97	431	7.55
6.	Credit Suisse First Boston	119.92	512	7.13
7.	Lehman Brothers	104.05	413	6.19
8.	Goldman Sachs & Co	89.39	299	5.31
9.	UBS Warburg	81.39	333	4.84
10.	Barclays Capital	68.73	311	4.09
11.	ABN AMRO	61.57	314	3.66
12.	BNP Paribas	51.67	289	3.07
13.	HSBC	44.55	471	2.65
14.	Dresdner Kleinwort Wasserstein	44.04	261	2.62
15.	Bank of America	21.78	58	1.29
16.	Societe Generale	19.54	89	1.16
17.	Bear Sterns & Co	18.37	53	1.09
18.	Hypovereinsbank - Bayerische Hypo-und Vereinsbank	16.98	122	1.01
19.	Credit Agricole Indosuez	16.93	103	1.01
20.	Commerzbank Securities	16.93	141	1.01
	Total	1,682.26	6542	100.00

Source: Dealogic Bondware.

THE DOCUMENTATION

Documentation for Euro equities is a complex and elaborate process in the procedure of GDR launch. A typical Euro-issue consists of the following main documents:

- a. Prospectus
- b. Depository agreement
- c. Custodian agreement
- d. Subscription agreement
- e. Paying and conversion agency agreement
- f. Trust deed
- g. Underwriting agreement and
- h. Listing agreement.

A brief discussion on the contents and the relevance of each of these documents is given below:

- a. **Prospectus:** As in domestic equity market, the prospectus is a major document containing all the relevant information concerning the issues – like the investment considerations, terms and conditions, use of proceeds, capitalization details, share information, industry review and overall description of the issuing company. As a marketing strategy, companies generally issue a preliminary prospectus which is referred to as pathfinder which will judge the potential demand for the equity that is being launched in the markets.

The aspects that need to be covered in the main prospectus may be grouped as follows:

- i. *Financial Matters:* Apart from the financials of the company, the prospectus should include a statement setting out important accounting policies of the company and a summary of significant differences between Indian GAAP and the UK GAAP and the US GAAP (in case of an ADR). (Refer to the table bringing out the differences between the US, and Indian GAAP later in the chapter).
- ii. *Non-financial Matters:* This may cover all aspects of management with the information relating to their background, names of nominee directors along with the names of the financial institutions which they represent and the names of senior management team. All other non-financial aspects that influence the working of the company need to be mentioned in the prospectus.
- iii. *Issue Particulars:* The issue size, the ruling domestic price, the number of underlying shares for each GDR and other information relevant for the issue as such, may be mentioned here.
- iv. *Other Information:* Statement regarding application to a foreign stock exchange for listing the securities and issuing of global certificates to a specified nominee as operator of the Euro-Clear (international clearing house in Euro-securities) system like Cedel (one of the major clearing houses in Eurobond market clearing, handling and storing the securities).

Option provided to the lead manager to cover over-allotments, exercisable on or before the business day prior to the closing date to subscribe for additional securities in the aggregate up to a specified limit.

- b. **Depository Agreement:** This is the agreement between the issuing company and the overseas depository providing a set of rules for withdrawal of deposits and for their conversion into shares. Voting rights of a depository are also defined. Usually, GDRs or Euro convertible bonds are admitted to the clearing system, and settlements are made only by book entries. The agreement lays down the procedure for the information transmission to be passed onto the GDR holders.
- c. **Underwriting Agreement:** As in domestic equity market, underwriters play the role of 'assurers' for picking the GDRs at a predetermined price depending on the market response. The agreement is for this purpose, between the company (guided by its lead manager) and the underwriter.
- d. **Subscription Agreement:** The lead manager and the syndicated members form a part of the investors who subscribe to GDRs or Euro convertible bonds as per this agreement. There is no binding, however, on the secondary market transaction on these entities i.e. market making facility.
- e. **Custodian Agreement:** It is an agreement between the depository and the custodian. In this agreement the depository and the custodian determine the process of conversion of underlying shares into depository receipts and vice versa. For the process of conversion of the GDRs into shares, (popularly termed as Re-materialization) shares have to be released by the Custodian.
- f. **Trust Deed and Paying and Conversion Agreement:** While the trust deed is a standard document which provides for duties and responsibilities of trustees, the paying and conversion agreement enables the paying and conversion agency which performs a typical banking function by undertaking to service the bonds until the conversion, and arranging for conversion of bonds into GDRs or shares, as necessary.
- g. **Listing Agreement:** As far as the listing is concerned, most of the companies which issue a GDR prefer Luxembourg Stock Exchange as the listing requirements in this exchange are by far, the most simplest. The New York Stock Exchange (NYSE) and the Tokyo Stock Exchange (TSE) have the most stringent listing requirements. London Stock Exchange and the Singapore Stock Exchange fit in the middle with relatively less listing requirements than the NYSE and TSE.

The listing agents have the onus of fulfilling the listing requirements of a chosen stock exchange. The requirements of London Stock Exchange are provided in the 48-hour documents. The 48-hour documents are the final documents that have to be lodged at the exchange not later than mid-day, at least two business days prior to the consideration of the application for admission to listing. These documents, among other things should include the following:

- An application for admission to listing.
- Declaration of compliance in the appropriate form issued by the exchange.
- Three copies of the listing particulars/equivalent offering document relating to the issue. The contents of these documents should meet the relevant requirements.
- A copy of any shareholders' resolution that is relevant to the issue of such securities.
- A copy of the board resolution authorizing the issue, the application for listing and the publication of the relevant documents.
- In case of a new company, a copy of the incorporation certificate, memorandum of certificate and articles of association.

THE LAUNCH

Two of the major approaches for launching of a Euro-Issue are Euro-Equity Syndication and Segmented Syndication. Euro-Equity syndication attempts to group together the placement strengths of the intermediaries, without any formal regional allocations. Segmented syndication, on the other hand, seeks to form a geographically targeted syndicate structure, so as to achieve broader distribution of paper by approaching both institutional and retail investors. As compared to Euro syndication, segmented syndication can be expected to achieve orderly and coordinated placement by restricting the choice of syndicate members with definite strengths in specific markets.

MARKETING

It is not only the Indian issues which thrive on suave marketing, but also the GDR and other International bond offerings. A judicious mix of financials and marketing would help in raising the investors interest in the issue. Most of the marketing activities are handled by the lead manager in consonance with the advertising agencies. A back-up material consisting of preliminary offering circular, recent annual report, interim financial statements, copies of newspaper articles about the business of the company and a review of the structure and performance of the Indian stock market, among other things is prepared.

Road Shows form a pre-dominant facet of the launch of any GDR. They are a series of face-to-face presentations with fund managers and analysts and is a vital part of marketing process. Road Shows, which involve much more than just informing about the company are getting increasing attention from the investors and the fund managers. Road shows for Euro equities acquire considerable relevance as investors, who are invited, participate in the ownership and assume a greater degree of risk than under any other financial instrument. Road Shows are backed by the information of the financials and operations and a view regarding the future profitability and growth prospects. This gives an opportunity to the investors (generally, fund managers) to interact with the senior management of the issuing company and understand the activities of the issuer company which may eventually lead to the investment in the company. These are normally conducted at the financial centers of the globe like London, New York, Boston, Los Angeles, Paris, Edinburgh, Geneva, Hong Kong, etc.

The back-up material prepared will support presentations made by the company's senior personnel inviting the fund managers to invest in the company. The price that is preferred for a particular number of shares is noted by the book-runner at each of such presentations and the eventual price that is most likely to find favor with the fund manager is finalized. This will go a long way in making the issue to be accepted.

PRICING AND CLOSING

This forms the most vital part of the whole process of a GDR issue. The pricing is key to the overall performance of a GDR after the same has been listed. The price is determined after the underwriters response has been considered and an inference of the response may be drawn.

The final price is determined after the Book Runner closes the books after the completion of the Road Shows. The book-runner keeps the books open for 1-2 weeks, for the potential investors to start placing their orders/bids with details of price and quantity. After analyzing all the bids at the end of book-building period, lead managers, in consultation with the issuer, will fix a particular price for the issue which will be communicated back to the bidders/investors and a fresh demand figure is arrived at. If there is excess demand, the company can go in for 'green shoe option' where it can issue additional GDRs in excess of target amount.

At the end of the issue various documents will be signed with all the fund managers at New York or London. Pursuant to this, the agreed number of depository receipts will be delivered and the payments in lieu of such delivery will be received by the issuer.

A tombstone advertisement will be issued in the financial press to publicize syndicated loans and other funding deals. Following this, the GDRs will get listed in the notified stock exchange signaling the consummation of the process of the issue of stock exchange.

The time period that is generally needed for a typical GDR issue is given in the following table. The table is arranged sequentially so as to convey information on the step-by-step process that is followed.

Table 2: Activities Undertaken by GDR Issuing Companies

Activity
Capital structuring with the relative components and formalities such as type of instruments etc.
Due diligence of the Company's operations/management/business plans/legal etc.
Drafting and Design of Red Herring Prospectus and of statutory and non-statutory advertisement including memorandum containing salient features of the Prospectus and any other publicity material. The BRLMs shall ensure compliance with stipulated requirements and completion of prescribed formalities with the Stock Exchanges, RoC and SEBI including finalization of the Prospectus and filing with the Stock Exchanges/RoC.
Appointment of other intermediaries viz. Registrar to the Issue, printers, advertising agency and Bankers to the Issue.
Retail and Non-Institution all marketing strategy, which will cover <i>inter alia</i> : <ul style="list-style-type: none"> • Formulation marketing strategies, preparation of publicity budget; • Finalize media and public relations strategy; • Finalize centers for holding conferences for press and brokers; • Finalize collection centers; • Follow-up on distribution of publicity and issue material; including form, prospectus and deciding on the quantum of the issue material.
Institutional marketing strategy, which will cover <i>inter alia</i> : <ul style="list-style-type: none"> • Finalize the list and division of investors for one-on-one meetings; • Managing the book, co-ordination with Stock Exchanges and pricing institutional allocation in consultation with the Company and the BRLMs. • Finalize roadshow presentations.
The post bidding activities including management of Escrow Accounts, coordination of non-institutional allocation, intimation of allocation and dispatch of refunds to Bidders, etc.
The post Issue activities will involve essential follow up steps, including finalization of trading and dealing instruments and dispatch of certificates and demat delivery of Equity Shares, with the various agencies connected with the work such as the Registrar to the Issue and Bankers to the Issue and the banks handling refund business. The BRLMs shall be responsible for ensuring that these agencies fulfill their functions and enable them to discharge this responsibility through suitable agreements with the Company.

Source: Red Herring Prospectus of a GDR Issuing Company.

COSTS

The cost incurred by the company is proportional to the issue size. The lead manager, justifiably, takes the lion's share in the issue expenses of the GDR. With the increased acceptance of marketing as a vital tool for the success of the issue, the cost that is incurred on marketing is fast increasing. The following table gives an indication on the total expenses incurred by a GDR issue.

Table 3: GDR Issue: Fees and Expenses

Item	Percent of issue amount
Underwriting Fee	0.60 – 1.00
Management Fee	0.60 – 1.00
Selling Commission	1.80 – 3.00
Total Fees	3.00 – 5.00

Other expenses include lead manager's expenses, printing costs, accounting fees, listing fees, road show expenses, etc.

There has, however, been a considerable fall in the quality of the GDR issues made by the Indian companies. The sole reason why some of the Indian companies came out with a Euro-issue was their eagerness to flaunt the GDR issue as a symbol of being well known in the international markets. Some of the companies coming out with GDRs could not explain the core business they are in and also whether they have judiciously utilized the investment made by the GDR holders.

Table 4
The Present Scenario
Indian GDR/ ADR Issues

Company name	Issue Month & year	Issue price	Issue size (Rs. Mn)	Share per GDR	GDR (no. Mn)
APTECH LTD.	10/29/2003	3.75	14.40	4	15.36
AMTEKAUTO	11/23/2004	–	69	2	–
APPLLO HOSPITALS ENTERPRISE	07/09/2005	7.8	65.1	1	8.35
ARVIND MILLS	07/13/2005	2.8	37.2	1	13.5
ASHOK LEYLAND LTD.	03/01/1995	12.79	137.8	3	10.77
BAJAJ AUTO LTD.	11/01/1994	25.33	110	1	4.43
BAJAJ HINDUSTHAN LTD.	05/12/2005	–	100	–	20.8
BHARAT HOTELS LTD.	05/21/1996	15	19.5	2	2.60
BOMBAY DYEING & MANUFACTURING CO.LTD.	12/01/1993	9.2	50	1	5.43
BSES LTD. 144A GDR	03/01/1996	14.4	125	3	8.68
CENTURION BANK	07/04/2005	4.8	80	15	–
CENTURY TEXTILES AND INDUSTRIES LTD.	07/28/1994	254	100	1	0.39
CESC LTD.	04/01/1994	10.67	125	1	11.72
CORE HEALTH CARE PRODUCTS	06/28/1994	12.6	70	1	5.56
CREW BOS PRODUCTS LIMITED	08/03/2005	2.75	5	1	–
CROMPTON GREAVES LTD.	07/01/1996	7.56	50	1	6.61
DCW LTD.	06/01/1994	13.55	25	5	1.85
DR. REDDY'S LABORATORIES LTD.	04/11/2001	11.16	48	1	4.3
E.I.D. PARRY (INDIA) LTD.	07/01/1994	8.39	40	1	4.77
EIH LTD.	10/01/1994	9.3	40	1	4.3
ELECTROSTEEL CASTINGS	09/30/2005	8.75	40	1	4.57
FINOLEX CABLES LTD.	07/27/1994	16.6	55	1	3.31
FLEX INDUSTRIES LTD.	12/01/1995	8.05	30	2	3.73
GARDEN SILK MILLS LTD.	03/01/1994	26.28	50	5	1.9

International Finance and Trade

Company name	Issue Month & year	Issue price	Issue size (Rs. Mn)	Share per GDR	GDR (no. Mn)
GRANULES INDIA	03/03/2005	2.3	8.7	1	3.76
GRASIM INDUSTRIES LTD.	06/09/1994	20.5	100	1	4.88
GREAT EASTERN SHIPPING CO.	02/01/1994	15.94	100	5	6.27
GUJARAT AMBUJA CEMENTS LTD.	12/01/1995	5.95	80	1	13.45
GUJARAT NARMADA VALLEY	10/01/1994	12.75	62	5	4.86
HDFC BANK	07/20/2001	13.85	150	3	10.83
HIMACHAL FUTURISTIC	07/31/1995	9.3	50	4	5.38
HINDALCO INDUSTRIES LTD.	07/01/1993	16	100	1	6.25
HINDUSTAN DEVELOPMENT CORP.	09/01/1994	2.05	76	1	37.07
I.T.C. LTD.	10/20/1993	7.65	69	1	9.02
ICICI LTD.	09/22/1999	9.80	275	5	28.06
INDIABULLS FINANCIAL SERVICES	08/05/2005	5.42	130	1	23.98
INDIA CEMENTS LTD.	10/18/1994	4.22	90	1	10.66
INDIAN ALUMINIUM CO. LTD.	03/01/1994	6.76	60	1	8.88
INDIAN HOTEL CO. LTD.	05/05/1995	16.6	86.2	1	5.19
INDIAN PETROCHEMICAL CORP.	12/01/1994	13.87	85	3	6.13
INDIAN RAYON & INDUSTRIES	01/01/1994	22.51	125	1	5.55
INDO GULF FERTILIZERS AND CHEMICAL	01/01/1994	4.51	100	1	22.17
INDO RAMA SYNTHETICS (INDIA) LTD.	03/01/1996	11.37	50	10	4.4
IND SWIFT LABORATORIES	08/16/2005	4.25	10.62	1	2.5
INFOSYS TECHNOLOGIES LTD.	03/16/1999	42.45	70.38	.5	20.70
JAGATJIT INDUSTRIES LTD.	05/01/1996	13	16.39	20	1.26
JCT LTD.	08/01/1994	16.96	45	10	2.65
JK CORP LTD.	10/01/1994	8	55	1	6.88
KESORAM INDUSTRIES LTD.	07/31/1996	1.6	30	1	18.75
LARSEN & TOUBRO LTD.	11/28/1994	15.35	150	2	9.77
MAHINDRA & MAHINDRA LTD.	12/14/1993	4.48	75	1	16.73
MICRO INKS	11/06/2005	13.27	40	–	–
MOSCHIP SEMICONDUCTOR TECHNOLOGY LTD.	04/26/2005	1.6	7.3	2	4.5
ORIENTAL HOTELS	12/16/1994	12.75	30	1	2.35
RANBAXY LABORATORIES	07/01/1994	19.37	100	1	5.16
RELIANCE INDUSTRIES LTD.	06/01/1992	16.35	150	2	9.17
SATYAM COMPUTER SERVICES	05/14/2001		161.91	2	
SHRIRAM INDUSTRIAL ENTERPRISES LTD.	10/14/1994	14.64	40	3	2.73
SHRIRAM INDUSTRIAL ENTERPRISES LTD.	10/01/1994	4.88	40	3	8.20
SILVERLINE TECHNOLOGIES LTD.	06/20/2000	25	130	2	5.2
STATE BANK OF INDIA	10/03/1996	14.15	369.98	2	26.15
STEEL AUTHORITY OF INDIA LTD.	03/14/1996	12.97	125	15	9.64
STERLITE INDUSTRIES	12/01/1994	17.88	100	1	5.59
UNITED PHOSPHORUS LTD.	03/03/1994	20.5	55	1	5.36
UTI BANK	03/17/2005	5.9	239.3	1	40.49
VIDEOCON INTERNATIONAL	01/01/1994	8.1	90	1	11.11
VIDESH SANCHAR NIGAM	02/10/1999	13.93			37.80
WIPRO LTD.	10/24/2000	41.375	130.75	1	3.16
WOCKHARDT LTD.	02/01/1994	14.35	75	1	5.23

Source: CMIE (Prowess Software)

American Depositary Receipts

Until 1990, companies had to issue separate receipts in the US (ADRs) and in Europe (IDRs) to access both the markets. The weakness was that there was no cross-border trading possible as ADRs had to be traded, settled and cleared through the Depository Trust Company (DTC) in the US, while the IDRs could be traded and settled via Euroclear in Europe. It was in April, 1990, when changes in Rule 144A and Regulations of the SEC of the US allowed non-US companies to raise capital in the US market without having to register the securities with the SEC or changing the financial statements to reflect the US accounting principles. Rule 144A is designed to facilitate certain investment bodies called Qualified Institutional Buyers (QIBs) to invest in overseas (non-US) companies without those companies needing to go through the SEC registration process.

The Instrument

ADR is a dollar denominated negotiable certificate, it represents non-US company's publicly traded equity. It was devised in the late 1920s, to help Americans invest in overseas securities and to assist non-US companies wishing to have their stock traded in the American Markets. ADRs are divided into 3 levels based on the regulation and privilege of each company's issue.

- i. **ADR Level-I:** It is often the first step for an issuer into the US public equity market. Issuer can enlarge the market for existing shares and thus diversify the investor base. In this instrument only minimum disclosure is required to the SEC and the issuer need not comply with the US GAAP (Generally, Accepted Accounting Principles). This type of instrument is traded in the US OTC market. The issuer is not allowed to raise fresh capital or list on any one of the national stock exchanges.
- ii. **ADR Level-II:** Through this level of ADR the company can enlarge the investor base for existing shares to a greater extent. However, significant disclosures have to be made to the SEC. The company is allowed to list in the American Stock Exchange (AMEX) or New York Stock Exchange (NYSE) which implies that the company must meet the listing requirements of the particular exchange.
- iii. **ADR Level-III:** This level of ADR is used for raising fresh capital through public offering in the US Capital Markets. The company has to be registered with the SEC and comply with the listing requirements of AMEX/NYSE while following the US-GAAP.

The reason for this may be attributed to the stiff disclosure requirements and accounting standards as per the US GAAP. The following table gives an indication on the difference between the US and Indian GAAP.

Table 5
Summary of Significant differences between the
Indian Accounting Standards and the US GAAP

India	USA
Financial Statements <ul style="list-style-type: none"> Prepared in accordance with the requirements of Schedule VI of the Companies Act, 1956. 	<ul style="list-style-type: none"> No Specific format is necessary as long as they comply with the disclosure requirements of the US Accounting Standards.
Consolidation <ul style="list-style-type: none"> Not required. 	<ul style="list-style-type: none"> Consolidation of group company accounts is mandatory.

India	USA
Earnings Per Share Data <ul style="list-style-type: none"> No disclosure requirements except those under Schedule VI, Part IV to the Companies Act, 1956. 	<ul style="list-style-type: none"> Disclosure is mandatory. This includes the EPS calculated using the weighted average shares outstanding (simple and complex capital structures) method and fully diluted EPS (considering the effect of warrants or options outstandings).
Taxation <ul style="list-style-type: none"> Normally provided for, based on the taxes payable method. 	<ul style="list-style-type: none"> Deferred tax assets or liabilities should be booked using the asset-liability approach.
Fixed Assets and Depreciation <ul style="list-style-type: none"> Revaluation of assets permitted. Depreciation is based (usually) on rates set out in Schedule XIV to the Companies Act, 1956. 	<ul style="list-style-type: none"> Revaluation of assets not permitted. Depreciation is over the useful economic lines of assets. Depreciation and profit/loss on sale is based on historic cost.
Investment in Own Shares <ul style="list-style-type: none"> Expressly prohibited. 	<ul style="list-style-type: none"> Permitted and is shown as reduction from shareholders' equity.
R&D <ul style="list-style-type: none"> Costs can be capitalized subject to the conditions of AS-8, R&D, issued by the ICAI. 	<ul style="list-style-type: none"> Costs are expenses as incurred.
Related Party Transactions <ul style="list-style-type: none"> No Specific disclosures required. Auditors have a duty to report certain transactions entered into by related parties as defined under the Companies Act, 1956. 	<ul style="list-style-type: none"> Disclosures are stringent and require descriptions of nature of relationships and control, transactions, amounts involved and amounts due.
Goodwill <ul style="list-style-type: none"> No standard except for brief references in AS-10, fixed assets and AS-14, Accounting for amalgamations. Goodwill arising from amalgamations can be written-off over 5 years. 	<ul style="list-style-type: none"> Treated as any other intangible asset and is capitalized and amortized. The maximum carry forward period is 40 years.
Pre-operative Expenses <ul style="list-style-type: none"> Allowed to be deferred and written-off over a period of 3-5 years or 10 years. 	<ul style="list-style-type: none"> Concept does not exist.
Assets and Liabilities <ul style="list-style-type: none"> No mandatory disclosure of current and long-term components. 	<ul style="list-style-type: none"> Mandatory disclosures about current and long-term components separately. Current component normally refers to one year of the period of the operating cycle.

India	USA
Foreign Currency Transactions <ul style="list-style-type: none"> Exchange fluctuations on liabilities incurred for fixed assets can be capitalized. 	<ul style="list-style-type: none"> Exchange gain/loss is taken to the income statement. The concept of capitalization of exchange fluctuations arising from foreign currency liabilities incurred for acquiring fixed assets does not exist.
Segmental Reporting <ul style="list-style-type: none"> Requirements exist for disclosure of quantitative particulars only as prescribed in Schedule VI to the Companies Act, 1956. 	<ul style="list-style-type: none"> Mandatory for SEC-registered companies to report revenues and net income by geographic regions and products/business lines; report sales to outstanding receivables from unaffiliated customers; report identifiable assets by geographical regions and products/business lines.
Impairment Evaluation <ul style="list-style-type: none"> No Standards. 	<ul style="list-style-type: none"> Mandatory for all assets. Future undiscounted cash flows from use and disposal of the assets are first compared to its carrying value to determine the impairment situation. Impairment loss is then recognized on the basis of the fair value of the asset. Disclosure of the facts and circumstances that led to impairment is mandatory.
Fair Value Disclosures <ul style="list-style-type: none"> Schedule VI (Directors to state expressly if, in their opinion, the current assets are not expected to realize their cost if they are sold.) 	<ul style="list-style-type: none"> Mandatory fair values are ascertained based on certain specific principles for items, such as loans, current assets, current liabilities, etc.

Source: KPMG Peat Marwick.

Intermediaries that are involved in an ADR issue perform the same work as in the case of a GDR issue. Additionally, the intermediaries involved will liaison with the QIBs for investing in ADRs. Some of the well known intermediaries for ADRs/GDRs are, Merrill Lynch International Ltd., Goldman Sachs & Co, James Capel & Co, Lehman Brother International, Robert Fleming Inc, Jardine Fleming, CS First Boston, JP Morgan, etc.

Regulatory Framework

At the outset, it should be clear that the regulatory framework for the ADRs is provided by Securities and Exchange Commission which operates through two main statutes, the Securities Act of 1933, and the Securities Exchange Act of 1934. The Securities Exchange Act provides for the disclosure and its periodic updating. As far as Indian regulatory procedures are concerned, the Ministry of Finance is yet to come out with comprehensive set of guidelines.

Rule 415 of the Securities Exchange Act of 1934, refers to Shelf Registration and applies to the issue of ADRs. Under this rule, select foreign companies are offered the facility to register the necessary documents before the actual issuance of

securities. For this, issuers are required to prepare the prospectus in two parts: Basic and supplementary. While the basic prospectus has to be filed at the time of shelf registration, the supplementary prospectus has to be filed at the time of the actual issuance of the securities. Wrapping around the basic prospectus, the supplementary prospectus records the recent developments in addition to filing a detailed financial condition statement. Underwriting arrangements, the certifications of auditors and legal counsel have to be procured for the actual issue of securities. New shelf filings, are required if the issuer seeks to raise larger amounts than originally indicated. Also, the issuer has the option to go in for de novo registration.

Shelf registration has been found to be useful to issuers as it reduces the incidence of fees considerably. More importantly, shelf registration affords the issuers opportunities for quickly accessing the markets as the offering process is substantially simplified.

POTENTIAL

Though there has been an increase in the limit of FII investment in an Indian company to 10% with the increase in the overall investment limit to 30%, FIIs eager to invest in certain blue chip companies are finding the GDR/ADR route as convenient to invest in such companies. The first company to have received the approval to issue ADR is BPL Cellular Holdings. The approval is given on case-to-case basis by the Ministry of Finance.

DEBT INSTRUMENTS

Eurobonds

The process of lending money by investing in bonds originated during the 19th century when the merchant bankers began their operations in the international markets. Issuance of Eurobonds became easier with no exchange controls and no government restrictions on the transfer of funds in international markets. Slowly, the US dollar came to be accepted as an international currency and New York joined the family of money centers of the world. The first Eurobond was made for US\$ 15 million only for the Italian motorway company – Autostrada, and the total Eurobond volume in the year of 1963 was US\$ 150 million. World Bank entered international markets in a big way to raise finance by issuing bonds.

THE INSTRUMENTS

All Eurobonds, through their features can appeal to any class of issuer or investor. The characteristics which make them unique and flexible are,

- a. No withholding of taxes of any kind on interests payments.
- b. A fundamental requirement is that the bonds are in bearer form with interest coupon attached.
- c. The bonds are listed on one or more stock exchanges but issues are generally traded in the over-the-counter market.

Typically, a Eurobond is issued outside the country of the currency in which it is denominated. It is like any other Euro instrument and through international syndication and underwriting, the paper is sold without any limit of geographical boundaries. Eurobonds, are generally listed on world's stock exchanges, usually on the Luxembourg Stock Exchange.

There were various innovations in the structuring of bond issues during the eighties. These structures used swap technique to switch from one currency to another, or to acquire multi-currency positions. Another variation was in the form of equity-related bonds as convertibles or bonds with equity warrants. Zero-coupon bonds were issued capitalizing on the tax treatment.

Bond issue structures can be classified into two broad categories: Fixed rate bonds (also referred as straights) and Floating-Rate Notes (FRNs).

Table 6: Top 10 Bookrunners

	1/1/2005 – 31/3/2005			1/1/2004 – 31/3/2004		Chg in Mkt Share
Bookrunners	Proceeds (US\$m)	Mkt. Share	No. Issues	Rank	Mkt. Share	
Citigroup	78,031.8	9.7	196	1	9.4	0.3
Deutsche Bank	70,507.7	8.8	217	2	8.0	0.8
JP Morgan	51,283.7	6.4	134	6	5.9	0.5
Barclays Capital	49,538.2	6.2	122	5	6.0	0.2
Morgan Stanley	43,911.4	5.5	99	3	7.2	-1.7
HSBC	36,869.5	4.6	109	12	3.8	0.8
ABN-AMRO	35,614.6	4.4	104	11	4.0	0.4
Goldman Sachs	35,564.6	4.4	65	10	4.4	0.0
UBS	35,406.3	4.4	112	8	5.0	-0.6
BNP Paribas	33,479.1	4.2	112	14	2.9	1.3
Top 10 Total	470,206.9	58.6	1,270	–	56.6	2.0
Industry Total	805,829.1	100.0	1,616	–	100.0	0.0

Source: www.thomson.com

- a. **Fixed Rate Bonds/Straight Debt Bonds:** Straight Debt Bonds are fixed interest bearing securities which are redeemable at face value. These unsecured bonds which are floated in domestic markets or international markets, are denominated in the respective currency with interest rates fixed on the basis of a certain formula applicable in a given market. The bonds issued in the Euro-market referred to as Euro-bonds, have interest rates fixed with reference to the creditworthiness of the issuer. The yields on these instruments depend on short-term interest rates. LIBOR is the most commonly used benchmark for measuring the yields on these bonds. The interest rate on dollar denominated bonds are set at a margin over the US treasury yields. The redemption of straights is done by bullet payment, where the repayment of debt will be in one lump sum at the end of the maturity period, and annual servicing. Further, there is no tax deduction at source on the income of these bonds. These bonds are listed either on London, Luxembourg or Singapore stock exchanges. In addition to the fixed rate bonds, there are the zero coupon bonds which do not pay the investors any interest and therefore, are not taxable on a year-to-year basis. Instead, the differential between maturity value and the issue price could be treated as capital gains and taxed at a lower rate accordingly. The first zero-coupon bond was floated in Euromarkets in 1981 for Pepsico which was made at a price of 67.5% for a maturity of three years, with repayment at 100% on the maturity date. This has provided a yield of 14.14% to the investors.
- b. **Floating Rate Notes (FRNs):** FRNs can be described as a bond issue with a maturity period varying from 5-7 years having varying coupon rates – either pegged to another security or re-fixed at periodic intervals. Conventionally, the paper is referred to as notes and not as bonds. The spreads or margin on these notes will be above 6 months LIBOR for Eurodollar deposits.

The bulk of the issues in the seventies were denominated in US dollars. Later, the concept was applied to other currencies, like Pound Sterling, Deutsche Mark, European currency units and others. Extensive usage of these FRNs is done by both American and Non-American Banks who would borrow to obtain dollar without exhausting credit lines with other banks. Thus, FRNs represent an additional way to raise capital for them. To cater to the varying shifts in the investor preferences and borrowers' financial requirements, variations have been introduced in the basic FRN concept. FRNs have thus been restructured into the following types:

- *Flip-Flop FRNs*: The investors have the option to convert the paper into flat interest paying instrument at the end of a particular period. The investor could change his mind and convert the note into perpetual note once again at maturity. World Bank had come out with a FRNs issue with perpetual life and having a spread of 50 basis points over the US treasury rate. Every 6 months the investors had the option of converting the FRN into 3-month note with a flat 3-month yield. The investor could also revert his decision and change it to a perpetual note.
- *Mismatch FRNs*: These notes have semi-annual interest payments though the actual rate is fixed monthly. This enables investors to benefit from arbitrage arising on account of differentials in interest rates for different maturities. They are also known as rolling rate FRNs.
- *Mini-Max FRNs*: These notes include both minimum and maximum coupons. The investors will earn a minimum rate as well as a maximum rate on these notes. Depending on the differential between these rates the spreads are earned on these notes. These notes are also known as collared FRNs.
- *Capped FRNs*: An interest rate cap is given over which the borrower is not required to service the notes, even if Libor goes above that level. Typically, the investors have margins higher than that is normally applicable.
- *VRN-Structured FRNs*: These represent long-dated paper with variable interest spreads, with margins over Libor. The margins rise for longer maturities.
- *Perpetual FRNs*: These notes which are irredeemable are also known as perpetual floaters or undated issues.

PROCEDURE

Coming out with a bond issue is the most complex and elaborate of the procedures of all the funding programs. Bonds need to be carefully designed and executed, especially as these are placed with international clientele.

The success of the bond issue depends not so much on costs as on the position and capabilities of the bidders for launching the issue. The cheapest bid therefore, may not be the best bid because the track record and current market standing of the bidders would have to be carefully weighed while choosing the lead manager. Therefore, the mandate of the bond issue has to be awarded after proper deliberation on the modalities involved. The bids should include all necessary information relating to the placement strategy, market support operations, listing details, paying agency arrangements, delivery and handling of notes and trustee arrangements.

After the receipt of a mandate, the mandated bank (referred to as lead manager or arrangers) has to initiate steps for the formation of a syndicate group to complete bond issue formalities. Since, it is the key member of the syndicate group, it is responsible for a series of tasks starting with the launching of the issue till its closure.

- a. **Syndication:** In particular, the Arranger's (lead managers) duties commence with a credit appraisal of the issuer on the basis of a financial and operational data. The lead manager has to organize detailed negotiations with the issuer for the purposes of settling various terms and conditions. A time table too has to be drawn for going through various stages of bond issue floatation.

It is also the lead managers' responsibility for drafting documents with the help of legal counsels. Bond issue documentation comprises, besides prospectus, subscription agreement, underwriting agreement, selling agency agreement, paying agency agreement, listing agreement and the trust deed. These agreements have the same kind of properties as in the case of a GDR issue mentioned earlier in the chapter.

Traditionally, international markets have been following open priced syndication procedures. Under this, the lead manager keeps pricing open until the subscription agreement is actually signed. The lead manager assesses not only the market mood but the precise level at which an issue would be supported and subscriptions can be procured in adequate measure.

International markets have also come up with an innovative method of syndication referred to as bought-out deal process. Under this system, pre-priced issue (pre-priced by the lead manager and co-management group) are presented to the market and the issuer knows the exact issue price and coupon rate before the former is launched in the market.

- b. **Launching, Offering and Closing:** Placement of new bond issues in markets follows a standard route. On receipt of various approvals and authorizations by the issuer, news concerning bond issue floatation is carried through the appropriate media. With the announcement of a bond issue launch, invitation telexes are sent to underwriters and to selling group members inviting their support. The main function of underwriters is to take up the issue on execution of the underwriting agreement. It is customary for them to sell the issue subsequently. Underwriting is done by three groups – the managers, major underwriters and minor underwriters. While the commitments on the first two categories of underwriters will be an average of 1 percent of the issue, the last category of underwriters will have a commitment of 0.5 percent of the issue.

Compared to underwriting, selling is organized in a different manner. While underwriters take title to the issue so underwritten, selling group members do not take title as they undertake to sell the issue if support is obtained. The selling group, therefore, do not carry any risk – in a technical sense – compared to the underwriting group.

The next stage in bond issue floatation is the offering. During this phase, terms consisting of coupon rate and issue price are finalized. Pricing is determined on the basis of the underwriters' response, and is undertaken one day before the offering. The lead manager, jointly with co-managers, have to assess the mood and response of the market and weigh the response of the underwriters accordingly. The two-day period prior to the offer is, therefore, very crucial and hectic discussions and negotiations are undertaken in order to arrive at a correct bond issue pricing.

During the offering period, the issuer and the lead manager organize a sales campaign. Various markets are tapped by means of roadshows. These are in fact investor meetings where the offering of a bond is formally presented to investors. Roadshows are organized at various centers and are important from the point of view of placing the issue. The offering phase is concluded with the actual sale of bonds, signing of necessary agreements and publicity regarding the transaction coming to an end.

Given below is the time schedule for the various activities in a Eurodollar bond issue. For frequent issuers of bonds, the time schedule is shorter as the familiarity of the parties with the process ensures expeditious completion of various stages.

Table 7: Time Schedule for a Traditional Eurodollar Bond Issue

Week of X – 14	<p>: Initial organizational meeting with the company to discuss:</p> <ol style="list-style-type: none"> Basic terms and conditions Time schedule and allocation of responsibilities Marketing and syndication strategy (possible syndicate tour) General form and content of offering circular, subscription and fiscal agency/trust deed and paying agency agreements Selection of trustee or fiscal agent and paying agents <p>Work begins on:</p> <ol style="list-style-type: none"> Offering circular (due diligence investigation) Agreement among managers, subscription agreement and underwriting agreement Syndicate telexes and press release List of syndicate members Listing application Sales material (optional)
Week of X – 7	<p>: a. Final authorizations and board approvals obtained</p> <ol style="list-style-type: none"> Working party meetings as necessary to prepare documents Drafts of documents sent to printers Borrower and lead manager discuss pre-announcement terms and commission ideas Preparation of statistical comparison and other sales materials (optional)
X-Day (announcement day)	<p>Announcement of issue released to press and stock exchanges</p> <p>Lead manager sends:</p> <ol style="list-style-type: none"> Invitation telex to co-managers and underwriters Invitation telex to selling group members Sales telex to foreign branch offices (optional) <p>Listing application made</p> <p>Documents and letters sent to the printer for final printing</p>
X + 1	<p>: Co-managers and underwriters required to telex or cable acceptance of underwriting commitment to lead manager</p> <p>Underwriters/Selling Group Members are mailed:</p> <ol style="list-style-type: none"> Preliminary offering circular Execution copies of underwriting/selling group agreement
X + 1 through X + 3 (Offering period)	<p>: Syndicate tour organized and carried out (optional)</p> <p>Indications of syndicate and investor interest are recorded in the book</p> <p>Pre-allotments are made in the amount of not less than 50% of underwriting commitment</p> <p>Documents sent to listing agent</p> <p>Progress of note printer is monitored</p> <p>Advertising agency contacted for preparation of tombstone advertisement and list of likely newspapers and magazines</p> <p>Preparation of final press release</p> <p>Preparation of pricing information and other arrangements for pricing day and signing ceremony</p>

X + 3	: Allotments determined internally by lead manager and telexed to syndicate
X + 4 (pricing day)	: Deadline for receipt by co-managers the draft agreements requiring signature Deadline for receipt by co-managers the draft of prospectus (or in exceptional circumstances, prospectus to be made available for viewing at the office of the lead manager) Final pricing meeting with borrowers (if an open-priced issue)
X + 5 (offering day)	: All syndicate agreements to be signed Signatures on the subscription agreement Release of final press announcement Final terms released to listing agent, document and bond printers and advertising agency for tombstone Printing of final prospectus (next day mailing)
X + 11 through X + 20 (syndicate stabilization)	: New issue supported by a syndicate bid until distribution judged complete. Syndicate notified when trading restrictions are lifted Printing of definitive bonds Preparation of final copy of tombstone advertisement Trust deed or fiscal agency agreement signed Listing application checked to assure listing on or before closing Closing memorandum reviewed setting out arrangements for closing Delivery and payment instruction forms received from underwriters and selling group members
X + 19	: Co-managers, underwriters and selling group members make payment for securities acquired through accounts with Euroclear or Cedel Pre-closing meeting held to determine receipt of all necessary authorizations, legal opinions and cold comfort letter Packaging and delivery arrangements for bonds are checked
X + 24 (closing day)	: Closing documents delivered Payment for the delivery of securities Signature of paying agency agreement
X + 23 through X + 30	: Publication of tombstone advertisement Preparation of bible containing offering documents and closing papers Syndicate stabilization can also continue up to 30 days after closing

Source: Fisher, F.G., *Eurobonds* pp.81 & 82 .

LISTING

Bond issues are listed at one or more stock exchanges depending upon the type of bond issue, the currency of denomination and the desire of the issuer to seek a quotation at various centers. Generally, the Eurobonds denominated in dollars are listed at London/Luxembourg Stock Exchanges, the bonds denominated in French Franc at Luxembourg Stock Exchange and those bonds denominated in DM at German Stock Exchanges. Bonds issued in domestic markets like Japan, Switzerland or Germany have to be listed as per the requirements. Bond issue procedures are finally concluded with the tombstone advertisement and bible compilation.

CLEARING ARRANGEMENTS

With a view to facilitating both new issue and secondary market operations, clearing house arrangements have been made and systems laid down for handling transactions. Eurobonds are usually handed over to either the Euroclear system (Brussels) or Cedel (Luxembourg). The two systems have been linked by what is known as an electric bridge.

Euroclear and Cedel follow two distinct practices, **fungible** and **non-fungible** accounts, for concluding transactions between parties. While the fungible accounts system is most popular in Euromarkets, the non-fungible system is useful for control purposes. In a fungible account system, details regarding the identity of the owners and location of individual securities are not provided. Euroclear system handles trades on fungible basis, whereas Cedel permits both procedures.

The two clearing systems have been providing various other facilities, apart from settlement of secondary market trading transactions. For instance, finance is provided by them for facilitating market-making operations.

THE PRESENT SCENARIO

India relied heavily on Eurocredits during the early eighties. During the mid-eighties India entered Japanese markets with floatations of privately placed Shibosai issues. This was followed by public bond issues in German and Swiss markets during the later half of the eighties. Towards the end of the decade, a couple of public sector institutions floated Eurodollar issues for the first time. However, either because of selective approvals by the government or sensitivities of the markets concerned, only four organizations had entered the external bond markets before the forex crisis of 1991 closed market doors to India. The ensuing three-year period (1991-93) saw the sensitive external bond market lose confidence in India. However, the scene has improved and some of the big Indian corporate houses have been tapping the international bond markets.

Foreign Bonds

These are relatively lesser known bonds issued by foreign entities for raising medium-to long-term financing from domestic money centers in their domestic currencies. A brief note on the various instruments in this category is given below:

- a. **Yankee Bonds:** These are US dollar denominated issues by foreign borrowers (usually foreign governments or entities, supranationals and highly rated corporate borrowers) in the US bond markets. Yankee bond has certain peculiar features associated with the US domestic market. SEC regulates the international bond issues and requires complete disclosure documents in detail than the prospectus used in Eurobond issues, foreign borrower will have to adopt the US accounting practices and the US credit rating agencies will have to provide rating for these bonds. These bonds are sponsored by a US domestic underwriting syndicate and require Securities and Exchange Board registration prior to selling them in the domestic US market. Reliance Industries Ltd. has been the most successful corporate to tap this instrument with a 50-year, \$50 million Yankee Bond issue.
- b. **Samurai Bonds:** These are bonds issued by non-Japanese borrowers in the domestic Japanese markets. Borrowers are supranationals and have at least a minimum investment grade rating (A rated). The maturities range between 3-20 years. The priority for allowing issuance of Samurai bonds is given to the sovereigns after the supranationals and their entities and to high quality private corporations specifically if there are Japanese trade links. This is also a registered bond and the settlement and administrative procedures make it relatively costly. Among the Yen financing instruments, this instrument is the most expensive in terms of issuing costs. As this instrument is issued for the public, the arrangements for underwriting and selling have to be made which involves large documentation.

There are two major parties to a Samurai bond issue, the securities house, which acts as lead arranger, and the bank, acting as a chief commissioned company. The process followed is generally the same as is followed elsewhere for the Eurobonds. However, it is to be noted that the documentation and formalities are friendly and hospitable.

- c. **Bulldog Bonds:** These are sterling denominated foreign bonds which are raised in the UK domestic securities market. The maturity of these bonds will be either for very short periods (5 years) or for very long maturities (25 years and above). Bonds with intermediate maturity periods are rare. These bulldog bonds are generally subscribed by long-term institutional investors like pension funds and life insurance companies. These bonds are generally redeemed on bullet basis (one time lump sum payment on maturity), however, due to the long maturities, early amortizations, say 5 equal annual installments prior to the maturity date, may also be allowed. A margin on the UK government bond will be the yield earned on this paper. These bonds which are offered either by placing or offer for sale process, will have to be listed on the London Stock Exchange.
- d. **Shibosai Bonds:** These are the privately placed bonds issued in the Japanese markets. The qualifying criteria is less stringent as compared to Samurai or EuroYen bonds. Shibosai bonds are offered to a different market segment that consists of institutional investors, including banks. The eligibility criteria, amount, maturity and redemption as well as coupon rate and issue price are all governed by Japan's Ministry of Finance (MoF) guidelines. In terms of eligibility, MoF has classified various borrowers (sovereign and corporate) into different groups. The rated borrowers are divided into three groups in accordance with the rating, while non-rated borrowers are segmented on the basis of country rating or previous bond issue floatation experience. The pricing formula is elaborate and starts with the computation of base rate, spreads being added according to the credit rating of the borrowers. The procedures for completing bond issue formalities are elaborate and take about forty-five days after the mandate is awarded.

Euro Notes

In the early '80s, the international capital markets were faced with problems of country defaults, uncertain supply of OPEC deposits, which were the main source of deposits in the '70s, and the macroeconomic imbalances which were resulting in rising inflation and volatility in exchange and interest rates. All these factors enhanced the risks in the international financial sphere.

The search in mid-eighties for a paper that goes beyond the interbank market for arranging funds and which has wider support for resource raising through primary investors in various markets has contributed to the birth of Euronotes. A series of developments during the eighties, triggered by the bank credit crisis provided impetus to the process of origin of these notes.

THE INSTRUMENTS

Euronotes as a concept is different from syndicated bank credit and is different from Eurobonds in terms of its structure and maturity period. Euronotes command the price of a short-term instrument usually a few basis points over LIBOR and in many instances at sub-LIBOR levels. The documentation formalities are minimal (unlike in the case of syndicated credits or bond issues) and cost savings can be achieved on that score too. The funding instrument in the form of Euronotes possess flexibility and can be tailored to suit the specific requirements of different types of borrowers. There are numerous applications of basic concepts of Euronotes. These may be categorized under the following heads:

- a. **Commercial Paper:** These are short-term unsecured promissory notes which repay a fixed amount on a certain future date. Euronotes, underlying CP, are unsecured and stand on the general creditworthiness of the issuers. Referred as Euro Commercial Paper, these papers are not underwritten and have maturities up to one year, mostly by way of three-month or six-month paper. Even though maturities are short, the overall funding program could be for

medium-to long-term. Usually, the borrowers plan a series of tranches to match their funding needs throughout the life of the program once they are established.

It takes about four to five weeks after the initial decision is taken by the concerned parties. Issuer of CP initiates proceedings by selecting a dealer and an issuing and paying agent. While it is not mandatory to have ratings, issuers often seek ratings for a successful launching of CP programs.

The documentation is simple and comprises an information memorandum, dealer agreement, issuing and paying agency agreement and the actual notes. The information memorandum is a fairly standard and routine document and carries basic information concerning the issuer. The relevant operational information and financials are summarized in an information memorandum for CP, which has to be updated periodically. In terms of disclosure requirements, the information memorandum is expected to help investors independently judge the creditworthiness of the CP issuer.

A significant variation of commercial paper is the asset-backed CP which is backed by financial assets such as mortgages or credit card receivables.

- b. **Note Issuance Facilities (NIFs):** The currency involved is mostly US dollars. A NIF is a medium-term legally binding commitment under which a borrower can issue short-term paper, of up to one year. The underlying currency is mostly US dollar. Underwriting banks are committed either to purchase any notes which the borrower is unable to sell, or to provide standing credit. These can be re-issued periodically.

In a typical NIF program, the issuer instructs the lead manager to issue Euro notes at desired intervals. Maximum and minimum amounts of each issue are also specified. The lead manager sells the notes as per the placement agreement of the sole placing agent, multiple agents or a tender panel that bids competitively for the paper. In cases where there is sole placing agency arrangement, the structure is called a Revolving Underwriting Facility (RUF). The notes are offered for sale during a specified selling period, usually ranging between three to ten business days.

NIFs primarily appeal to professional investors. These include commercial banks, and non-bank financial institutions such as insurance companies and provident funds. The underwriting support is provided by commercial banks. Savings bank, investment companies and insurance companies also play a small role.

NIFs carry three major cost components, underwriting fees (payable on the full amount of underwriting), a one-time management fee (for structuring, pricing, syndication and documentation) and margin on the notes themselves. The margin on Euronotes is expressed either in the form of spreads over LIBOR or built into the NIF pricing itself.

- c. **Medium-Term Notes (MTNs):** MTNs are defined as sequentially issued fixed interest securities which have a maturity of over one year. A typical MTN program enables an issuer to issue Euronotes for different maturities, from over one year up to the desired level of maturity. These are essentially fixed rate funding arrangements as the price of each preferred maturity is determined and fixed up front at the time of launching. These are conceived as non-underwritten facilities, even though international markets have started offering underwriting support in specific instances.

A Global MTN (G-MTN) is issued worldwide by tapping Euro as well as the US markets under the same program. In view of placement of certain proportion of notes in the US markets, issuers are required to seek shelf registration from SEC.

Under G-MTN programs, issuers of different credit ratings are able to raise finance by accessing retail as well as institutional investors. In view of flexible access, speed and efficiency, and enhanced investor base G-MTN programs afford numerous benefits to the issuers.

Spreads paid on MTNs depend on credit ratings, treasury yield curve and the familiarity of the issuers among investors. Investors include Private Banks, Pension Funds, Mutual Funds and Insurance Companies.

THE INDIAN SCENE

Until 1994, there were only a few banks and financial institutions that have come out with a CP and RUF-type program. With the opening of the international markets in 1994, serious attempts must be made by the Indian borrowers to explore this route as a drive towards resource diversification. In the overall context, there is certainly considerable scope for prime Indian corporates to access the Euronote market.

EURO CREDIT SYNDICATION

The Genesis

Syndicated Euro-credits are in existence since the late 1960s. The first syndicate was organized by Bankers' Trust in an effort to arrange a large credit for Austria. During the early seventies, Euromarkets saw the demand for Eurocredits increasing from non-traditional and hitherto untested borrowers. The period after first oil crisis was marked by a boom phase. To cope with the increasing demand for funds, lenders expanded their business without undertaking due credit appraisal of their clients or the countries thus financed. Further, the European banks had short-term deposits while bulk of borrowers required long-term deposits. These lendings were at fixed rates thus exposing these banks to interest rate risks. The banks evolved the concept of lending funds for medium/long-term i.e. 7-15 years on a variable interest rate basis Linked to the Interbank Rate (LIBOR). Revision of rates would take place every 3-6 months. These loans are extended in currencies denominated by US\$, Yen, DM, Swiss Franc and European Currency Unit (ECU). Amortization of the loan would be by way of half-yearly installments on completion of 2-3 years of grace period. At present, this instrument on a variable interest rate basis has emerged as one of the most notable and popular financing instruments in the international financial markets. Syndicated Credit remains as the simplest way for different types of borrowers to raise forex finances.

Syndicates are classified into two types – club loans and syndicated loans.

The club loan is a private arrangement between lending banks and a borrower. Conventionally, the entry into Euromarkets for a funding deal is well-publicized. When the loan amounts are small and parties familiar with each other, lending banks form a club and advance a loan. Therefore, in view of this private arrangement, an information memorandum is not compiled and neither is the deal publicized in the financial press.

Syndicate credits are created when lenders and borrowers come together and execute an agreement, defining terms and conditions, under which a loan can be advanced. These procedures and practices have, over the years, been developed and perfected so that a standard package has evolved now.

Documentation Formalities

Along with the syndication process, the lead manager/lead bank also initiates action of drafting the loan documentation, comprising an information memorandum and loan agreement. The information memorandum describes the borrowing entity, its formation, ownership and management. A somewhat detailed account of operations, past and present, and the cash flow position (along with a

summary of the financials) find an important place in it. It must be noted that the information memorandum does not have the same status and recognition as a prospectus, neither does the lead manager take any responsibility for its accuracy.

The information memorandum also contains a detailed description of the guarantor, in case loans carry a state guarantee. Many developing country transactions carry the guarantee of their respective governments and conventions have evolved for describing the guarantor.

Since the information memorandum is registered with any stock exchange, it does not carry the weightage of a bond issue prospectus. However, it is an important document from the commercial point of view. Prospective lenders rely upon the statements it carries and hence due diligence must be observed.

The principal loan document is the loan agreement and it is the responsibility of the lead manager to draft and conclude it satisfactorily. The agreement is signed by all participating banks and the borrower. It describes the basic transaction, drawdown arrangements, interest rate and its determination, commitment fees, warranties and undertakings, default circumstances, financial covenants (if any), 'agent bank' and the participating banks. The loan is underwritten by a management group assembled by the lead bank. Sometimes the lead bank itself underwrites more than half of the loan amount.

Pricing Methodology

As mentioned earlier, the loan, will be charged at an interest rate that is linked to the LIBOR. The rate will be LIBOR plus the spread the bank would like to maintain. This spread which may be any where from 0.125 percent to 1.5 percent, may remain constant over the life of the loan or may be changed after a certain fixed number of years. In addition, the lead manager's fee, which will be 0.125 percent of the loan, the commitment fee of 0.5 percent on the undrawn loan amount and agent's fee will be the total annual charges. Front-end charges include participation fee for the banks taking part in the loan and the management fees for the underwriting banks and lead banks. These loans will require a bank guarantee and the bank should confirm to the capital adequacy norms. However, there are no other collaterals attached.

Indian Scenario

While the early '80s saw the Indian PSUs, banks, and FIs raise funds by way of syndicated loans, subsequent rating position of India, did not seem to be congenial for the same. Future borrowings with this method of loan syndication will also depend to a large extent on this sovereign rating.

Offshore Banking

Offshore banking has been described aptly by Giddy as "financial intermediation performed primarily for borrowers and depositors who are not residents of the country where the bank is located. Its principal attraction is its freedom from expensive and intrusive official regulation". In simple words, offshore banking involves a bank offering its services of accepting deposits from, and extending credit to foreign residents, in any currency. These activities are free from capital controls, taxes and reserve requirements.

STRATEGIC CONSIDERATIONS

The companies that are contemplating to tap the avenues of international finance should consider the factors that assess the ability of the particular instrument to raise finances for the company. One important factor that needs to be considered is the instrument maturity and its consequent impact on the asset-liability balance. However, external financing is subject to a series of uncertainties concerning the basic element of cost in terms of interest rate and exchange rate changes between currency and in the margins payable in respect of Euronote issuance programs. Hence, a thorough strategy has to be chalked out to avoid any pitfalls and to help

the company garner. For such a strategy, each of the instruments need to be analyzed from the various points. The table below compares each of the instrument on the basis of critical parameters.

Table 8: Comparative Analysis of Financial Instruments

Euro-Loans	Loans are amortizing medium-term financing facilities extended by Eurobanks having a maturity period of 7 years. They are commonly assessed by customers and are available in two forms: club (private) and syndicated loan (public). Amortization on loans is made in the form of Half-yearly payments after grace period. The interest rates charged on these loans include Libor + Margin. Management fee is charged on loans at a flat rate of 1/2 % whereas the commitment fee is charged at a rate of 1/4% on undrawn balances. The Out-of-pocket expenses on loans accumulates to \$50,000 and the Agency fee is charged annually on a recurring basis. Banks issue guarantee on loans.
Bonds	Bonds are securities issued to primary investors through a prospectus having a maturity period of 7 years. Bonds have a very selective access and are available in two forms: Floating rate (FRNs) and fixed rate (straights) bonds. Amortization on bonds is made in Bullet Payment. The interest rates charged on FRNs include Libor + Margin; and straights are charged on the basis of benchmarks. Management fee is charged on bonds at a flat rate of 2 – 3%. The Out-of-pocket expenses on bonds accumulates to \$200,000 and the Paying agents commissions is charged annually on a recurring basis. State issue guarantee on bonds.
Euronotes	Euronotes are short-term notes issued under a medium-term program having a maturity period of 3-6 months for investors and 3-5 years for issuers. Only the Professional investors/issuers have the access to Euronotes and they are available in the form of Commercial paper (non-under written) and NIFs (underwritten). Amortization on Euronotes is made in the form of continuous payments. The interest rates charged on Euronotes include Libor + Margin. Management fee charged on Euronotes is negligible. The Out-of-pocket expenses on bonds accumulates to \$25,000.
Euro equities	Euro equities are Forex denominated equity issued to non-residents – backed by underlying rupee shares having a maturity period of 3-5 years for Convertibles. They are available to customers based on the strength of their balance sheets and are available in the form of Global depository rights and Euro convertibles. Amortization on Convertibles is made through Bullet Payment. The interest on Convertibles is charged at the rate below bond rates. Management fee is charged on Euro equities at a flat rate of 3 – 5%. The Out-of-pocket expenses on bonds accumulates to \$400,000 and the Custodian fees and depository fees are charged annually on a recurring basis.

Source: ICFAI Research Team.

Therefore, from the above table, the company may decide on the various parameters before deciding on the instrument. For example, for a company which hopes to get the state guarantee and which has a capability to go-in for the bullet repayment may opt for the bonds as the instrument. Credit rating also plays a major role in deciding the type of instruments that the company selects for its international finance. Typically, debt rating of the company is a current assessment of the creditworthiness of an obliger with respect to a specific obligation. Standard & Poor and Moody are two major rating agencies which assess the companies which tap the international market. The rating process analyzes the financials of the company, present as well as future, since in the ultimate analysis

the financial strength of the company acts as an indicator of bond issues. The credit rating that the company obtains from the agencies will ultimately decide the investment strategy of the fund manager interested in the company.

Last but not the least, the market which the company prefers to tap is also a consideration to be dwelt upon. The various parameters that constitute the market as a whole are tabulated for various major markets around the globe.

Table 9: Comparative Analysis of Global Financial Markets

US	US market is the Biggest and versatile market having the most popular currency dollar(\$). The financial market in US is regulated under Securities Act 1933; and Securities and Exchange Act, 1934. The Credit rating in US is Formalized and obligatory. Under Glass Steagall Act, sharp distinction is considered between banks and merchant banks. The US market issues multiple instruments such as CP, MTNs, and Bonds, etc. The documentation procedure in US is Complex and detailed and is reviewed by SEC. Prime lending treasury rates, commercial paper rates are taken as benchmarks. The overall market is considered to be bold and competitive.
Japan	Japan was late entry into global financial markets enjoying steady interest rates. The financial market in Japan is regulated by Ministry of Finance. The market is monitored, controlled yet competitive. They rely on US ratings for assessment. Under Article 65 of SEC, sharp demarcation is considered between banks and securities companies. The Japan market issues multiple instruments such as Samurai, Shibosai bonds, loans, etc. The documentation procedure in Japan is Complex and is original in Japanese. Long-term prime rate, gensaki rate (short-term) are taken as benchmarks. The overall market is considered to be Quiet but effective, based on consensus.
Swiss/ German	Swiss and German market is the biggest foreign bond market having low interest rates. There are no formal laws for regulation of securities, yet the Central bank (BUBA/SNB) monitors the markets. The Credit rating is informal yet effective. These markets follow universal banking. The Swiss and German market believe in simplicity of approach and comprise Public and unlisted bonds. The documentation procedure is compact and simplest. The overall market is considered to be cautious and conservative.
Euromarkets	Euromarkets is the Single wholesale market – EU-wide capital rising having Common legal framework for integrated securities and derivatives markets. There is no specific legislation for regulation of securities. The Regulatory framework in Euromarkets is market driven and BIS norms on capital adequacy and banking prudence are ensured. The Credit rating is not obligatory, they lay emphasis on internal rating. No formal distinction is considered between banking and merchant banking. The Euro market comprise of instruments such as Loans, bonds, Euronotes, euro equities, etc. They have elaborate documentation procedure sought for protection against risks. Libor is taken as a benchmark. The overall market is considered to be bold and innovative.

Source: ICFAI Research Team.

Again, the company which has the capability to go through the complex process of SEC and which can claim popularity among the QIBs of the US may go in for the American market and gain the advantage of a large market.

Hence, it is clear that unless the company ponders and ruminates over the parameters listed above and arrives at a strategy, it cannot evolve its financing plan.

SUMMARY

- There are a lot of opportunities for Indian companies to raise funds in international equity markets for right kind of usage of the funds.
- After analyzing the performance of the Indian issues, the following factors are identified for successful international equity/convertible issue:
 - i. Fundamentals of the company
 - ii. Experienced lead manager
 - iii. Size of the issue
 - iv. Innovative packaging of instrument
 - v. Timing of the issue
 - vi. Careful pricing
 - vii. Effective marketing/salesmanship
 - viii. After market service
 - ix. Having up to date information about developments in the global markets.

Appendix 1

Issue of Foreign Currency Convertible Bonds (FCCBs) and Ordinary Shares (Through Depository Receipt, Mechanism) Scheme, 1993 and Guidelines for Euro Issues (Amended till September 5, 2005)

G.S.R. No.700 (E) – Central Government hereby notifies the following scheme, for facilitating issue of Foreign Currency Convertible Bonds and ordinary shares through Global Depository Mechanism by Indian Companies, namely:

Short Title and Commencement

1. (1) This scheme may be called the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993.
- (2) It shall be deemed to have come into force with effect from the first day of April, 1992.

Definitions

2. In this scheme, unless the context otherwise requires—
 - (a) “Domestic Custodian Bank” means a banking company which acts as a custodian for the ordinary shares or foreign currency convertible bonds of an Indian Company which are issued by it against global Depository receipts or certificates;
 - (b) “Foreign Currency Convertible Bonds” means bonds issued in accordance with this scheme and subscribed by a non-resident in foreign currency and convertible into ordinary shares of the issuing company in any manner, either in whole, or in part, on the basis of any equity related warrants attached to debt instruments;
 - (c) “Global Depository Receipts” means any instrument in the form of a Depository receipt or certificate (by whatever name it is called) created by the Overseas Depository Bank outside India and issued to non-resident investors against the issue of ordinary shares or Foreign Currency Convertible Bonds of issuing company;
 - (d) “Issuing Company” means an Indian Company permitted to issue Foreign Currency Convertible Bonds or ordinary shares of that company against Global Depository Receipts;
 - (e) “Overseas Depository Bank” means a bank authorized by the issuing company to issue global Depository receipts against issue of Foreign Currency Convertible Bonds or ordinary shares of the issuing company;
 - (f) The words and expressions not defined in the Scheme, but defined in the Income Tax Act, 1961 (43 of 1961), or the Companies Act, 1956 (1 of 1956), or the Securities and Exchange Board of India Act, 1992 (15 of 1992), or the Rules and Regulations framed under these Acts, shall have the meaning respectively assigned to them, as the case may be, in the Income Tax Act or the Companies Act, or the Securities and Exchange Board of India Act.

Eligibility for Issue of Convertible Bonds or Ordinary Shares of Issuing Company

3. (1) An issuing company desirous of raising funds by issuing Foreign Currency Convertible Bonds or ordinary shares for equity issues through Global Depository Receipts is required to obtain prior

permission of the Department of Economic Affairs, Ministry of Finance, Government of India.

- A. An Indian company, which is not eligible to raise funds from the Indian capital market including a company which has been restrained from accessing the securities market by the Securities and Exchange Board of India (SEBI) will not be eligible to issue (i) Foreign Currency Convertible Bonds and (ii) Ordinary Shares through Global Depositary Receipts under the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993.
 - B. Unlisted Indian Companies issuing Global Depositary Receipts/Foreign Currency Convertible Bonds shall be required to simultaneously list in the Indian Stock Exchange(s).
 - C. Erstwhile Overseas Corporate Bodies (OCBs) who are not eligible to invest in India through the portfolio route and entities prohibited to buy, sell or deal in securities by SEBI will not be eligible to subscribe to (i) Foreign Currency Convertible Bonds and (ii) Ordinary Shares through Global Depositary Receipts under the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993.
- (2) An issuing company seeking permission under sub-paragraph (1) shall have a consistent track record of good performance (financial or otherwise) for a minimum period of three years, on the basis of which an approval for finalizing the issue structure would be issued to the company by the Department of Economic Affairs, Ministry of Finance.
 - (3) On completion of finalization of issue structure in consultation with the Lead Manager to the issue, the issuing company shall obtain the final approval for proceeding ahead with the issue from the Department of Economic Affairs.

Explanation

For the purposes of sub-paragraph (2) and (3) “issue structure” means any of the requirements which are provided in the paragraphs 5 and 6 of this Scheme.

- (4) The Foreign Currency Convertible Bonds shall be denominated in any freely convertible foreign currency and the ordinary shares of an issuing company shall be denominated in Indian rupees.
- (5) When an issuing company issues ordinary shares or bonds under this Scheme, that company shall deliver the ordinary shares or bonds to a Domestic Custodian Bank who will, in terms of agreement, instruct the Overseas Depository Bank to issue Global Depositary Receipt or Certificate to non-resident investors against the shares or bonds held by the Domestic Custodian Bank.
- (6) A Global Depositary Receipt may be issued in the negotiable form and may be listed on any international stock exchanges for trading outside India.
- (7) The provisions of any law relating to issue of capital by an Indian company shall apply in relation to the issue of Foreign Currency Convertible Bonds or the ordinary shares of an issuing company and the issuing company shall obtain the necessary permission or exemption from the appropriate authority under the relevant law relating to issue of capital.

Limits of Foreign Investment in the Issuing Company

4. The ordinary shares and Foreign Currency Convertible Bonds issued against the Global Depository Receipts shall be treated as direct foreign investment in the issuing company. The aggregate of the foreign investment made either directly or indirectly (through Global Depository Receipts Mechanism) shall not exceed 51% of the issued and subscribed capital of the issuing company. Provided that the investments made through Offshore Funds or by Foreign Institutional Investors will not form part of the limit laid down in this paragraph.

Issue Structure of the Global Depository Receipts

5. (1) A Global Depository Receipt may be issued for one or more underlying shares or bonds held with the Domestic Custodian Bank.
- (2) The Foreign Currency Convertible Bonds and Global Depository Receipts may be denominated in any freely convertible foreign currency.
- (3) The ordinary shares underlying the Global Depository Receipts and the shares issued upon conversion of the Foreign Currency Convertible Bonds will be denominated only in Indian currency.
- (4) The following issues will be decided by the issuing company with the Lead Manager to the issue, namely:
- (a) Public or private placement;
 - (b) Number of Global Depository Receipts to be issued;
 - (c) The issue price;
 - c(a) Listed Companies – The pricing should not be less than the higher of the following two averages:
 - c(a) (i) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date;
 - c(a) (ii) The average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.

The “relevant date” means the date thirty days prior to the date on which the meeting of the general body of shareholders is held, in terms of section 81(IA) of the Companies Act, 1956, to consider the proposed issue.
 - c(b) Unlisted Companies – The pricing should be in accordance with Reserve Bank of India Regulations notified under Foreign Exchange Management Act, 1999.
 - (d) The rate of interest payable on Foreign Currency Convertible Bonds; and
 - (e) The conversion price, coupon, and the pricing of the conversion options of the Foreign Currency Convertible Bonds.
 - (e)(i) Listed Companies – The conversion price of the Foreign Currency Convertible Bonds should be in accordance with para 5(4)(ca) ibid.
 - (e)(ii) Unlisted Companies – The conversion price of the Foreign Currency Convertible Bonds should be in accordance with Reserve Bank of India Regulations notified under Foreign Exchange Management Act, 1999.

- (5) There would be no lock-in-period for the Global Depository Receipts issued under this scheme.

Listing of the Global Depository Receipts

6. The Global Depository Receipts issued under this scheme may be listed on any of the Overseas Stock Exchanges, or Over-the-Counter-Exchanges or through Book Entry Transfer Systems prevalent abroad and such receipts may be purchased, possessed and freely transferable by a person who is a non-resident within the meaning of Section 2(q) of the Foreign Exchange Regulation Act, 1973 (46 of 1973), subject to the provisions of the Act.

Transfer and Redemption

7. (1) A non-resident holder of Global Depository Receipts may transfer those receipts, or may ask the Overseas Depository Bank to redeem those receipts. In the case of redemption, Overseas Depository Bank shall request the Domestic Custodian Bank to get the corresponding underlying shares released in favor of the non-resident investor, for being sold directly on behalf of the non-resident, or being transferred in the books of account of the issuing company in the name of the non-resident.
- (2) In case of redemption of the Global Depository Receipts into underlying shares, a request for the same will be transmitted by the Overseas Depository Bank to the Domestic Custodian Bank of India, with a copy of the same being sent to the issuing company for information and record.
- (3) On redemption, the cost of acquisition of the shares underlying the Global Depository Receipts shall be reckoned as the cost on the date on which the Overseas Depository Bank advises the Domestic Custodian Bank for redemption. The price of the ordinary shares of the issuing company prevailing in the Bombay Stock Exchange or the National Stock Exchange on the date of the advice of redemption shall be taken as the cost of acquisition of the underlying ordinary shares.
- (4) For the purposes of conversions of Foreign Currency Convertible Bonds, the cost of acquisition in the hands of the non-resident investors would be the conversion price determined on the basis of the price of the shares at the Bombay Stock Exchange, or the National Stock Exchange, on the date of conversion of Foreign Currency Convertible Bonds into shares.

Guidelines for Euro-Issues

A scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipts Mechanism) was notified by Government of India in November, 1993. Revisions/Modifications in the operative guidelines for Euro-issues are announced from time to time.

On the basis of the periodic review and assessment of the current situation, the following Euro-issue guidelines, the continuation of the Notification of November, 1993, shall come into effect for approvals granted on, or after the date of issue of these guidelines, in supersessions of all previous guidelines on the subject.

Track Record

An issuing company seeking permission for raising foreign funds by Euro-issues having a consistent track record of good performance (Financial or otherwise) for a period of three years shall be allowed to issue GDRs/FCCBs.

In view of the importance of the infrastructure projects, and the need to encourage equity financing of such projects, the three years track record requirement would be relaxed in case of companies seeking GDR/FCCB issues to finance investments in infrastructure industries such as power generation, telecommunication, petroleum exploration and refining, ports, airports and roads.

Approvals

Euro-issues shall be treated as direct foreign investment (subject to extant policies governing direct foreign investments) in the issuing company. Accordingly, a company which is implementing projects not predominantly contained in Annexure III of the New Industrial Policy of 1991, or a company which undertakes a project contained in Annexure III but whose direct foreign investment after the proposed Euro-issue is likely to exceed 51% of the post issue subscribed capital, will need to obtain prior FIPB clearance before final approval to the Euro-issue is given by the Finance Ministry.

Number of Issues

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

End-use: GDRs

In relaxation of earlier guidelines GDR end-uses will include;

- Financing capital goods, imports;
- Capital expenditure including domestic purchased/installation of plant, equipment and building and investments in software development;
- Prepayment or scheduled repayment of earlier external borrowings;
- Investments abroad where these have been approved by competent authorities;
- Equity investment in JVs/WOSs in India.

However, investments in stock markets and real estate will not be permitted.

Within this framework, GDR raising companies will be allowed full flexibility in deploying the proceeds.

Up to a maximum of 25% of the total proceeds may be used for general corporate restructuring, including working capital requirements of the company raising the GDR.

However, Banks, FIs, and Non-Banking Finance Companies (NBFCs) registered with RBI will be eligible for GDR issues without reference to the end-use criteria mentioned in para 7 to 10 above with the restriction that investments in stock markets and real estate will not be permitted.

A company shall be required to specify the proposed end-use of the issue proceeds at the time of making their applications, and will be required to submit quarterly statement of utilization of funds for the approved end-uses.

End-Use-FCCBS

Currently, companies are permitted to access foreign capital market through Foreign Currency Convertible Bonds for restructuring of external debt which helps to lengthen maturity and soften terms, and for end-use of funds which conform to the norms, and prescribed by the Government for External Commercial

Borrowings (ECB) from time to time. In addition to these, not more than 25% of FCCB issue proceeds may be used for general corporate restructuring including working capital requirements.

FCCB Pricing

FCCBs are available and accessible more freely as compared to external debt, and the expectation of the Government is that FCCBs should have a substantially finer spread than ECBs. Accordingly, the all-in costs for FCCBs should be significantly better than the corresponding debt instruments (ECBs).

Companies will not be permitted to issue warrants along with their Euro-Issue.

Repatriation of Proceeds

Companies may retain the proceeds abroad or may remit funds into India in anticipation of the use of funds for approved end-uses.

Validity

Both the in-principle and final approvals will be valid for three months from the date of their respective issue.

Review

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

Appendix II

RBI/2005-06/87

A.P. (DIR Series) Circular No. 5

August 1, 2005

To

All banks authorised to deal in foreign exchange

Madam/Sirs,

External Commercial Borrowings (ECB)

Attention of Authorised Dealers is invited to the A.P. (DIR Series) Circular No.40 dated April 25, 2005 and A.P. (DIR Series) Circular No.60 dated January 31, 2004 in connection with External Commercial Borrowings (ECB). A review of the ECB guidelines has been undertaken keeping in view the current macroeconomic situation, the experience gained so far by the Reserve Bank in administering the ECB policy and requests received from certain sectors.

2. **Accordingly, it has been decided to liberalise/modify the ECB** policy as indicated below:
 - (i) ECB with minimum average maturity of 5 years by non-banking financial companies (NBFCs) from multilateral financial institutions, reputable regional financial institutions, official export credit agencies and international banks to finance import of infrastructure equipment for leasing to infrastructure projects would be considered by the Reserve Bank under the Approval Route;
 - (ii) Foreign Currency Convertible Bonds (FCCB) by housing finance companies satisfying specific criteria would be considered by the Reserve Bank under the Approval Route;
 - (iii) Minimum holding of equity by the foreign equity holder in the borrower's company (which would qualify the foreign equity holder as a recognised lender for ECB) has been clarified;
 - (iv) Prepayment of ECB up to USD 200 million (as against the existing limit up to USD 100 million) may be allowed by Authorised Dealers without prior approval of RBI subject to compliance of applicable minimum average maturity period for the loan. Pre-payment of ECB for amounts exceeding USD 200 million would be considered by the Reserve Bank under the Approval Route.
 - (v) Currently, domestic rupee denominated structured obligations are permitted by the Government of India to be credit enhanced by international banks/international financial institutions/joint venture partners. Such applications would henceforth be considered by the Reserve Bank under the Approval Route.
3. The amended ECB policy will come into force with immediate effect and is subject to review.
4. Comprehensive and revised ECB guidelines are set out in the Annex to this circular.
5. Necessary amendments to the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 dated May 3, 2000 are being issued separately.
6. Authorised Dealer banks may bring the contents of this circular to the notice of their constituents and customers.
7. The direction contained in this circular has been issued under sections 10(4) and 11(1) of the Foreign Exchange Management Act, 1999 (42 of 1999) and is without prejudice to permissions/approvals, if any, required under any other law.

Yours faithfully,

(Vinay Baijal)

Chief General Manager

Annex to A.P. (DIR Series) Circular No. 5 dated August 1, 2005

External Commercial Borrowings (ECB)

1. ECB refer to commercial loans [in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments (e.g. floating rate notes and fixed rate bonds)] availed from non-resident lenders with minimum average maturity of 3 years. ECB can be accessed under two routes, viz., (i) Automatic Route outlined in paragraph 1(A) and (ii) Approval Route indicated in paragraph 1(B).

A. AUTOMATIC ROUTE

Under the extant policy, ECB for investment in real sector -industrial sector, especially infrastructure sector-in India, are under Automatic Route, i.e., do not require RBI/Government approval. In case of doubt as regards eligibility to access Automatic Route, applicants may take recourse to the Approval Route.

i. Eligible borrowers

- a. Corporate registered under the Companies Act except financial intermediaries (such as banks, financial institutions (FIs), housing finance companies and NBFCs) are eligible. Individuals, Trusts and non-profit making organisations are not eligible to raise ECB.
- b. Non-Government Organisations (NGOs) engaged in micro finance activities are eligible to avail ECB. Such NGOs (i) should have a satisfactory borrowing relationship for at least 3 years with a scheduled commercial bank authorised to deal in foreign exchange and (ii) would require a certificate of due diligence on 'fit and proper' status of the board/committee of management of the borrowing entity from the designated Authorised Dealer (AD).

ii. Recognised Lenders

- a. Borrowers can raise ECB from internationally recognised sources such as (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions (such as IFC, ADB, CDC etc.), (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators, and (vii) foreign equity holders. Furthermore, overseas organisations and individuals complying with following safeguards may provide ECB to NGOs engaged in micro finance activities.
- b. Overseas organisations planning to extend ECB would have to furnish a certificate of due diligence from an overseas bank which in turn is subject to regulation of host-country regulator and adheres to Financial Action Task Force (FATF) guidelines to the designated AD. The certificate of due diligence should comprise the following (i) that the lender maintains an account with the bank for at least a period of two years, (ii) that the lending entity is organized as per the local law and held in good esteem by the business/local community, and (iii) that there is no criminal action pending against it.
- c. Individual Lender has to obtain a certificate of due diligence from an overseas bank indicating that the lender maintains an account with the bank for at least a period of two years. Other evidence documents such as audited statement of account and income tax return which the overseas lender may furnish need to be certified and forwarded by the overseas bank. Individual lenders from countries wherein banks are not required to adhere to Know Your Customer (KYC) guidelines are not permitted to extend ECB.

- d. The key operative part in the credential of the overseas lender is that ECB should be availed from an internationally recognised source and one of the recognized categories is “foreign equity holder” as indicated above. It is clarified that for a “foreign equity holder” to be eligible as “recognized lender” under the automatic route would require minimum holding of equity in the borrower’s company as under: (d. i) ECB up to USD 5 million – minimum equity of 25 per cent held directly by the lender, (d. ii) ECB more than USD 5 million – minimum equity of 25 per cent held directly by the lender and debt-equity ratio not exceeding 4:1 (i.e. the proposed ECB not exceeding four times the direct foreign equity holding).

iii. Amount and Maturity

- a. ECB up to USD 20 million or equivalent with minimum average maturity of three years.
- b. ECB above USD 20 million and up to USD 500 million or equivalent with minimum average maturity of five years.
- c. The maximum amount of ECB which can be raised by a corporate is USD 500 million during a financial year.
- d. NGOs engaged in micro finance activities can raise ECB up to USD 5 million during a financial year.
- e. ECB up to USD 20 million can have call/put option provided the minimum average maturity of 3 years is complied before exercising call/put option.

iv. All-in-cost ceilings

All-in-cost includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee, and fees payable in Indian Rupees. Moreover, the payment of withholding tax in Indian Rupees is excluded for calculating the all-in-cost.

The all-in-cost ceilings for ECB are indicated from time to time. The following ceilings are valid till reviewed.

Average Maturity Period	All-in-cost Ceilings over 6 month LIBOR*
Three years and up to five years	200 basis points
More than five years	350 basis points

* for the respective currency of borrowing or applicable benchmark.

v. End-use

- a. ECB can be raised only for investment (such as import of capital goods, new projects, modernization/expansion of existing production units) in real sector – industrial sector including small and medium enterprises (SME) and infrastructure sector – in India. Infrastructure sector is defined as (i) power, (ii) telecommunication, (iii) railways, (iv) road including bridges, (v) ports, (vi) industrial parks and (vii) urban infrastructure (water supply, sanitation and sewage projects);
- b. ECB proceeds can be utilized for overseas direct investment in Joint Ventures (JV)/Wholly Owned Subsidiaries (WOS) subject to the existing guidelines on Indian Direct Investment in JV/WOS abroad.

- c. Utilisation of ECB proceeds is permitted in the first stage acquisition of shares in the disinvestment process and also in the mandatory second stage offer to the public under the Government's disinvestments programme of PSU shares.
 - d. NGOs engaged in micro finance activities may utilise ECB proceeds for lending to self-help groups or for micro-credit or for bonafide micro finance activity including capacity building.
 - e. Utilisation of ECB proceeds is not permitted for on-lending or investment in capital market or acquiring a company (or a part thereof) in India by a corporate.
 - f. Utilisation of ECB proceeds is not permitted in real estate. The term 'real estate' excludes development of integrated township as defined by Ministry of Commerce and Industry, Department of Industrial Policy and Promotion, SIA (FC Division), Press Note 3 (2002 Series, dated 04.01.2002).
 - g. End-uses of ECB for working capital, general corporate purpose and repayment of existing Rupee loans are not permitted.
- vi. **Guarantees**
- Issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by banks, financial institutions and NBFCs relating to ECB is not permitted.
- vii. **Security**
- The choice of security to be provided to the lender/supplier is left to the borrower. However, creation of charge over immovable assets and financial securities, such as shares, in favour of overseas lender is subject to Regulation 8 of Notification No. FEMA 21/RB-2000 dated May 3, 2000 and Regulation 3 of Notification No. FEMA 20/RB-2000, dated May 3, 2000, as amended from time to time, respectively.
- viii. **Parking of ECB proceeds overseas:** ECB proceeds should be parked overseas until actual requirement in India. It is clarified that ECB proceeds parked overseas can be invested in the following liquid assets (a) deposits or Certificate of Deposit or other products offered by banks rated not less than AA(-) by Standard and Poor/Fitch IBCA or Aa3 by Moody's; (b) deposits with overseas branch of an authorised dealer in India; and (c) Treasury bills and other monetary instruments of one year maturity having minimum rating as indicated above. The funds should be invested in such a way that the investments can be liquidated as and when funds are required by the borrower in India.
- ix. **Prepayment:** Prepayment of ECB up to USD 200 million may be allowed by ADs without prior approval of RBI subject to compliance with the stipulated minimum average maturity period as applicable to the loan.
- x. **Refinance of existing ECB:** Refinancing of existing ECB by raising fresh ECB at lower cost is permitted subject to the condition that the outstanding maturity of the original loan is maintained.
- xi. **Debt Servicing:** The designated Authorised Dealer (AD) has the general permission to make remittances of installments of principal, interest and other charges in conformity with ECB guidelines issued by Government/RBI from time to time.
- xii. **Procedure:** Borrower may enter into loan agreement complying with ECB guidelines with recognised lender for raising ECB under Automatic Route without prior approval of RBI. The borrower may note to comply with the reporting arrangement under paragraph 1(C)(i). The

primary responsibility to ensure that ECB raised/utilised are in conformity with the ECB guidelines and the Reserve Bank regulations/directions/circulars is that of the concerned borrower and any contravention of the ECB guidelines will be viewed seriously and may invite penal action. The designated AD is also required to ensure that raising/utilisation of ECB is in compliance with ECB guidelines at the time of certification.

B. APPROVAL ROUTE

The following types of proposals for ECB are covered under the Approval Route.

i. Eligible borrowers

- a. Financial institutions dealing exclusively with infrastructure or export finance such as IDFC, IL&FS, Power Finance Corporation, Power Trading Corporation, IRCON and EXIM Bank are considered on a case by case basis.
- b. Banks and financial institutions which had participated in the textile or steel sector restructuring package as approved by the Government are also permitted to the extent of their investment in the package and assessment by RBI based on prudential norms. Any ECB availed for this purpose so far are deducted from their entitlement.
- c. Cases falling outside the purview of the automatic route limits and maturity period indicated at paragraphs 1A(iii)(a) and 1A(iii)(b).
- d. ECB with minimum average maturity of 5 years by Non-banking Financial Companies (NBFCs) from multilateral financial institutions, reputable regional financial institutions, official export credit agencies and international banks to finance import of infrastructure equipment for leasing to infrastructure projects.
- e. Foreign Currency Convertible Bonds (FCCB) by housing finance companies satisfying the following minimum criteria: (i) the minimum net worth of the financial intermediary during the previous three years shall not be less than Rs.500 crore, (ii) a listing on the BSE or NSE, (iii) minimum size of FCCB is USD 100 million, (iv) the applicant should submit the purpose/plan of utilization of funds.

ii. Recognised Lenders

- a. Borrowers can raise ECB from internationally recognised sources such as (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions (such as IFC, ADB, CDC etc.), (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders.
- b. From 'foreign equity holder', where the minimum equity held directly by the foreign equity lender is 25 per cent but debt-equity ratio exceeds 4:1 (i.e., the proposed ECB exceeds four times the direct foreign equity holding).

iii. All-in-cost ceilings

All-in-cost includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee, and fees payable in Indian Rupees. Moreover, the payment of withholding tax in Indian Rupees is excluded for calculating the all-in-cost. The all-in-cost ceilings for ECB are indicated from time to time. The following ceilings are valid till reviewed.

Average Maturity Period	All-in-cost Ceilings over 6 month LIBOR*
Three years and up to five years	200 basis points
More than five years	350 basis points

* for the respective currency of borrowing or applicable benchmark.

iv. **End-use**

- a. ECB can be raised only for investment (such as import of capital goods, new projects, modernization/expansion of existing production units) in real sector-industrial sector including small and medium enterprises (SME) and infrastructure sector-in India. Infrastructure sector is defined as (i) power, (ii) telecommunication, (iii) railways, (iv) road including bridges, (v) ports, (vi) industrial parks, and (vii) urban infrastructure (water supply, sanitation and sewage projects);
- b. ECB proceeds can be utilised for overseas direct investment in Joint Ventures (JV)/Wholly Owned Subsidiaries (WOS) subject to the existing guidelines on Indian Direct Investment in JV/WOS abroad.
- c. Utilisation of ECB proceeds is permitted in the first stage acquisition of shares in the disinvestment process and also in the mandatory second stage offer to the public under the Government's disinvestments programme of PSU shares.
- d. Utilisation of ECB proceeds is not permitted for on lending or investment in capital market or acquiring a company (or a part thereof) in India by a corporate except for banks and financial institutions eligible under paragraph 1B(i)(a) and 1B(i)(b).
- e. Utilisation of ECB proceeds in real estate is not permitted. The term 'real estate' excludes development of integrated township as defined by Ministry of Commerce and Industry, Department of Industrial Policy and Promotion, SIA (FC Division), Press Note 3 (2002 Series, dated 04.01.2002).
- f. End-uses of ECB for working capital, general corporate purpose and repayment of existing Rupee loans are not permitted.

- v. **Guarantees:** Issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by banks, financial institutions and NBFCs relating to ECB is not normally permitted. Applications for providing guarantee/standby letter of credit or letter of comfort by banks, financial institutions relating to ECB in the case of SME will be considered on merit subject to prudential norms.

- vi. **Security:** The choice of security to be provided to the lender/supplier is left to the borrower. However, creation of charge over immovable assets and financial securities, such as shares, in favour of overseas lender is subject to Regulation 8 of Notification No. FEMA 21/RB-2000 dated May 3, 2000 and Regulation 3 of Notification No. FEMA 20/RB-2000, dated May 3, 2000, as amended from time to time, respectively.

- vii. **Parking of ECB proceeds overseas:** ECB proceeds should be parked overseas until actual requirement in India. It is clarified that ECB proceeds parked overseas can be invested in the following liquid assets (a) Deposits or Certificate of Deposit or other products offered by banks rated not less than AA(-) by Standard and Poor/Fitch IBCA or Aa3 by Moody's; (b) Deposits with overseas branch of an authorised dealer in India; and (c) Treasury bills and other monetary instruments of one year maturity having minimum rating as indicated above. The funds should be invested in such a way that the investments can be liquidated as and when funds are required by the borrower in India.

viii. Prepayment:

- a. Prepayment of ECB up to USD 200 million may be allowed by ADs without prior approval of RBI subject to compliance with the stipulated minimum average maturity period as applicable to the loan.
- b. Pre-payment of ECB for amounts exceeding USD 200 million would be considered by the Reserve Bank under the Approval Route.

ix. Refinance of existing ECB: Refinancing of outstanding ECB by raising fresh ECB at lower cost is permitted subject to the condition that the outstanding maturity of the original loan is maintained.**x. Debt Servicing:** The designated AD has the general permission to make remittances of installments of principal, interest and other charges in conformity with ECB guidelines issued by Government / RBI from time to time.**xi. Procedure:** Applicants are required to submit an application in form ECB through designated AD to the Chief General Manager, Foreign Exchange Department, Reserve Bank of India, Central Office, External Commercial Borrowings Division, Mumbai – 400 001 along with necessary documents.**xii. Empowered Committee**

RBI has set-up an Empowered Committee to consider proposals coming under the approval route.

C. REPORTING ARRANGEMENTS AND DISSEMINATION OF INFORMATION**i. Reporting Arrangements**

- a. With a view to simplify the procedure, submission of copy of loan agreement is dispensed with.
- b. Borrowers are required to submit Form 83, in duplicate, certified by the Company Secretary (CS) or Chartered Accountant (CA) to the designated AD. One copy is to be forwarded by the designated AD to the Director, Balance of Payments Statistics Division, Department of Statistical Analysis and Computer Services (DESACS), Reserve Bank of India, Bandra-Kurla Complex, Mumbai – 400 051 for allotment of loan registration number.
- c. The borrower can draw-down the loan only after obtaining the loan registration number from DESACS, RBI.
- d. Borrowers are required to submit ECB-2 Return certified by the designated AD on monthly basis so as to reach DESACS, RBI within seven working days from the close of month to which it relates.

ii Dissemination of Information: For providing greater transparency, information with regard to the name of the borrower, amount, purpose and maturity of ECB under both Automatic Route and Approval Route are put on the RBI website on a monthly basis with a lag of one month to which it relates.**2. Foreign Currency Convertible Bonds (FCCB)**

The policy for ECB is also applicable to FCCB in all respects.

3. Structured Obligations

In order to enable corporates to raise resources domestically and hedge exchange rate risks, domestic rupee denominated structured obligations are permitted by the Government to be credit enhanced by international banks/ international financial institutions/joint venture partners. Such applications would henceforth be considered by the Reserve Bank under the Approval Route.

Appendix 3
Comparative Cost of Domestic
Equity Issue and GDR issue

	Domestic		GDR Issue		
	Rs. m	%	Rs. m	\$m	%
A. Assumptions					
Size of issue	1500	100	1500	50.00	100
Subscription (times)	2	–	NA	NA	–
No. of applications (m)	3	–	NA	NA	–
B. Nature of Expenses					
1. Commissions					
a. Brokerage	22.5	1.5	9.00	0.30	0.60
b. Underwriting	37.5	2.5	9.00	0.30	0.60
c. Management	3.80	0.3	27.0	0.90	1.80
Total (1)	63.8	4.3	45.0	1.50	3.00
2. Legal Fees					
a. Indian Counsel	0.00	–	1.00	0.03	0.10
b. International Counsel	0.00	–	6.00	0.20	0.40
Total (2)	0.00	–	–	7.00	0.23
3. Expenses					
a. Travel	0.000	0.0	3.50	0.12	0.20
b. Printing	4.000	0.3	2.10	0.07	0.10
c. Listing	0.000	0.0	0.50	0.02	0.00
d. Advertising	30.00	2.0	0.00	0.00	0.00
e. Registrar's expenses	15.00	1.0	0.00	0.00	0.00
f. Postal charges	9.000	0.6	0.00	0.00	0.00
g. Banker's charges	9.000	0.6	0.00	0.00	0.00
h. Stamp duty	1.500	0.1	1.50	0.05	0.10
i. Accounting fees	0.000	0.00	1.100	0.04	0.10
j. Contingencies	6.000	0.40	0.400	0.00	0.00
Total (3)	80.50	5.40	8.600	0.29	0.60
Total Expenses (1 + 2 + 3)	144.3	9.60	60.60	2.02	4.00

The regulatory treatment for a GDR vis-a-vis a Domestic Issue is briefly compared below.

Comparison of a Domestic Issue and a Foreign Issue

Items	For a Domestic Issue	For a Foreign Issue
1. Draft prospectus	SEBI and Stock Exchange approval needed	No approval needed
2. Prospectus and Application	Has to be supplied in large numbers to the general public	Allowed to be supplied to select institutional investors
3. Elaborate arrangements for the Bank for collection	Needed	Not as vital as in domestic issue
4. Issue Price	Should be predetermined and specified in the prospectus	The price of securities is not predetermined but is fixed a day before the issue date based on the market price of the shares for the previous week and the day before the date of the issue.
5. Allotment Document	Share certificates should be issued	Only deposit receipts are issued to the applicants by the depository agents
6. Cost involved	High costs	Relatively low costs

Appendix 4

1.	Issuer	SCICI Ltd.	EIP Parry (India) Ltd.
2.	Instrument	Convertible Bond due 2004	GDR(1 GDR = Equity Share)
3.	Issue Date	20th October, 1993	7th July, 1994
4.	Interest Rate	3.5%	N.A
5.	Conversion Period	2nd January, 1994 to 1st March, 2004	N.A
6.	Conversion Price	Rs.130 per share @ Rs.31.37 = 1 US \$	N.A
7.	Redemption	1st April, 2004	
8.	Put Option Period (for the Bondholder)	Any time Prior to 1st April, 1999	N.A
9.	Call Option Period (for the Company)	1st April, 1990 to 1st April, 2004	N.A
10.	Trustee	Bankers Trust Company Ltd. (London)	N.A
11.	Principal paying and Agent	Bankers Trust Company (London)	N.A
12.	Legal Adviser to the – Indian Law	Amarchand & Mangaldar Hiralal Shroff and Co. (Mumbai)	Little & Co. (Mumbai)
	– English Law	N.A	Wilde Sapte (London)
13.	Lead Manager	Barclays Dezoete Wedd Ltd. James Capel and Co. Lazard Brothers & Co.	Paribas Capital Markets Cazenove & Co. Barclays De Zoete Wedd Ltd.
14.	Co-managers	ABN Amro Bank and others	Jardine Fleming and others
15.	Legal Advisers to Lead Manager/ Co-managers		
	– Indian Law	Bhaishanker Kanga & Girdharlal (Mumbai)	Bhaishanker Kanga Girdharlal (Mumbai)
	– English Law	Linklaters & Paines (London)	Linklaters & Pains (London)
	– US Law	Clearly, Golttlieh Steen & Hamilton (London)	Sullivan & Cromcal (Paris)
16.	Depository	N.A	The Bank of New York (New York)
17.	Custodian	N.A	The Industrial Credit and Investment Corporation of India Ltd. (Mumbai)
18.	Auditors	SB Billimoria & Co. (Mumbai)	Lovelock & Lewes (Chennai)
19.	Listing Agent	Banque International (Luxembourg)	Banque Paribas Luxembourg (Luxembourg)
20.	Listing	Luxembourg Stock Exchange	London Stock Exchange

Chapter XIII

International Equity Investments

After reading this chapter you will be conversant with:

- Advantages of International Equity Investments
- Risks of International Investments
- International CAPM
- Segmentation of Markets
- International Listing

In the introductory chapter it was mentioned that an integrated financial system results in a more efficient allocation of capital across the globe, and provides diversification benefits to the investors. One of the ways through which capital moves across countries is through investment in the equity capital of foreign companies. This chapter discusses this aspect of integration and covers such investments where the holdings are not big enough to let the investor enjoy control over the management of the company.

ADVANTAGES OF INTERNATIONAL EQUITY INVESTMENTS

Investment in foreign securities offers the same diversification benefits, as investment in a diversified domestic portfolio does. According to the CAPM, diversifying investments over a number of securities can help an investor in reducing his risk level for a given level of return or increasing his return for a given level of risk, provided that the returns on the securities are having a negative correlation or low positive correlation. Extending the same logic to international investments, diversifying across national boundaries would result in the investor reducing his risk or increasing the returns. This happens because different countries would be generally at different points of the economic cycle at a given time. Secondly, a number of factors that affect share prices (like tax structures, fiscal and monetary policies, political scenario etc.) differ from country to country. Furthermore, industrial structures differ across countries and hence an international event affecting the whole world affects them differently. These factors provide scope for the correlation between the returns from these economies to be less than perfect, hence providing diversification benefits. Recalling CAPM, even if the returns offered by the foreign securities are less than that offered by the domestic securities, diversification may still benefit by reducing the risk more than the reduction in returns.

The returns on a foreign security would be denominated in the foreign currency. The rate at which the realizations from the security would be converted into the domestic currency is most likely to be different from the rate at which currency conversion took place at the time of investment, due to the volatile nature of the forex markets. Due to this, the returns from a foreign security in terms of the domestic currency has two components – the return from the security in foreign currency terms, and the returns due to changes in the exchange rate over the period of investment. Hence, the expected returns on a foreign security can be represented by the following equation:

Expected domestic returns on foreign currency

$$= r_f + \bar{S} \quad \dots \text{Eq. (1)}$$

Where, r_f is the expected return in foreign currency terms and \bar{S} is the expected change in the exchange rate.

RISKS OF INTERNATIONAL INVESTMENTS

Investments in foreign securities carry some additional risks when compared to domestic investments. These risks stem from the uncertainties related to the conversion of the realization proceeds into the domestic currency which can be broadly classified as country risk (also known as political risk) and currency (or exchange) risk.

Country risk is the uncertainty as to whether the investor would be able to convert the realization proceeds into the domestic currency. This risk arises due to the possibility of the foreign government preventing the conversion of its currency for various reasons. The government may even expropriate the security, which would result in a complete loss to the investor.

Currency risk is the uncertainty as to the rate at which the realization proceeds would be converted into the domestic currency. As this rate would not be known in advance, there would be the risk of a loss due to an unfavorable movement of the exchange rate. This risk can be hedged to a certain extent by covering it in the forwards, futures or option markets. Yet, the costs of the hedging have to be

considered while taking such a step. Another way to reduce these risks is to invest across many countries, so that a loss suffered due to the weakening currency of one country would get at least partially offset by the gains on the stronger currencies. Sometimes there may not be a currency risk at all as investors may be buyers of other goods (other than securities) in those very markets in which they invest, thus eliminating the need to convert the currencies.

While it is not possible to measure the political risk, currency risk can be measured and factored into the risk of foreign investment. From Eq. 1 it follows that

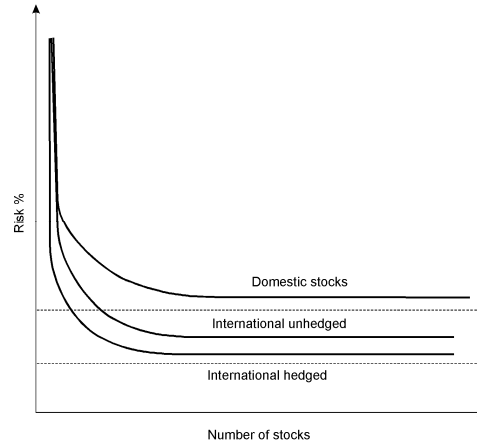
Variance of domestic currency returns on foreign investment

$$= \text{Var}(r_f) + \text{Var}(\bar{S}) + 2 \text{Cov}(r_f, \bar{S}) \quad \dots(\text{Eq. 2})$$

Equation 2 shows that the risk on foreign investment consists of three elements – the variability of the returns on the foreign security, the variability of the exchange rate, and the covariance between the exchange rate and the returns on the foreign security. Thus, exchange rates increase the riskiness of a foreign investment by being volatile, and more so if they are positively correlated with the foreign security returns.

The diversification benefits of international investments are depicted in figure 1.

Figure 1: The benefits of international diversification with hedged and unhedged exchange risk



INTERNATIONAL CAPM

The CAPM states that the investors in a security are compensated only for the systematic risk of the security, and the unsystematic risk can be diversified. The systematic risk of the security is measured by the sensitivity of the security returns to a change in the market returns, given by the beta of the security. International CAPM extends the same logic to the world security markets as a whole. According to this theory, the market portfolio consists of all the securities available in any of the countries, and the beta of a security measures the sensitivity of the security returns to a change in the returns on this extended market portfolio. Hence, restricting one's investments to the domestic market would imply being below the efficiency frontier. According to international CAPM, the return on a security is given by

$$r_i = r_f + (\beta_w - \beta_f)(r_w - r_f)$$

Where, r_f = World risk-free rate of return

β_w = World beta of the security

$$= \frac{\text{Cov}(r_i, r_w)}{\text{Var}(r_w)}$$

r_w = Return on the world-market portfolio.

Figure 2: The International CAPM

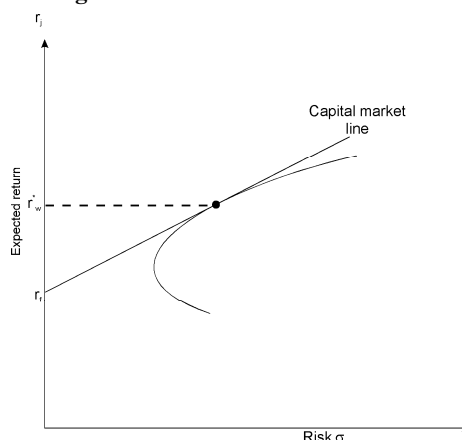


Figure 2 portrays the international CAPM.

However, it is very difficult to apply this model in real life due to the difficulties in estimating the various variables involved. Yet, the implications of this model are very important for evaluating the usefulness of international investments. If this model would hold good, holding a purely domestic portfolio would involve foregoing some return or taking on additional risk than that which is warranted by the returns, considering that a purely domestic portfolio would be below the efficiency frontier.

The above discussion assumes that there are no restrictions on foreign investments and that all the currencies of the world are completely convertible. The absence of any of these factors gives rise to segmentation of markets.

SEGMENTATION OF MARKETS

Segmentation, or the non-integration of markets can result from a number of factors. These are:

- *Regulations restricting foreign investments:* The presence of regulations restricting or prohibiting foreign investments prevent the market forces from acting in a manner which results in the integration of the markets.
- *Non-convertibility of currencies:* Non-convertibility of currencies makes it impossible for investors to invest in foreign securities, and hence results in segmentation of markets.
- *Home-country bias:* Some investors do not feel comfortable investing abroad and prefer to invest only in domestic securities. This prevents integration of markets.
- *Indirect barriers:* Investment in foreign securities is restricted by the presence of indirect barriers in the form of non-availability of information regarding foreign securities, or the difficulty in interpreting such information.

Segmentation of markets results in the possibility of abnormal gains for those investors who can overcome these barriers and invest abroad.

INTERNATIONAL LISTING

Some companies get their shares listed not only on the domestic bourses, but also on stock exchanges in foreign countries. This is done either through a direct listing or through the GDR route. A GDR (Global Depositary Receipt) is a financial asset representing indirect ownership of a specified number of shares of a foreign company. The shares are held in the custody of a custodian based in the country of the issuing company. A domestic listing of a foreign security removes lot of problems and risks involved with international investments. In case of a GDR, the investor does not face currency risk (at least on capital gains) as the instrument is denominated in the currency of the country where it is issued, and is listed and

traded on a domestic stock exchange. The investors are also not subject to the regulations of the issuing country, which reduces the country risk to a large extent. Other technical matters like conversion of dividend payments into the domestic currency and collection of financial reports are taken care of by a domestic depository on behalf of the investors. Thus, the domestic listing of foreign securities provides the benefits of international diversification without exposing the investor to many of its risks.

GUIDELINES FOR FII INVESTMENT IN INDIA

Since September 1992, foreign residents are allowed to make portfolio investments in India. These investments are regulated by the SEBI (Foreign Institutional Investors) Regulations, 1995. These regulations are not applicable to investors investing in GDRs, FCCBs and FCBs issued by Indian companies and listed, traded and settled overseas.

SECURITIES AND EXCHANGE BOARD OF INDIA (FOREIGN INSTITUTIONAL INVESTORS) REGULATIONS, 1995

SEBI/LE/918(E). In exercise of the powers conferred by Section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992) the Board hereby, makes the following regulations, namely:-

CHAPTER I PRELIMINARY

Short title and commencement

1. 1. These regulations may be called the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995.
2. They shall come into force on the date of their publication in the Official Gazette.

Definitions

2. In these regulations, unless the context otherwise requires, -
 - a. "Act" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);
 - b. "Certificate" means a certificate of registration granted by the Board under these regulations;
 - c. "designated bank" means any bank in India, which has been authorised by the Reserve Bank of India to act as a banker to Foreign Institutional Investors;
 - ¹*[(cc) 'domestic asset management company' means an asset management company approved by the Board under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 and who has been granted certificate of registration under Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993]
 - d. "domestic custodian" includes any person carrying on the activity of providing custodial services in respect of securities;
 - ²[(dd) 'domestic portfolio manager' means a portfolio manager registered under the Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993.]

³*[(e)***]

1 Sub-regulation "cc" inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 published in the Official Gazette of India, dated 29.02.2000.
 2 Sub-regulation "dd" inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 published in the Official Gazette of India, dated 29.02.2000.
 3 Omitted by the SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 published in the Official Gazette of India, dated 27.09.2003

- e. “enquiry officer” means any officer of the Board, or any other person appointed by the Board under Chapter V of these regulations;
- f. “Foreign Institutional Investor” means an institution established or incorporated outside India which proposes to make investment in India in securities;
⁴“Provided that a domestic asset management company or domestic portfolio manager who manages funds raised or collected or brought from outside India for investment in India on behalf of a sub-account, shall be deemed to be a Foreign Institutional Investor.”]
- g. “form” means a form specified in the First Schedule to these regulations;
- h. “Government of India Guidelines” means the guidelines dated September 14, 1992 issued by the Government of India for Foreign Institutional Investors, as amended from time to time;
- i. “institution” includes every artificial juridical person;
- j. “schedule” means a schedule to these regulations;
- k. “sub-account” includes ⁵[foreign corporates or foreign individuals and] those institutions, established or incorporated outside India and those funds, or portfolios, established outside India, whether incorporated or not, on whose behalf investments are proposed to be made in India by a Foreign Institutional Investor.

CHAPTER II

REGISTRATION OF FOREIGN INSTITUTIONAL INVESTOR

Application for certificate

- 3. 1. No person shall buy, sell or otherwise deal in securities as a Foreign Institutional Investor unless he holds a certificate granted by the Board under these regulations.
- 2. An application for the grant of certificate shall be made to the Board in form A.
- 3. Notwithstanding anything contained in sub-regulation (2), any Foreign Institutional Investor who has made an application for the grant of a certificate to the Board prior to the commencement of these regulations shall be deemed to have made an application under sub-regulation (2) and the application shall be accordingly dealt with under these regulations.
- 4. Notwithstanding anything contained hereinabove, any person who has before the commencement of these regulations, made an application for registration and has been granted registration by the Board under the Government of India Guidelines to act as a Foreign Institutional Investor shall be deemed to have made an application under sub-regulation (2) above may continue to buy, sell or otherwise deal in securities subject to the provisions of these regulations, till the grant or refusal of a certificate under these regulations.

Furnishing of information, clarification, and personal representation

- 4. 1. The Board may require the applicant to furnish such further information or clarification as the Board considers necessary regarding matters relevant to the activities of the applicant for grant of certificate.

⁴ Proviso inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 published in the Official Gazette of India, dated 29.02.2000.

⁵ foreign corporates or foreign individuals and" inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 published in the Official Gazette of India, dated 29.02.2000.

2. The applicant or his authorised representative shall, if so required by the Board, appear before the Board for personal representation in connection with the grant of a certificate.

Application to conform to the requirements

5. Subject to the provisions of sub-regulation (3) and sub-regulation (4) of regulation 3, any application, which is not complete in all respects and does not conform to the instructions specified in the form or is false or misleading in any material particular, shall be rejected by the Board.

Provided that, before rejecting any such application, the applicant shall be given a reasonable opportunity to remove, within the time specified by the Board, such objections as may be indicated by the Board.

Consideration of application

- 6 1. For the purpose of the grant of certificate the Board shall take into account all matters which are relevant to the grant of a certificate and in particular the following, namely:
 - a. the applicant's track record, professional competence, financial soundness, experience, general reputation of fairness and integrity;
 - b. whether the applicant is regulated by an appropriate foreign regulatory authority;
 - c. whether the applicant has been granted permission under the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973) by the Reserve Bank of India for making investments in India as a Foreign Institutional Investor;
 - d. whether the applicant is:
 - i. an institution established or incorporated outside India as Pension Fund or Mutual Fund or Investment Trust; or
 - ii. an Asset Management Company or Nominee Company or Bank or Institutional Portfolio Manager, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds ⁶[and its proprietary funds, if any;] or
 - iii. a Trustee or a Power of Attorney holder, incorporated or established outside India, and proposing to make investments in India on behalf of broad based funds ^{6*}[and its proprietary funds, if any]
 - iv. ⁷university fund, endowments, foundations or charitable trusts or charitable societies.

Provided that while considering the application from the applicants under clause (iv) the Board may take into account the following namely:

- a. whether the applicant has been in existence for a period of at least 5 years.
- b. Whether it is legally permissible for the applicant to invest in securities outside the country of its incorporation or establishment;

6 "and its proprietary funds, if any" inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulations, 1997 published in the Official Gazette of India dated 12.02.1997.

6* "and its proprietary funds, if any" inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulations, 1997 published in the Official Gazette of India dated 12.02.1997.

7 Clause (vii) inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulations, 1996 published in the Official Gazette of India dated 09.10.1996.

- c. Whether the applicant has been registered with any statutory authority in the country of their incorporation or establishment;
- d. Whether any legal proceeding has been initiated by any statutory authority against the applicant.]

Explanation:

For the purposes of this regulation, “broad based fund” means a fund, established or incorporated outside India, which has at least fifty ⁸[twenty] investors, with no single individual investor holding more than five ⁹[ten] percent of the shares or units of the fund.

Provided that if the broad based fund has institutional investor(s) it shall not be necessary for the fund to have fifty ⁸[twenty] investors:

Provided further that if the broad based fund has an institutional investor who holds more than five ⁹[ten] percent of the shares or units in the fund, then the institutional investor must itself be a broad based fund; or

- e. Whether the grant of certificate to the applicant is in the interest of the development of the securities market.
- f. ¹⁰Whether the applicant is a fit and proper person.]

¹¹(2)(a) A domestic portfolio manager or domestic asset management company shall be eligible to be registered as a foreign institutional investor to manage the funds of sub-accounts.

- b. the domestic portfolio manager or domestic asset management company shall make an application in terms of regulations 3, 4 and 5.
- c. For the grant of certificate to a domestic asset management company or to a domestic portfolio manager the Board shall consider the following:
 - i. whether the applicant is an approved asset management company or a registered portfolio manager and that the approval or registration is valid
 - ii. whether any disciplinary proceeding is pending before the Board against such applicant.]

Procedure and grant of certificate

- 7. Where an application is made for grant of certificate under these regulations, the Board shall, as soon as possible but not later than three months after information called for by it is furnished, if satisfied that the application is complete in all respects, all particulars sought have been furnished and the applicant is found to be eligible for the grant of certificate, grant a certificate in form B, subject to payment of fees in accordance with the Second Schedule.

¹²[“Provided that the Board may exempt from the payment of fees, an applicant such as the World Bank and other institutions established outside

8 Substituted for “fifty” by the SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 1999 published in the Official Gazette of India dated 17.08.1999.

9 Substituted for “five” by the SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 2000 published in the Official Gazette of India dated 29.02.2000.

10 Clauses (e) and (f) inserted by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulation, 1997 published in the Official Gazette of India dated 05.12.1997.

11 Sub-regulation (2) inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulation, 2000 published in the Official Gazette of India dated 29.02.2000.

12 Proviso inserted by SEBI (Foreign Institutional Investors) (Amendment) Regulations, 1996 published in the Official Gazette of India dated 09.10.1996.

India for providing aid, and which have been granted privileges and immunities from the payment of tax and duties by the Central Government.

Provided further that the Board shall refund the fees already collected from the institutions which are exempted from the payment of fees by the proviso mentioned above.”]

¹³[Provided further that a domestic portfolio manager or domestic asset management company shall not be liable to pay fee.”]

^{13a}[7A A foreign institutional investor holding a certificate shall, at all times, abide by the Code of Conduct as specified in Third Schedule”.]

Validity of certificate

8. The certificate and each renewal thereof shall be valid for a period of five years from the date of its grant or renewal, as the case may be.

^{14*}["Provided that in case of domestic portfolio manager or domestic asset management company the certificate and each renewal thereof shall be valid for a period not exceeding the validity or registration or approval granted under Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993 or Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, as the case may be.

Provided further that the certificate of registration granted or approved under the Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993 or the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, expires before the expiry of registration under these Regulations, or the certificate of such entity is suspended, the domestic portfolio manager or domestic asset management company shall cease to carry on any activity as foreign institutional investor and shall be subject to the directions of the Board with regard to the fund, securities or records that may be in its custody or control as a foreign institutional investor.”]

Application for renewal of certificate

9. 1. Three months before the expiry of the period of certificate, the Foreign Institutional Investor, if he so desires, may make an application for renewal in Form A.

^{15*}[Provided that a Foreign Institutional Investor who does not desire to renew its registration or has failed to make an application for renewal under sub-regulation (1), shall, at the time of expiry of registration, obtain a specific permission from the Board, for disinvesting the securities held by it on its own account or on behalf of its sub-account(s), within a stipulated time period, subject to such terms and conditions as may be specified by the Board.

Provided further that where a Foreign Institutional Investor does not desire to renew registration of any of its sub-account(s) or has failed to make an application for renewal of registration of sub-account(s), the Foreign Institutional Investor shall at the time of expiry of registration, obtain, a specific permission from the Board, for disinvesting the securities held by it on behalf of sub-account(s) within a stipulated time period, subject to such terms and conditions as may be specified by the Board]

¹³ Proviso inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulations, 2000 published in the Official Gazette of India dated 29.02.2000.

^{13a} Regulation 7A inserted by SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 2003 published in the Official Gazette of India dated 28.08.2003.

^{14*} Proviso inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulations, 2000 published in the Official Gazette of India dated 29.02.2000.

^{15*} Proviso inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulations 2001 published in the Official Gazette of India dated 13.02.2001.

2. The application for renewal under sub-regulation (1) shall, as far as may be dealt with in the same manner as if it were an application made under sub-regulation (2) of regulation 3 for grant of a certificate.
3. The Board shall, on such application, if satisfied that the applicant fulfils the requirements specified in regulation 6, grant a certificate in form B, subject to payment of fees in accordance with the Second Schedule.

Conditions for grant or renewal of certificate to foreign institutional investors.

10. The grant or renewal of certificate to the Foreign Institutional Investor shall be subjected to the following conditions namely:
 - a. he shall abide by the provisions of these regulations;
 - b. if any information or particulars previously submitted to the Board are found to be false or misleading, in any material respect, he shall forthwith inform the Board in writing;
 - c. if there is any material change in the information previously furnished by him to the Board, which has a bearing on the certificate granted by the Board, he shall forthwith inform the Board;
 - d. he shall appoint a domestic custodian and before making any investments in India, enter into an agreement with the domestic custodian providing for custodial services in respect of securities;
 - e. he shall, before making any investments in India, enter into an arrangement with a designated bank for the purpose of operating a special non-resident rupee or foreign currency account;
 - f. before making any investments in India on behalf of a sub-account, if any, he shall obtain registration of such sub-account, under these regulations.

Procedure where certificate is not granted

11.
 1. Where an application for grant or renewal of a certificate does not satisfy the requirements specified in regulation 6, the Board may reject the application after giving the applicant a reasonable opportunity of being heard.
 2. The decision to reject the application shall be communicated by the Board to the applicant in writing stating therein the grounds on which the application has been rejected.
 3. The applicant, who is aggrieved by the decision of the Board under sub-regulation (1) may, within a period of thirty days from the date of receipt of communication under sub-regulation (2), apply to the Board for reconsideration of its decision.
 4. The Board shall, as soon as possible, in the light of the submissions made in the application for reconsideration made under sub-regulation (3) and after giving a reasonable opportunity of being heard, convey its decision in writing to the applicant.

Application for registration of sub-accounts

12.
 1. A Foreign Institutional Investor shall seek from the Board registration of each sub-account on whose behalf he proposes to make investments in India.
 2. Notwithstanding any thing contained in sub-regulation (1) above, any sub-account which has been granted approval prior to the commencement of these regulations by the Board shall be deemed to have been granted registration as a sub-account by the Board under these regulation.

3. An application for registration as a sub-account shall contain particulars specified in ^{16*} [para 1 of Annexure B to Form A of the First Schedule].

Procedure and grant of registration of sub-accounts

13. 1. For the purpose of grant of registration the Board shall take into account all matters which are relevant to the grant of such registration to the sub-account and in particular the following, namely-
 - a. the applicant is an institution or fund or portfolio established or incorporated outside India and proposes to make investment in India;
 - b. the applicant is a broad based fund ^{17*} [or proprietary fund] ^{18*} [or a foreign corporate or individual]
^{19*} [(bb) the applicant is a fit and proper person.]
^{20*} ["Provided that a non-resident Indian or an overseas corporate body registered with Reserve Bank of India shall not be eligible to invest as sub-account or as foreign institutional investor."]
 - c. the Foreign Institutional Investor through whom the application for registration is made to the Board holds a certificate of registration as Foreign Institutional Investor; and
 - d. the Foreign Institutional Investor through whom an application for registration of sub-account is made, is authorised to invest on behalf of the sub-account.
 - e. ^{21*} The foreign institutional investor through whom the application for registration is made, has submitted undertakings that the sub-account fulfils the criteria referred to in this sub-regulation in a manner specified in para 2 of Annexure B to Form A of the First Schedule.
^{22*} [(ee) In case the sub-account is a foreign corporate or individual, the foreign institutional investor, through whom the application for registration is made, shall furnish information and undertaking as specified in para 3 of Annexure B to Form A of the First Schedule.]
 - f. The sub-account has paid registration fees in accordance with the Second Schedule.]
2. ^{23*} [The Board on receipt of the undertakings and the registration fees as referred to in sub-regulation (1), may grant registration to the sub-account.]
3. A sub-account granted registration in accordance with sub-regulation (2) of this regulation shall be deemed to be registered as a Foreign

^{16*} Substituted for "sub-para (b) of para 5 of form A" Amended by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulations 1998 published in the Official Gazette of India dated 30.06.1998.

^{17*} "or proprietary fund" inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 1997 published in the Official Gazette of India dated 12.02.1997.

^{18*} "or a foreign corporate or individual" inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 published in the Official Gazette of India dated 29.02.2000.

^{19*} Clause (bb) inserted by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1997 published in the Official Gazette of India dated 05.12.1997.

^{20*} Proviso inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 published in the Official Gazette of India dated 29.02.2000.

^{21*} Clauses (e) and (f) inserted by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 published in the Official Gazette of India dated 30.06.1998.

^{22*} Clause (ee) inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 published in the Official Gazette of India dated 29.02.2000.

^{23*} Substituted for "The Board on being satisfied that the applicant is eligible for a grant of registration shall grant registration to the sub-account" by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulations 1998, published in the Official Gazette of India dated 30.06.1998.

Institutional Investor with the Securities and Exchange Board of India for the limited purpose of availing of the benefits available to Foreign Institutional Investors under Section 115 AD of Income Tax Act, 1961, (43 of 1961).

CHAPTER III INVESTMENT CONDITIONS AND RESTRICTIONS

Commencement of investment

14. A Foreign Institutional Investor shall not make any investments in securities in India without complying with the provisions of this Chapter.

Investment restrictions

15. 1. A Foreign Institutional Investor may invest only in the following:-
- securities in the primary and secondary markets including shares, debentures and warrants of companies^{24*} [unlisted] listed or to be listed on a recognised stock exchange in India; and
 - units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed on a recognised stock exchange or not
 - ^{25*} dated Government Securities.
 - ^{26*} derivatives traded on a recognised stock exchange.
 - ^{27*} commercial paper].
2. Notwithstanding anything contained in sub-regulation (1) of this regulation, the total investments in equity and equity related instruments (including fully convertible debentures, convertible portion of partially convertible debentures and tradable warrants) made by a Foreign Institutional Investor in India, whether on his own account or on account of his sub-accounts, shall not be less than seventy per cent of the aggregate of all the investments of the Foreign Institutional Investor in India, made on his own account and on account of his sub-accounts.
- ^{28*} [Provided that nothing contained in sub-regulation (2) shall apply to any investment of the foreign institutional investor either on its own account or on behalf of its sub-accounts in debt securities which are ^{29*} [unlisted] or listed or to be listed on any stock exchange if the prior approval of the Board has been obtained for such investments.
- Provided further that the Board may while granting approval for the investments impose conditions as are necessary with respect to the maximum amount which can be invested in debt securities by the foreign institutional investor on its own account or through its sub-accounts.]
- ^{30*} [Provided further that a foreign corporate or individual shall not be eligible to invest through the hundred percent debt route.”]

24* "unlisted" inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 1996 published in the Official Gazette of India dated 09.10.1996.

25* Clause (c) inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulations, 1998 published in the Official Gazette of India dated 20.04.1998.

26* Clause (d) inserted by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 published in the Official Gazette of India dated 30.06.1998.

27* Clause (e) inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2001 published in the Official Gazette of India dated 13.02.2001.

28* Proviso inserted by the SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 1996 published in the Official Gazette of India dated 19.11.1996.

29* "unlisted" inserted by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 published in the Official Gazette of India dated 30.06.1998.

30* Proviso inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 dated published in the Official Gazette of India 29.02.2000.

^{31*}[Explanation: for the purpose of the provisos to this sub-regulation, the expression “debt securities” shall include dated Government securities, ^{32*}[commercial paper] and ^{33*}[treasury bills]

3. In respect of investments in the secondary market, the following additional conditions shall apply:-

a. the Foreign Institutional Investors shall transact business only on the basis of taking and giving deliveries of securities bought and sold and shall not engage in short selling in securities;

^{34*} [Provided that nothing contained in clause (a) shall apply in respect of transactions in derivatives traded on a stock exchange]

b. no transaction on the stock exchange shall be carried forward;

c. the transaction of business in securities shall be only through stockbrokers who has been granted a certificate by the Board under sub section (1) of Section 12 of the Securities and Exchange Board of India Act,1992;

³⁵[Provided that the transactions in government securities, ³⁶[commercial paper] ³⁷[including treasury bills] shall be carried out in a manner specified by the Reserve Bank of India:]

³⁸[Provided further that nothing contained in clause (c) shall apply to sale of securities by a Foreign Institutional Investor in response to a letter of offer sent by an acquirer in accordance with the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 ³⁹[or to sale of securities by a Foreign Institutional Investor in response to an offer made by any promoter or acquirer in accordance with the Securities and Exchange Board of India (Delisting of Securities) Guidelines, 2003] :]

⁴⁰[Provided further that in case of an open offer by a company to buy-back its securities, the foreign institutional investors may sell the securities held by it to such company in accordance with the Securities and Exchange Board of India (Buy-Back of securities) Regulations,1998;]

⁴¹[“Provided further that nothing contained in clause (c) shall apply to divestment of securities by the Foreign Institutional Investors in response to an offer by Indian Companies in accordance with Operative Guidelines for Disinvestment of Shares by Indian Companies in the overseas market through issue of American Depository Receipts (ADR) or Global Depository

31* Explanation inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 1997 dated published in the Official Gazette of India 12.02.1997.

32* “commercial paper” inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations 2001 dated published in the Official Gazette of India 13.02.2001.

33* “treasury bills” inserted by the SEBI (Foreign Institutional Investors) (second Amendment) Regulations, 1998 published in the Official Gazette of India dated 18.05.1998.

34* Proviso inserted by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 published in the Official Gazette of India dated 30.06.1998.

35 Proviso inserted by the SEBI (Foreign Institutional Investors) (Second Amendment) Regulation , 1997 published in the Official Gazette of India dated 10.07.1997.

36 “commercial paper” inserted by the SEBI(Foreign Institutional Investors)Amendment Regulations, 2001 published in the Official Gazette of India dated 13.02.2001.

37 “Treasury bills” inserted by the SEBI (Foreign Institutional Investors) (Second Amendment)Regulation, 1998 published in the Official Gazette of India dated 18.05.1998.

38 Proviso Inserted by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1998 published in the Official Gazette of India dated 30.06.1998.

39 Inserted by the SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 2004 published in the Official Gazette of India dated 19.02.2004.

40 Proviso inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulations, 1999 published in the Official Gazette of India dated 16.04.1999.

41 Proviso inserted vide Notification No. SO 548E dated 14.5.2003

Receipts (GDR) as notified by the Government of India vide notification No.15/23/99-NRI, dated July 29, 2002 and directions issued by Reserve Bank of India from time to time under Section 10(4) and Section 11(1) of the Foreign Exchange Management Act, 1999 (42 of 1999)”]

⁴²[Provided further that nothing contained in clause (c) shall apply to any bid for, or acquisition of, securities by a Foreign Institutional Investor in response to an offer for disinvestment of shares made by the Central Government or any State Government.]

⁴³[(d) a Foreign Institutional Investor or a sub account having an aggregate of securities which are worth rupees ten crores or more, as on the latest balance sheet data, shall, subject to such instructions as may be issued from time to time by the Board, settle their transactions entered on or after January 15, 1998 only through dematerialised securities.]

4. Unless otherwise approved by the Board, securities shall be registered –
 - a. in the name of the Foreign Institutional Investor, provided the Foreign Institutional Investor is making investments on his own behalf; or
 - b. in his name on account of his sub-account, or in the name of the sub-account, in case he is investing on behalf of the sub-account:

Provided that the names of the sub-accounts on whose behalf the Foreign Institutional Investor is investing are disclosed to the Board by the Foreign Institutional Investor.
5. The purchase of equity shares of each company by a Foreign Institutional Investor investing on his own account shall not exceed five ⁴⁴[ten] percent of the total issued capital of that company.
6. In respect of a Foreign Institutional Investor investing in equity shares of a company on behalf of his sub-accounts, the investment on behalf of each such sub-account shall not exceed five ⁴⁵ [ten] percent of the total issued capital of that company.

⁴⁶[Provided that in case of foreign corporates or individuals, each of such sub-account shall not invest more than 5% of the total issued capital of the company in which such investment is made]

42 Proviso Inserted by the SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 2004 published in the Official Gazette of India dated 19.02.2004.

43 “Clause (d)” inserted by the SEBI (Foreign Institutional Investors) (Third Amendment) Regulations, 1997 published in the Official Gazette of India dated 05.12.1997.

44 Substituted for “five” by the SEBI (Foreign Institutional Investors) Amendment Regulations, 1996 published in the Official Gazette of India dated 09.10.1996.

45 Substituted for “five” by the SEBI (Foreign Institutional Investors) Amendment Regulations, 1996 published in the Official Gazette of India dated 09.10.1996.

46 Substituted for “Provided that in case of foreign corporates or individuals, all the investments made by all foreign corporates or individuals together as sub-accounts, shall not exceed 5% of the total issued capital

7. The investment by the Foreign Institutional Investor shall also be subject to Government of India Guidelines.

⁴⁷[A Foreign Institutional Investor or sub-account may lend securities through an approved intermediary in accordance with stock lending scheme of the Board] ⁴⁸[15A. (1) A Foreign Institutional Investor or sub account may issue, deal in or hold, off-shore derivative instruments such as Participatory Notes, Equity Linked Notes or any other similar instruments against underlying securities, listed or proposed to be listed on any stock exchange in India, only in favor of those entities which are regulated by any relevant regulatory authority in the countries of their incorporation or establishment, subject to compliance of “know your client” requirement:

Provided that if any such instrument has already been issued, prior to 3rd February 2004, to a person other than a regulated entity, contract for such transaction shall expire on maturity of the instrument or within a period of five years from 3rd February, 2004, whichever is earlier.

- (2.) A Foreign Institutional Investor or sub account shall ensure that no further down stream issue or transfer of any instrument referred to in sub-regulation (1) is made to any person other than a regulated entity.]

CHAPTER IV

GENERAL OBLIGATIONS AND RESPONSIBILITIES

Appointment of domestic custodian

16. 1. A Foreign Institutional Investor or a global custodian acting on behalf of the Foreign Institutional Investor, shall enter into an agreement with a domestic custodian to act as custodian of securities for the Foreign Institutional Investor.
2. The Foreign Institutional Investor shall ensure that the domestic custodian takes steps for -
 - a. monitoring of investments of the Foreign Institutional Investor in India;
 - b. reporting to the Board on a daily basis the transactions entered into by the Foreign Institutional Investor;
 - c. preservation for five years of records relating to his activities as a Foreign Institutional Investor; and
 - d. furnishing such information to the Board as may be called for by the Board with regard to the activities of the Foreign Institutional Investor and as may be relevant for the purpose of this regulation.
3. A Foreign Institutional Investor may appoint more than one domestic custodian with prior approval of the Board, but only one custodian may be appointed for a single sub-account of a Foreign Institutional Investor.

Appointment of designated bank

of the company in which such investment is made." by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 published in the Official Gazette of India dated 20.10.2000. The above substituted proviso was inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 2000 published in the Official Gazette of India dated 29.02.2000.

⁴⁷ Inserted by the SEBI (Foreign Institutional Investors) Amendment Regulations, 1998 published in the Official Gazette of India dated 20.04.1998.

⁴⁸ Inserted by the SEBI (Foreign Institutional Investors) (Amendment) Regulations, 2004 published in the Official Gazette of India dated 27.01.2004.

17. A Foreign Institutional Investor shall appoint a branch of a bank approved by the Reserve Bank of India for opening of foreign currency denominated accounts and special non-resident rupee accounts.

⁴⁹**[Investment Advice in publicly accessible media]**

- 17A. 1. A Foreign Institutional Investor or any of his employees shall not render directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non real-time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice.
2. In case, an employee of the Foreign Institutional Investor is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.]

Maintenance of proper books of accounts, records, etc.

18. 1. Every Foreign Institutional Investor shall keep or maintain, as the case may be, the following books of accounts, records and documents, namely:
- a. true and fair accounts relating to remittance of initial corpus for buying, selling and realising capital gains of investment made from the corpus;
 - b. accounts of remittances to India for investments in India and realising capital gains on investments made from such remittances;
 - c. bank statement of accounts;
 - d. contract notes relating to purchase and sale of securities; and
 - e. communication from and to the domestic custodian regarding investments in securities.
2. The Foreign Institutional Investor shall intimate to the Board in writing the place where such books, records and documents will be kept or maintained.

Preservation of books of accounts, records, etc.

19. Subject to the provisions of any other law, for the time being in force, every Foreign Institutional Investor shall preserve the books of accounts, records and documents specified in Regulation 18 for a minimum period of five years.

⁵⁰**Appointment of Compliance Officer**

- 19A. 1. Every Foreign Institutional Investor shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act,

49 Regulation 17A inserted by the SEBI (Investment Advice by Intermediaries) Regulations, 2001 published in the Official Gazette of India dated 29.05.2001.

50 Regulation 19A inserted by the SEBI (Investment Advice by Intermediaries) Regulations, 2001 published in the Official Gazette of India dated 29.05.2001.

rules and regulations, notifications, guidelines, instructions, etc., issued by the Board or the Central Government.

2. The compliance officer shall immediately and independently report to the Board any non-compliance observed by him.]

Information to the Board

20. Every Foreign Institutional Investor shall, as and when required by the Board or the Reserve Bank of India, submit to the Board or the Reserve Bank of India, as the case may be, any information, record or documents in relation to his activities as a Foreign Institutional Investor as the Board or as the Reserve Bank of India may require.

⁵¹20A. Foreign Institutional Investors shall fully disclose information concerning the terms of and parties to off-shore derivative instruments such as Participatory Notes, Equity Linked Notes or any other such instruments, by whatever names they are called, entered into by it or its sub-accounts or affiliates relating to any securities listed or proposed to be listed in any stock exchange in India, as and when and in such form as the Board may require.”

SUMMARY

- This chapter discussed the advantages and disadvantages of investment in foreign securities, where the investments are not big enough to let the investor enjoy control over the foreign company. The international CAPM extended the logic of measuring the systematic risk of security by sensitivity of the security returns to change in the market returns portrayed through beta of the security, considering the world market as a whole.
- The next chapter analyzes those investments where the investor holds the controlling stake, i.e. Foreign Direct Investment (FDI).

51 Regulation 20A inserted by the SEBI (Foreign Institutional Investors) (Second Amendment) Regulations, 2003 published in the Official Gazette of India dated 28.08.2003.

Chapter XIV

Short-term Financial Management

After reading this chapter, you will be conversant with:

- Cash Management in Multinational Corporations
- Centralized Cash Management System
- Practical Issues in Cash Management

A multinational corporation can be defined as an entity which has branches or subsidiaries spread over many countries. Since multinational corporations have operations in different countries, the financial transactions will also be denominated in multiple currencies. Hence, financial management of short-term assets and liabilities in an MNC is much more important and complex in nature. It involves management of current assets and current liabilities denominated in different currencies.

This chapter deals exclusively with cash management in MNCs. With the existence of branches/subsidiaries in different countries, MNCs have the scope and the need to mobilize and deploy cash in multiple currencies. Hence, cash management in MNCs has become significant.

CASH MANAGEMENT IN MULTINATIONAL CORPORATIONS

Multinational corporations, by virtue of their presence in different countries, have access to much wider international money markets. Hence, there is a need for the finance manager to develop a strategy to meet the actual requirement of the MNC which proposes either to mobilize the funds or to deploy the surplus cash in investments. The objective of cash management is (i) to maximize the return by proper allocation of short-term investments and (ii) to minimize the cost of borrowing by borrowing in different money markets.

To achieve the above objective the MNCs have to evolve a strategy by taking the following aspects into consideration:

- i. The borrowing cost in a particular currency and the relationship between nominal interest rate between the currencies and anticipated exchange rates of the currencies (International Fisher effect).
- ii. The exchange risk of the MNC consequent to the firm's exposure in different currencies with regard to the receivables and payables.
- iii. The level of risk acceptable to the management of the MNC.
- iv. The availability of tools for hedging.
- v. Tax structure prevailing in various countries.
- vi. Political environment and the consequent risk relating to various countries.

MNCs have access to various international financial instruments like CPs, Banker's acceptances, CDs, bank loans etc., for their short-term borrowing or investment.

In the earlier chapters, we have seen that in the euro currencies the yields are equal on a covered basis. Fisher's equation provides a relationship between the nominal interest rate (i), the real interest rate (r) and expected rate of inflation. Fisher's open equation is given by

$$i_A - i_B = \hat{S}_e (A/B)$$

Where, $\hat{S} (A/B)$ = expected appreciation of currency B against currency A.

If interest rate parity holds good, then it should not really matter in which currency funds are borrowed or invested. However, there still exist situations where cost of borrowing/yield on investment differ in different markets. If the forward rates are unbiased estimates of future spot rates, a speculator will not make any gains by entering into forward contracts.

If we assume that the speculators are risk averse we have to consider Risk Premium (RP) also.

The above equation can then be written as

$$i_A - i_B = \hat{S}_e(A/B) + RP.$$

Interest parity implies that

$$F(A/B) = S_e(A/B) + RP.$$

Where, $F(A/B)$ is the forward rate and $S_e(A/B)$ is expected future spot rate.

This being the situation in the market, the MNC will compare the effective cost of borrowing on covered basis for different currencies. The perception of the firm with regard to forward rate and future spot rate will influence the decisions.

A firm which is not risk averse may opt for uncovered investment since its approach is to profit from forecasting of future spot rates.

CENTRALIZED CASH MANAGEMENT SYSTEM

MNCs will have divisions/subsidiaries in different countries. Each of the subsidiary or division will have cash positions, receivables and payables in the same currencies or different currencies. The composition of receivables and payables and cash can be in any combination. One division may have huge receivables in the US dollar and hedged with a short position while another division which has a huge dollar payable, might have hedged with a long position with the same maturity. Similarly, one division may be having a surplus cash position while another division in another country may be having a cash deficit and borrowing at a high cost. These type of situations warrant proper cash management systems. To overcome these type of problems for cash management, MNCs resort to centralized cash management system.

Advantages

- i. **Netting:** In large MNC's, intra-corporate transactions among various subsidiaries of the parent company or subsidiaries with parent corporate are a common feature. As a consequence there will be receivables and payables among the group subsidiaries resulting in cash inflows and outflows in different currencies. At times the inflows and outflows between two subsidiaries may have matching maturities or may have maturity mismatches. If the receivables and payables are of different currencies, the transaction costs can be higher.

In a centralized cash management system all cash transactions of group companies are settled through a single point.

In such circumstances, netting is possible whereby the receivables are netted out against payables and net cash flows are settled among the group subsidiaries.

When we are considering the transactions between the subsidiaries, leading and lagging of receivables/payables is possible to enable matching of maturities. Netting with other corporate entities is also possible.

- ii. **Management of currency exposure:** Another advantage of centralized cash management system is exchange risk management. In a centralized cash management system, the parent can evolve a corporate strategy for exchange risk management keeping overall position of receivables and payables in different currencies of the various subsidiaries in mind. This strategy will reduce the transaction cost of the hedging which otherwise would be incurred by each subsidiary individually.

- iii. **Pooling of cash:** Each of the subsidiary will maintain certain amount of liquid position. Some of the subsidiaries may have surplus cash whereas some others may have a deficit. In a centralized cash management system, the center may pool up the cash from surplus subsidiaries for transfer to the deficit units. This will eliminate borrowing cost to the deficit units. The existence of cash pooling center will reduce the burden of cash management at the subsidiary level.

Problems involved in Centralized Cash Management System

1. Cash requirement in domestic currency for a subsidiary is quite unpredictable. A centralized cash pooling system sometimes may cause hardships to the subsidiary if unforeseen expenditure is to be met by the subsidiary. The parent should evolve a centralized cash pooling system which enables the subsidiary to meet urgent cash requirements.
2. Even the transfer of funds involves cost. Hence, centralized cash management system should ensure that fund transfer events are not too many by the pooling center and the system is cost effective in nature.
3. Even in these days of electronic fund transfer systems, delays in fund transfers and making cash available to the subsidiary are possible.
4. Exchange control regulations of the country where the subsidiary is located will have a serious impact on cash inflows and outflows from subsidiaries to other group corporates or to the parent company.
5. Tax structure in the countries where the subsidiaries are located will be another important factor in centralized cash management system. Cash management system should ensure that the transfer of funds from one subsidiary to another should be cost effective even if the total borrowing cost inclusive of withholding tax at cash surplus center is taken into consideration.
6. A decentralized cash management system can benefit from the proximity of various subsidiaries to major financial centres in the world. A centralized cash management system is generally located at the same place as the parent company, which may not be near any major financial centre. This may act as a drawback.

PRACTICAL ISSUES IN CASH MANAGEMENT

Notwithstanding the fact whether a corporate has chosen centralized or decentralized cash management, there are certain situations encountered by a Treasurer which involve decision-making after undertaking a cost benefit analysis. The most important issue is that the Treasurer should consider all the possible alternatives and then choose the optimal alternative.

Transaction Costs

The prevailing interest rates either on borrowing or on investing will determine financing/investing decisions to a great extent. However, transaction costs also play a significant role in these decisions since they can make all the difference.

Let us understand this through an example.

An MNC is holding surplus dollar funds. It proposes to invest in Pound Sterling for 6 months. The rates of interest for dollar and pound securities are 6% and 9% respectively.

Spot \$/£ = 1.6721/31

6 months forward = 1.6521/51

Option 1: Investment in dollars for 6 months

Amount available at the time of maturity = 1.03

Option 2: Investment in pounds for 6 months

Dollar funds will be converted to pounds. We take spot ask rate 1/1.6731 to buy pounds which will be invested for 6 months at 9% and a forward contract is taken to sell pound at £1.6521

$$\text{i.e. } \frac{1.6521}{1.6731} \times (1.045) = 1.03188$$

We can see that the transaction costs will have a significant impact on the investment pattern. If the additional return of 0.00188 which is available by investing in pound is offset by the additional transactions, then investment in US dollars can be a better option. One needs to be careful since some costs may not be conspicuous.

Apart from the transaction costs, selection of the currency of investment/borrowing will also depend upon the availability of instruments with the required maturity and the degree of liquidity that the instrument enjoys.

The MNCs will be encountering typical situations in practice. Let us examine a few.

- i. On certain occasions the MNC may have surplus funds but not sufficient to invest in the market lot of the selected instruments. What should be the investment decision?

Illustration 1

An MNC has a surplus of US\$170,000 for 90 days. Minimum size of CD is \$100,000 @10%. Bank offers 5% on 90 day deposit. What should be the investment decision if interest on overdraft is 12%?

Solution

The break even size of investment can be obtained from

$$E = M[(k - i)/(k - d)]$$

Where, E = Surplus funds at break even level

M = Minimum lot of investment

k = Interest rate on borrowed funds

i = Rate of interest for investment

d = Rate of interest for deposit.

$$\begin{aligned} E &= \$1,00000[0.12 - 0.10]/(0.12 - 0.05)] \\ &= \$100,000 [(0.02)/(0.07)] \\ &= \$28,571 \end{aligned}$$

The surplus funds are \$170,000, well above the break even level. Hence, the firm can go for borrowing of \$30,000 to make investment in 2 CDs i.e. \$200,000 at 12% for 10 days.

Let us see the incremental gain made by the treasurer in the transaction.

Deposit interest rate 5%. If amount is invested in bank deposit for 90 days MNC will get interest of \$2,095.90

If MNC borrows \$30,000, interest payable at 12% for 90 days is \$887.70

If \$200,000 is invested in CDs at 10% for 90 days, the interest earned is \$4,931.50

Net income = \$4,931.50 – 887.70 = \$4,043.80

Otherwise by investing in bank deposit MNC gets only \$2,095.80. Hence, the additional gain is \$1,947.90.

Illustration 2

An MNC has surplus funds of \$100,000 which is to be deployed for 20 days. However, the minimum tenure of a bank deposit is one month and the interest offered by the bank is 6%. The firm has an opportunity to borrow at 12%. What should the treasurer do?

Solution

The firm may have to keep the funds idle in view of the minimum tenure of 1 month for the deposit, in which case it does not earn any income.

Alternatively, if the firm borrows \$100,000 for 10 days, then the net return will be as under.

$$\begin{aligned}\text{Interest earned on deposit} &= 100,000 \times 0.06 \times \frac{1}{12} \\ &= \$500\end{aligned}$$

$$\begin{aligned}\text{Interest paid on borrowing} &= 100,000 \times 0.12 \times \frac{10}{365} \\ &= \$328.75\end{aligned}$$

$$\text{Net return} = \$500 - \$328.75 = \$171.25$$

It may sometimes be less costly for a firm to borrow for a longer maturity than the duration for which it requires the funds. Let us see an example.

Illustration 3

An MNC requires \$70,000 for a period of one month. The borrowing rates for one-month and two-month maturities are 8.25% and 8.5% respectively. What is the borrowing rate for the MNC?

Solution

The MNC has two options:

Option I

To borrow at 8.25% for a period of one month.

$$\text{Cost of borrowing} = \$70,000 \times 0.0825 \times \frac{1}{12} = \$481.25$$

Option II

Borrow for 2 months at 8.5%, use the funds for one month and invest the funds at the end of one month for a maturity of one month.

$$\text{Interest payable} = \$70,000 \times 0.085 \times \frac{2}{12} = \$991.67$$

Let us now find the one-month investment rate that should prevail after one month to make the cost of borrowing under the two options equal. Let this investment rate be denoted by r_{11}

$$\begin{aligned} \$70,000 \times r_{11} \times \frac{1}{12} &= 991.67 - 481.25 \\ r_{11} &= 0.0875 = 8.75\% \end{aligned}$$

If the firm feels that the interest rates are going to rise and the one-month investment rate prevailing at the end of one month will be greater than 8.75%, then it may go for the second option and thereby reduce its cost of borrowings.

SUMMARY

- Interest rates and exchange rates are important inputs in the decisions regarding management of short-term funds.
- If interest rate parity holds, the decision regarding the choice of currency in which funds are borrowed or invested becomes redundant.
- However, practical realities show that it is wise to choose the appropriate currency, in order to increase the returns or reduce the costs.
- For this purpose, the Treasurer should be able to generate forecasts regularly and needs to be constantly in touch with the market.

Chapter XV

International Accounting and Taxation

After reading this chapter, you will be conversant with:

- International Accounting Translation of Financial Statements of a Foreign Entity
- International Taxation

INTERNATIONAL ACCOUNTING

In today's globalized scenario, the presence of Multinational Corporations (MNCs) has become a well-accepted phenomenon. Having subsidiaries abroad makes financial reporting more complex for MNCs than for other companies. This stems from the fact that MNCs need to consolidate their subsidiaries' accounts for the purpose of financial reporting. (In India, however, such consolidation is not mandatory). Even if a company has branches in other countries (and not full-fledged subsidiaries), such consolidation of accounts is required. (This is required according to Indian regulations also). Even purely domestic companies may have some foreign currency denominated assets or liabilities or may have some transactions like exports and imports denominated in foreign currencies. All these companies have one factor in common – they need to translate foreign currency denominated assets, liabilities, earnings or expenses in terms of their reporting currency, which is most often their domestic currency.

This requirement makes it essential for these companies to decide upon a policy as to the different exchange rates that are to be applied to convert the various categories of foreign currency denominated assets, liabilities, incomes and expenses into the domestic currency, and for the treatment of any exchange gains or losses that arise out of such conversions. The formation of a policy becomes essential to make financial statements transparent. The absence of a consistent policy can lead to companies shifting profit or losses from one accounting year to another, or to window-dress the accounts. The translation also has tax implications.

The foreign currency transactions of a firm can be divided into two broad categories:

- Transactions in a foreign currency, e.g. exports, imports, raising foreign currency loans, etc., that need to be stated in domestic currency terms.
- The presence of foreign operations whose financial statements need to be translated into the domestic currency.

Foreign operations can again be of two types:

- **Integral foreign operations:** Foreign operations that are just an extension of the domestic operations, are referred to as integral foreign operations. For example, a foreign branch that only buys goods from the head office and sells them, would be treated as integral foreign operation.
- **Independent foreign operations:** An entity that operates independently by having its own expenses, incomes, assets and liabilities is referred to as an independent foreign operation. It is generally in the form of a subsidiary whose transactions with the parent company are generally few with respect to its total operations, and whose day-to-day activities are financed locally rather than by the parent company.

Let us see the rules for reporting of these foreign currency activities one by one.

Reporting of Foreign Currency Transactions

In India, reporting of foreign currency transactions are governed by Accounting Standard – 11 prescribed by the ICAI. The text of this Accounting Standard is given in Appendix – 1. According to this Standard, a transaction in a foreign currency should be translated at the spot rate as on the date of the transaction. For the sake of convenience, transactions in a particular period may be reported at the average rate for the period.

A foreign currency transaction may result in a receivable or a payable arising in a foreign currency. This receivable or payable may be settled at a date subsequent to the transaction date. The spot rate as on the date of settlement may be different than the rate applicable to the transaction, thus resulting in an exchange gain/loss. According to the Standard, this gain/loss should be recognized in the year in which

the settlement takes place. Further, any receivables or payables which are not settled by the balance sheet date, should be translated at the spot rate as on that date. This should be done on all subsequent balance sheet dates till the receivable/payable is settled.

Exposure arising out of foreign currency transactions may be covered using forward contracts, or other hedging tools. The accounting treatment of such contracts is also specified by the Accounting Standard. It states that the difference between the contract rate and the spot rate as on the date of the transaction should be recognized as income or expenditure, spread over the life of the contract. Also, any profit/loss arising due to cancelation/extension of a forward contract should be accounted for as income or expenditure for the period in which it arises. Illustration 1 makes the application of these rules clear.

Illustration 1

An Indian company sells goods worth \$1,000,000 to a US firm on January 1. The payment is to be received after 6 months. The firm hedges itself by taking a 6-month forward. The Indian firm's accounting year ends on March 31. The exchange rates on various dates are

Spot rate on January 1 = Rs.44.00/\$

6-month forward on January 1 = Rs.42.00/\$

Spot rate on March 31 = Rs.41.50/\$

Spot rate on June 30 = Rs.41.00/\$

The following entries will be passed in the books of the Indian company.

January 1

- | | | | |
|----|--------------------------|------------|------------|
| 1. | Sundry debtors | 44,000,000 | |
| | To Sales | | 44,000,000 |
| 2. | Forward (Rs.) Receivable | 42,000,000 | |
| | Deferred Discount | 2,000,000 | |
| | To Forward (\$) Payable | | 44,000,000 |

March 31

- | | | | |
|----|----------------------|-----------|-----------|
| 3. | Exchange Loss | 2,500,000 | |
| | To Sundry Debtors | | 2,500,000 |
| 4. | Forward (\$) Payable | 2,500,000 | |
| | To Exchange Gain | | 2,500,000 |
| 5. | Discount Expense | 1,000,000 | |
| | To Deferred Discount | | 1,000,000 |

June 30

- | | | | |
|----|-----------------------------|------------|------------|
| 6. | Cash | 41,000,000 | |
| | Exchange Loss | 500,000 | |
| | To Sundry Debtors | | 41,500,000 |
| 7. | Forward (Rs.) Payable | 41,500,000 | |
| | To Exchange Gain | | 500,000 |
| | To Cash | | 41,000,000 |
| 8. | Cash | 42,000,000 | |
| | To Forward (Rs.) Receivable | | 42,000,000 |
| 9. | Discount Expenses | 1,000,000 | |
| | To Deferred Discount | | 1,000,000 |

In accordance with the accounting standard, the original transaction is initially recorded at the spot rate as on the date of the transaction (entry 1). The receivable is translated on March 31 at the ruling spot rate, and the exchange loss is accounted for in the period in which it arose (entry 3). Again, when the debtors are realized on June 30, the exchange loss is accounted for.

The treatment of the forward contract is also in accordance with the accounting standard. The discount is spread over the life of the contract, and accounted for in the relevant periods (entries 5 and 9).

Translation of Financial Statements of a Foreign Entity

There are four methods which guide the translation of the financial statements of a foreign entity, whether independent or integrated. These are

- Current/Non-current method
- Monetary/Non-monetary method
- Temporal method
- Current rate method.

For understanding these methods, we need to first understand a few terms:

Historical exchange rate: It is the rate at which a transaction was actually settled. For example, the rate which was used to convert the domestic currency into the foreign currency for settling the payment for a machinery bought by the company. In cases where no actual currency conversion takes place, it is the rate prevailing at the time the original transaction took place. For example, if the machinery in the above example was bought by a foreign subsidiary, there would have been no conversion of currency. In that case, the historical rate would have been the rate prevailing when the machinery was bought.

Current or closing exchange rate: It is the rate prevailing on the date of translation of accounts.

Average rate: It is the average of the rates prevailing over a certain period of time.

CURRENT/NON-CURRENT METHOD

This method is based on the premise that exposure is linked to the maturity of the asset or liability and hence, does not give importance to its nature. It advocates the conversion of all current assets and liabilities at the closing rate, and all non-current assets and liabilities at the historical rate. All items of income and expenditure are required to be converted at the average rate for the relevant period, except those items that are related to non-current assets and liabilities. All such items (like depreciation) are to be converted at the same rate as the related asset or liability.

As the non-current assets and liabilities are converted at the historical rate, this method results in only the current assets and liabilities being exposed to exchange rate movements. Hence, when the foreign subsidiary has a positive working capital, the parent company books an exchange gain on depreciation of the domestic currency, and an exchange loss on its appreciation. Conversely, when the foreign subsidiary has a negative working capital, the parent company would book an exchange loss on depreciation of the domestic currency, and an exchange gain on its appreciation.

MONETARY/NON-MONETARY METHOD

This method emphasizes the nature of the item rather than its maturity. It classifies assets and liabilities into monetary and non-monetary. Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. Under this method, the monetary assets and liabilities (like cash, accounts receivables, accounts payable) are translated at the closing rate, and

the non-monetary items (like inventory, building are translated at the historical rate). Items of the income statement are translated at the average rate, except for those related to the non-monetary items (like depreciation and cost of raw material consumed). These are translated at the rate at which the corresponding non-monetary asset or liability is translated. This differentiation between the items of the income statement may lead to some mismatches. For example, while sales are translated at the average rate, a part of cost of goods sold (to be specific, cost of raw materials consumed) may get reflected at the historical rate.

TEMPORAL METHOD

This method classifies items on the basis of whether they are valued at historical basis or on market price basis. All the items of the balance sheet that are valued on historical cost basis are translated at the historical rate, and those which are valued on current value (or realizable value) are valued at the closing rate. Effectively, this method is a modification of the monetary/non-monetary method, as the monetary assets and liabilities get converted at the closing rate, with the non-monetary items getting converted at the historical cost. The modification lies in the fact that under the temporal method, the inventory gets converted at the closing rate despite being a non-monetary item, if it is valued in the balance sheet at the realizable value. Under this method, the income statement items are also translated in the same way as under the monetary/non-monetary method.

CURRENT RATE METHOD

Under this method, all assets, liabilities, incomes and expenditures are translated at the current or closing rate. The idea is to retain the relationship (ratios) between various items of the balance sheet and income statement.

THE INDIAN ACCOUNTING STANDARD

In India, the translation of foreign assets, liabilities, incomes and expenses of a foreign branch or any other integrated foreign operation, and the accounting treatment of the gain or loss arising out of exchange rate movements is also governed by Accounting Standard – 11 mentioned earlier. The translation of any foreign currency denominated asset or liability of a domestic company is also governed by these rules. The standard prescribes the temporal method except for the requirement regarding the value at which fixed costs are to be carried in the balance sheet. According to the standard, in addition to the fixed asset being translated at the historical rate, its value has to be adjusted for any increase or decrease in the value of any liability taken for purchase of that fixed asset. It also prescribes that:

- Exchange gains or losses should be accounted for, in the period in which they arise.
- All foreign currency transactions of such an entity should be translated at the spot rate as on the date of the transaction. Alternatively, an average rate may be used for a group of transactions.
- Various items in the financial statements of a foreign branch should be translated in accordance with the principles specified above. The transfer of goods and money between the head office and a branch is recorded in the 'Branch A/c' and the 'Head Office A/c' in the financial statements of the head office and the branch respectively. No specific exchange rate needs to be applied to the balance in the 'Head Office A/c' for translation purposes. Instead, the balance in the 'Branch A/c' (after reconciliation of the two accounts) is to be taken as the corresponding figure.

Let us now see a few illustrations to understand the process of translation of accounts.

Illustration 2

An Indian company has the following foreign currency assets and liabilities:

Long-term loan	\$10,000
Investments	\$ 5,000
Real asset in US	\$15,000

The exchange rate at the beginning of the year was Rs.42.50/\$. At the end of the year it was Rs.43.50/\$. The rate when the real estate was bought was Rs.32.50/\$.

At the beginning of the year, the assets and liabilities will be translated at:

Long-term loan	\$10,000 @ Rs.42.50/\$ = Rs.4,25,000
Investments	\$ 5,000 @ Rs.42.50/\$ = Rs.2,12,500
Real estate	\$15,000 @ Rs.32.50/\$ = Rs.4,87,500

Net foreign currency assets

$$= \text{Rs.}(2,12,500 + 4,87,500 - 4,25,000)$$

$$= \text{Rs.}2,75,000$$

At the end of the year, the assets and liabilities will be translated at:

Long-term loan	\$10,000 @ Rs.43.50/\$ = Rs.4,35,000
Investments	\$ 5,000 @ Rs.43.50/\$ = Rs.2,17,500
Real estate	\$15,000 @ Rs.32.50/\$ = Rs.4,87,500

Net foreign currency assets

$$= \text{Rs.}(2,17,500 + 4,87,500 - 4,35,000)$$

$$= \text{Rs.}2,70,000$$

The difference between Rs.2,75,000 and Rs.2,70,000 (i.e. Rs.5,000) will be booked as exchange loss in the profit and loss account.

Illustration 3

An Indian company has a branch in New York. The Profit and Loss Account and the Balance Sheet of the branch are given as under:

	('000 \$)
Sales	1,500
Opening Inventory	150
Received from Head Office	800
	950
Closing Inventory	50
Cost of Goods Sold	900
Depreciation	40
Other Expenses	60
	1,000
PBT	500
Tax	200
PAT	300
Assets:	
Fixed Assets	200
Debtors	150
Cash	50
Inventory	200
	600
Liabilities:	
Head Office Balance	100
Profit for the Year	300
Long-term Loans	100
Current Liabilities	100
	600

The exchange rates are as follows:

At the beginning of the year	Rs.43.00/\$
At the end of the year	Rs.44.00/\$
Average rate	Rs.43.50/\$
At the time of acquisition of the fixed assets	Rs.40.00/\$

The balance in the 'branch account' in the books of the head office stands at Rs.5,000,000.

The branch's accounts will be translated in the following manner. The fixed assets will be translated at the historical rate of Rs./\$40.00. All other assets will be translated at the closing rate of Rs./\$44.00. Here, the assumption is that the inventory has been valued at the market value. The head office balance will be taken at Rs.5,000,000. Loans and current liabilities will be translated at the closing rate. The profit in the balance sheet will be the balancing figure. This balancing figure will be inclusive of exchange gain/loss and will be taken to the P&L Account.

In the P&L Account, sales will be translated at the average rate of Rs./\$43.50. The opening and the closing inventory will be valued at the opening and the closing rates respectively. Depreciation will be translated at the same rate as fixed assets. All other items of income and expenditure will be translated at the average rate. The translated accounts will be:

Profit and Loss Account

	('000 \$)	Translation Rate	('000 Rs.)
Sales	1,500	43.50	65,250
Opening inventory	150	43.00	6,450
Received from H.O.	800	43.50	34,800
	950		41,250
Closing inventory	50	44.00	2,200
Cost of goods sold	900		39,050
Depreciation	40	40.00	1,600
Other expenses	60	43.50	2,610
	1,000		43,260
PBT	500		21,990
Tax	200	43.50	8,700
PAT	300		13,290

Balance Sheet

	('000 \$)	Translation Rate	('000 Rs.)
Assets:			
Fixed Assets	200	40.00	8,000
Debtors	150	44.00	6,600
Cash	50	44.00	2,200
Inventory	200	44.00	8,800
	600		25,600
Liabilities:			
Head Office balance	100		5,000
Profit for the year	300		11,800
Long-term loans	100	44.00	4,400
Current liabilities	100	44.00	4,400
	600		25,600

The profit figure in the balance sheet (in Rs.) is the balancing figure. This figure is inclusive of the exchange gain/loss and is transferred to the Profit and Loss Account. Hence, the completed P&L A/c will look as follows:

	(`000 \$)	Translation Rate	(`000 Rs.)
PBT	500		21,990
Tax	200	43.50	8,700
PAT	300		13,290
Exchange gain (loss)	–		(1,490)
	300		11,800

As mentioned previously, Indian laws do not require the consolidation of a subsidiary's accounts with the parent company's accounts. Hence, the Indian accounting standards do not state the requirements either about the exchange rate to be used for translating the assets and liabilities of a subsidiary, or about the treatment of the resultant exchange gain or loss in the parent company's books. Hence, the provisions of the International Accounting Standard (IAS – 21) need to be studied for the translation of a subsidiary's accounts. According to the International Accounting Standard, all the assets and liabilities of a subsidiary (or any other independent foreign entity) should be translated at the closing exchange rate, and the exchange gain or loss recorded as a part of the equity of the subsidiary. This exchange gain or loss is not to be recorded as an income or expense till the investment in the subsidiary is disposed off. Similarly, any exchange gain or loss arising out of translating incomes and expenditures at the spot rate as on the date of the transaction (or the average rate), should not be recognized as income or expenditure for the period. This is because a change in the value of the assets or liabilities of the subsidiary is nothing except a change in the value of the parent company's investment in the subsidiary. The International Accounting Standard – 21 is given in Appendix 2. Let us see an illustration.

Illustration 4

The balance sheets of A Ltd. and its foreign subsidiary B Ltd. as on 31.3.2005 are as follows:

	A Ltd. (in Rs.)	B Ltd. (in \$)
Assets:		
Fixed assets	25,00,000	25,000
Investment in subsidiary	10,00,000	–
Net current assets	5,00,000	12,000
	40,00,000	37,000
Liabilities:		
Share capital	15,00,000	10,000
Reserves and surplus	15,00,000	17,000
Long-term loans	10,00,000	10,000
	40,00,000	37,000

A Ltd. acquired 100% shares of B Ltd. on April 1, 2004. Out of the present reserves of B Ltd., Rs.15,000 are pre-acquisition reserves. The exchange rate at the time of acquisition was Rs.40/\$. The closing exchange rate is Rs.44.00/\$, and the average exchange rate over the year was Rs.43.00/\$. Prepare the consolidated balance sheet of A Ltd. as on 31.3.2005.

B Ltd.'s translated balance sheet will be:

	(in \$)	Translation rate	(in Rs.)
Assets:			
Fixed assets	25,000	44.00	11,00,000
Net current assets	12,000	44.00	5,28,000
	<u>37,000</u>		<u>16,28,000</u>
Liabilities:			
Share capital	10,000	40.00	4,00,000
Reserves and surplus			
Pre-acquisition	15,000	40.00	6,00,000
Post-acquisition	2,000	43.00	86,000
Exchange difference (b.f.)			1,02,000
Long-term loans	<u>10,000</u>	44.00	<u>4,40,000</u>
	<u>37,000</u>		<u>16,28,000</u>

The consolidated balance sheet of A Ltd. will be:

	(in Rs.)
Assets:	
Fixed assets	36,00,000
Net current assets	<u>10,28,000</u>
	<u>46,28,000</u>
Liabilities:	
Share capital	15,00,000
Reserves and surplus	
Reserves	15,86,000
Exchange difference	1,02,000
Long-term loans	<u>14,40,000</u>
	<u>46,28,000</u>

In accordance with the accounting standard, all the assets and liabilities are translated at the closing rate. The post-acquisition reserves, reflecting the net profit earned after the acquisition, are translated at the average rate.

Though the exchange rate that needs to be applied to B Ltd.'s share capital and pre-acquisition reserves (in its translated balance sheet) is not specified in the IAS-21, other provisions of the Accounting Standard imply that it should be the historical rate. Let us analyze the reason. Let us suppose that the share capital and pre-acquisition reserves are translated at the closing rate. This would make their combined value equal to Rs.11,00,000. This will, in turn, reduce the exchange difference (which is a balancing figure) to Rs.2,000. This would effectively amount to revaluing A Ltd.'s investment in B Ltd. at the closing rate, and reducing the exchange difference by a corresponding amount (thus understating it). This would imply recognizing the exchange gain as a profit, before the disposal of the investment in the subsidiary, which is specifically prohibited by the International Accounting Standard. Hence, the initial investment in the subsidiary, which is reflected in B Ltd.'s share capital and pre-acquisition reserves in the above problem, should be translated at the historical rate. It may be noted that in the illustration, the exchange difference is not recorded as a profit for the period, and is instead taken as a part of 'Reserves'.

The above illustration is a very simplified example of the consolidation of the accounts of a parent company and its foreign subsidiary. In reality, there may be a number of complications like the parent company holding more than 50% but less than 100% shares of the subsidiary, or the investment in the subsidiary not being equal to the share capital and pre-acquisition reserves of the subsidiary, implying

the fair value of the latter's assets and liabilities being different than their book value. These, and other issues (the accounting for which is beyond the scope of this book), make accounting for international operations a complex procedure.

INTERNATIONAL TAXATION

An entity operating in more than one country faces a multiplicity of tax rules. Each country determines its own tax rules as to the scope of income that it can tax, depending upon the residential status of the business entity and the place where the entity's source of income is situated.

The Income Tax Act, as amended from time to time, determines the tax rules in India. In order to boost exports, the Income Tax Act gives a number of concessions to Indian exporters. These concessions are in the form of exempt incomes and deductions allowed to be claimed from total income. The various incentives are

- Under Section 10A of the Income Tax Act, any new industrial undertaking set-up which has begun to manufacture or produce articles or things or computer software during the previous year relevant to assessment year 2003-04 onward in a Free Trade Zone or Export Processing Zone can claim tax exemption for a period of 10 years from the year of beginning of production. This exemption will not be available to the undertaking beginning to manufacture or produce after 31.3.2009.

Note: The benefit of this deduction is available to any undertaking only up to the A.Y. 2018-19.

- Under Section 10B of the Act, a newly established 100 percent Export Oriented Unit (EOU) can claim complete tax exemption for a period of 10 years from the year it begins production. No deduction under Section 10 B is available after assessment year 2009-10.

Deductions in case of both Sections 10A and 10B

Amount of deduction = (Export turnover/total turnover) x Profits of the business

Period of deduction

First 5 consecutive assessment years	100% of profits and gains
Next 2 assessment years	50% of profits and gains
Next 3 assessment years	Amount transferred to "Special Economic Zone Reinvestment Allowance Reserve Account" or 50% of profits and gains, whichever is lower.

- Under Section 10AA of the Act, newly established units in Special Economic Zones can claim tax exemption for a period of 15 years from the year it begins production.

Amount of deduction: The amount of deduction depends on the quantum of profit derived from export of articles or things or services (including computer software).

Amount of deduction = (Export turnover/Total turnover) x Profits of the business

Period of deduction

First 5 consecutive assessment years	100% of profits and gains
Next 5 assessment years	50% of profits and gains
Next 5 assessment years	50% of profits and gains provided the same amount is debited to P&L A/c and the same amount is transferred to "special economic zone reinvestment allowance reserve account"

- Under Section 10BA of the Act, a special deduction can be claimed in respect of profits derived by an undertaking from the export of artistic hand-made wooden articles. This deduction shall not be applicable to an undertaking availing deduction u/s. 10A or 10B.

Amount of deduction

Amount of deduction = (Export turnover/total turnover) x Profits of the business

Note: The benefit of this deduction is available to an undertaking only up to the A.Y. 2009-10.

Taxation of Exchange Gains or Losses

According to the Income Tax Act, an income becomes taxable if it is revenue in nature. Similarly, an expense becomes tax deductible if it is revenue in nature. As the Act does not contain any specific rules regarding taxation of exchange gains or losses, the same rule is used to decide the taxability of any particular gain or loss. There are quite a few decided cases also, which help in the process.

Double Taxation

One of the major factors acting as an impediment to international trade is the possibility of double taxation. The income earned by an entity in a foreign country may be taxed twice, once in the country in which it has been earned, and the second time in the country in which the entity is based. The effect of this double taxation is to reduce the after-tax income available to the entity, thus reducing the benefits of international trade. Let us see an example. Suppose a company based in New York undertakes and completes a project in France. It is eligible to receive \$10,000 for the project. This earning is, however, subject to a withholding tax @ 10 percent. (Withholding tax is the tax that an entity has to pay to a foreign government on incomes earned in that country.) Finally, the company's income is taxable @ 10 percent in the US. The after-tax income of the company from the project will be:

Pre-tax income	=	\$10,000
Withholding tax	=	\$ 1,000
Home tax payable	=	\$ 1,000
Post-tax income	=	<u>\$ 8,000</u>

This drawback of double-taxation is recognized the world over. Several countries have entered into bilateral treaties with other countries to overcome this problem. Under a bilateral treaty, two countries agree upon the scope of such international transactions which can be taxed in the respective countries. Sometimes, while the same income is still taxed in both the countries, under the bilateral treaty the taxes are split between the two countries in such a way that the total tax payable does not exceed the amount that would have been payable, had the income been taxable only in one country.

In the absence of a bilateral treaty between two countries, sometimes the country in which the business entity is domiciled extends a unilateral relief to the entity in the form of a tax credit. A tax credit is given by way of reduction in the tax payable by the entity on an international transaction by the amount it has paid as withholding taxes. For example, if the US were extending a tax credit to the business entity in the above example, its after-tax income would have been

Pre-tax income	=	\$10,000
Withholding tax	=	\$ 1,000
Home tax payable	=	Nil
Post-tax income	=	<u>\$ 9,000</u>

Thus, a tax credit results in the firm effectively paying only one tax – the domestic tax or the withholding tax, whichever is higher. To recall this was the tax rate that was used to evaluate a foreign project.

SUMMARY

- International accounting and taxation are very complex and extensive topics, due to the multiplicity of rules in different countries of the world.
- It is essential to understand the various implications properly before taking up any international activity. This may not be possible without the advice of experts in the respective fields.
- Yet, gaining the basic familiarity is essential to understand and follow the experts' advice, imparting which was the aim of this chapter.

Appendix 1
Accounting Standard (AS) 11*
(revised 2003)
The Effects of Changes in Foreign Exchange Rates

Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates (revised 2003), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard supersedes Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable.

The following is the text of the revised Accounting Standard.

Objective

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be translated into the enterprise's reporting currency.

The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.

Scope

1. This Statement should be applied:
 - a. In accounting for transactions in foreign currencies; and
 - b. In translating the financial statements of foreign operations.
2. This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.
3. This Statement does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Statement requires disclosure of the reason for using that currency. This Statement also requires disclosure of the reason for any change in the reporting currency.
4. This Statement does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.
5. This Statement does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, Cash Flow Statements).
6. This Statement does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see paragraph 4(e) of AS 16, Borrowing Costs).

* Source: www.icai.org

Definitions

7. The following terms are used in this Statement with the meanings specified:

Average rate is the mean of the exchange rates in force during a period.

Closing rate is the exchange rate at the balance sheet date.

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates. Exchange rate is the ratio for exchange of two currencies. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Foreign currency is a currency other than the reporting currency of an enterprise.

Foreign operation is a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

Forward exchange contract means an agreement to exchange different currencies at a forward rate.

Forward rate is the specified exchange rate for exchange of two currencies at a specified future date.

Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Net investment in a non-integral foreign operation is the reporting enterprise's share in the net assets of that operation.

Non-integral foreign operation is a foreign operation that is not an integral foreign operation.

Non-monetary items are assets and liabilities other than monetary items.

Reporting currency is the currency used in presenting the financial statements.

Foreign Currency Transactions

INITIAL RECOGNITION

8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:
 - a. buys or sells goods or services whose price is denominated in a foreign currency;
 - b. borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;
 - c. becomes a party to an unperformed forward exchange contract; or
 - d. otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.
9. A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.
10. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Reporting at Subsequent Balance Sheet Dates

11. At each balance sheet date:
 - a. foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date;
 - b. non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and
 - c. non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.
12. Cash, receivables, and payables are examples of monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items. The carrying amount of an item is determined in accordance with the relevant Accounting Standards. For example, certain assets may be measured at fair value or other similar valuation (e.g., net realisable value) or at historical cost. Whether the carrying amount is determined based on fair value or other similar valuation or at historical cost, the amounts so determined for foreign currency items are then reported in the reporting currency in accordance with this Statement. The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

Recognition of Exchange Differences

13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15.
14. An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Net Investment in a Non-integral Foreign Operation

15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a nonintegral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.
16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither

planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.

Financial Statements of Foreign Operations

CLASSIFICATION OF FOREIGN OPERATIONS

17. The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".
18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.
19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and nonmonetary items held by the non-integral foreign operation.
20. The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:
 - a. while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;
 - b. transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;
 - c. the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;
 - d. costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;
 - e. the foreign operation's sales are mainly in currencies other than the reporting currency;
 - f. cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;
 - g. sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

- h. there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a nonintegral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification.

Financial Statements of Foreign Operations

INTEGRAL FOREIGN OPERATIONS

21. The financial statements of an integral foreign operation should be translated using the principles and procedures in paragraphs 8 to 16 as if the transactions of the foreign operation had been those of the reporting enterprise itself.
22. The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate. An adjustment may be required to reduce the carrying amount of an asset in the financial statements of the reporting enterprise to its recoverable amount or net realisable value even when no such adjustment is necessary in the financial statements of the foreign operation. Alternatively, an adjustment in the financial statements of the foreign operation may need to be reversed in the financial statements of the reporting enterprise.
23. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Non-integral Foreign Operations

24. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:
 - a. the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;
 - b. income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and
 - c. all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.
25. For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate income and expense items of a foreign operation.

26. The translation of the financial statements of a non-integral foreign operation results in the recognition of exchange differences arising from:
- translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;
 - translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and
 - other changes to equity in the non-integral foreign operation.

These exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

27. Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate in accordance with paragraph 24.
28. A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.
29. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of Interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognised as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.
30. When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise. When it is impracticable to do this, AS 21, Consolidated Financial Statements, allows the use of financial statements drawn up to a different reporting date provided that the difference is no greater than six months and adjustments are made for the effects of any significant transactions or other events that occur between the different reporting dates. In such a case, the assets and liabilities of the non-integral foreign operation are translated at the exchange rate at the balance sheet date of the non-integral foreign operation and adjustments are made when appropriate for significant movements in exchange rates up to the balance sheet date of the reporting enterprises in accordance with AS 21. The same approach is used in applying the equity method to associates and in applying proportionate consolidation to joint ventures in accordance with AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures.

Disposal of a Non-integral Foreign Operation

31. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.
32. An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A writedown of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

Change in the Classification of a Foreign Operation

33. When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.
34. The consistency principle requires that foreign operation once classified as integral or non-integral is continued to be so classified. However, a change in the way in which a foreign operation is financed and operates in relation to the reporting enterprise may lead to a change in the classification of that foreign operation. When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

All Changes in Foreign Exchange Rates

TAX EFFECTS OF EXCHANGE DIFFERENCES

35. Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22, Accounting for Taxes on Income.

Forward Exchange Contracts

36. An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

8 See footnote 3.

37. The risks associated with changes in exchange rates may be mitigated by entering into forward exchange contracts. Any premium or discount arising at the inception of a forward exchange contract is accounted for separately from the exchange differences on the forward exchange contract. The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate at the date of the inception of the forward exchange contract and the forward rate specified in the contract. Exchange difference on a forward exchange contract is the difference between (a) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled during the reporting period, and (b) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date.
38. A gain or loss on a forward exchange contract to which paragraph 36 does not apply should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period. The premium or discount on the forward exchange contract is not recognised separately.
39. In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Disclosure

40. An enterprise should disclose:
 - a. the amount of exchange differences included in the net profit or loss for the period; and
 - b. net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.
41. When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.
42. When there is a change in the classification of a significant foreign operation, an enterprise should disclose:
 - a. the nature of the change in classification;
 - b. the reason for the change;
 - c. the impact of the change in classification on shareholders' funds; and
 - d. the impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.
43. The effect on foreign currency monetary items or on the financial statements of a foreign operation of a change in exchange rates occurring after the balance sheet date is disclosed in accordance with AS 4, Contingencies and Events Occurring After the Balance Sheet Date.
44. Disclosure is also encouraged of an enterprise's foreign currency risk management policy.

Appendix 2

Summary IAS 32

Financial Instruments: Disclosure and Presentation

This Standard is to be applied in presenting and disclosing information about all types of financial instruments, both recognized and unrecognized, other than:

- a. interests in subsidiaries (covered in IAS 27);
- b. interests in associates (covered in IAS 28);
- c. interests in joint ventures (covered in IAS 31);
- d. employers' and plans' obligations for post-employment benefits, including retirement benefits (covered in IAS 19 and IAS 26);
- e. employers' obligations under employee stock option and stock purchase plans (covered in refer IAS 19); and
- f. obligations arising under insurance contracts.

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise, and such classification reflects substance, not form. Although IAS 32 does not apply to an enterprise's interests in subsidiaries, it does apply to all financial instruments included in the consolidated financial statements of a parent, regardless of whether those instruments are held or issued by the parent or by a subsidiary. IAS 32 also applies to financial instruments held or issued by a joint venture and included in the financial statements of a venturer either directly or through proportionate consolidation. Enterprises that have obligations under insurance contracts are encouraged to consider the appropriateness of applying the provisions of the standard in presenting and disclosing information about such obligations.

The issuer of a financial instrument classifies the instrument, or its component parts, as a liability or as equity in accordance with the substance of the contractual arrangement on initial recognition and the definitions of a financial liability and an equity instrument. A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise; or to exchange financial instruments with another enterprise under conditions that are potentially unfavorable. Where the rights and obligations regarding the manner of settlement of a financial instrument depend on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder, the financial instrument is classified as a liability. Please note that mandatorily redeemable preferred stock is debt. An equity instrument is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities. Where the possibility of the issuer being required to settle in cash or another financial asset is remote at the time of issuance, the contingent settlement provision is ignored and the instrument is classified as equity. It follows that the issuer of a financial instrument that contains both a liability and an equity element classifies the instrument's component parts separately as stated above.

A financial asset and a financial liability are offset and the net amount reported in the balance sheet when an enterprise not only has a legally enforceable right to set off the recognised amounts but also intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. A financial asset is defined as any asset that is cash; or a contractual right to receive cash or another financial asset from another enterprise; or a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or an equity instrument of another enterprise. Split accounting is required for compound financial instruments such as convertible securities. When income and expense items are presented on a net basis, even though the

corresponding financial assets and financial liabilities on the balance sheet have not been offset, the reason for that presentation if the effect is significant is to be disclosed.

Interest, dividends, losses and gains relating to a financial instrument, or a component part, classified as a financial liability are reported in the income statement as income or expense. The cost of a financial liability (interest) is deducted in measuring net profit or loss of the enterprise. Distributions to holders of a financial instrument classified as an equity instrument are debited by the issuer directly to equity. The cost of equity financing (dividends) is a distribution of equity. Treasury shares are presented in the face of balance sheet or in the notes as a deduction from equity. The acquisition of treasury shares is presented in the financial statements as a change in equity. If the enterprise or any of its subsidiaries re-acquires its own shares from parties able to control or exercise significant influence over the enterprise, disclosure will be in accordance with IAS 24 giving the nature of the related party relationships; the types of transactions; and the elements of the transactions necessary for an understanding of the financial statements.

The standards do not prescribe either the format of the information required to be disclosed or its location within the financial statements. Disclosures may include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the instruments and their relative significance to the enterprise. Determination of the level of detail to be disclosed about particular financial instruments is a matter for judgment. The purpose of the disclosures required is to provide information that will enhance understanding of the significance of on-balance sheet and off-balance sheet financial instruments to an enterprise's financial position, performance and cash flows and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments. A discussion of management's policies for controlling the risks associated with financial instruments, including policies on matters such as hedging of risk exposures, avoidance of undue concentrations of risk and requirements for collateral to mitigate credit risks, provides a valuable additional perspective that is independent of the specific instruments outstanding at a particular time. With regard to recognized financial instruments, to the extent that the required information is presented on the face of the balance sheet, it is not necessary for it to be repeated in the notes. With regard to unrecognized financial instruments, however, information in notes or supplementary schedules is the primary means of disclosure.

Terms, Conditions and Accounting Policies

For each class of financial asset, financial liability and equity instrument, both recognised and unrecognised, an enterprise should disclose the information about the extent and nature of the financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows; and the accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied. When financial instruments held or issued by an enterprise, either individually or as a class, create a potentially significant exposure to the price, credit, liquidity and cash flow risks, the terms and conditions that may warrant disclosure include:

- a. the principal, stated, face or other similar amount which, for some derivative instruments, such as interest rate swaps, may be the amount (referred to as the notional amount) on which future payments are based;
- b. the date of maturity, expiry or execution;
- c. early settlement options held by either party to the instrument, including the period in which, or date at which, the options may be exercised and the exercise price or range of prices;

- d. options held by either party to the instrument to convert the instrument into, or exchange it for, another financial instrument or some other asset or liability, including the period in which, or date at which, the options may be exercised and the conversion or exchange ratio(s);
- e. the amount and timing of scheduled future cash receipts or payments of the principal amount of the instrument, including instalment repayments and any sinking fund or similar requirements;
- f. stated rate or amount of interest, dividend or other periodic return on principal and the timing of payments;
- g. collateral held, in the case of a financial asset, or pledged, in the case of a financial liability;
- h. in the case of an instrument for which cash flows are denominated in a currency other than the enterprise's reporting currency, the currency in which receipts or payments are required;
- i. in the case of an instrument that provides for an exchange, information described in items (a) to (h) for the instrument to be acquired in the exchange; and
- j. any condition of the instrument or an associated covenant that, if contravened, would significantly alter any of the other terms (for example, a maximum debt-to-equity ratio in a bond covenant that, if contravened, would make the full principal amount of the bond due and payable immediately).

When the balance sheet presentation of a financial instrument differs from its legal form, it is desirable to disclose the nature of the instrument in the notes. The accounting policies should disclose the criteria applied in determining when to recognize a financial instrument on the balance sheet and when to cease to recognize it; the basis of measurement applied to financial instruments on initial recognition and subsequently; and the basis on which income and expense arising from financial instruments is recognized and measured. Types of transactions for which it may be necessary to disclose the accounting policies include:

- a. transfers of financial assets when there is a continuing interest in, or involvement with, the assets by the transferor, such as securitizations of financial assets, repurchase agreements and reverse repurchase agreements;
- b. transfers of financial assets to a trust for the purpose of satisfying liabilities when they mature without the obligation of the transferor being discharged at the time of the transfer, such as an in-substance defeasance trust;
- c. acquisition or issue of separate financial instruments as part of a series of transactions designed to synthesize the effect of acquiring or issuing a single instrument;
- d. acquisition or issue of financial instruments as hedges of risk exposures; and
- e. acquisition or issue of monetary financial instruments bearing a stated interest rate that differs from the prevailing market rate at the date of issue.

For financial instruments carried on the cost basis, disclosure of the method of accounting for the following may be necessary:

- a. costs of acquisition or issue;
- b. premiums and discounts on monetary financial assets and financial liabilities;
- c. changes in the estimated amount of determinable future cash flows associated with a monetary financial instrument such as a bond indexed to a commodity price;
- d. changes in circumstances that result in significant uncertainty about the timely collection of all contractual amounts due from monetary financial assets;
- e. declines in the fair value of financial assets below their carrying amount; and
- f. restructured financial liabilities.

For financial instruments carried at fair value, disclose whether carrying amounts are determined from quoted market prices, independent appraisals, discounted cash flow analysis or another appropriate method, and any significant assumptions made in applying those methods. The basis for reporting realized and unrealized gains and losses, interest and other items of income and expense associated with financial assets and financial liabilities in the income statement, with the information about the basis on which income and expense arising from financial instruments held for hedging purposes are recognized, shall be disclosed.

Interest Rate Risk

For each class of financial asset and financial liability, both recognized and unrecognized, an enterprise should disclose information about exposure to interest rate risk, including contractual repricing or maturity dates, whichever dates are earlier; and effective interest rates, when applicable. The financial instruments are exposed to interest rate price risk, which are exposed to interest rate cash flow risk, and which are not exposed to interest rate risk, are to be indicated. The nature and extent of exposure to interest rate risks associated with financial assets removed from the balance sheet as a result of a transaction, such as securitization; and a transaction in which no financial asset or financial liability is recognized on the balance sheet, such as commitment to lend funds at a fixed interest rate are to be disclosed. In the event of securitization, the disclosure normally includes the nature of the assets transferred; their stated principal; the interest rate and term to maturity; and the terms of the transaction. In the case of a commitment to lend funds, the above disclosure normally includes the stated principal; the interest rate and term to maturity; and the significant terms of the transaction. Interest rate sensitivity information, i.e., information about an enterprise's exposure to interest rate risks by indicating the effect of a hypothetical change in the prevailing level of market interest rates on the fair value of its financial instruments and future earnings and cash flows, including the basis of preparation and any significant assumptions may be useful disclosure.

Information about interest rate risk may be presented in one or more of the following recommended ways:

- a. Carrying amounts of financial instruments exposed to interest rate risk are presented in tabular form, grouped by those that are contracted to mature or be repriced:
 - i. within one year of balance sheet date;
 - ii. more than one year and less than five years from balance sheet date; and
 - iii. five years or more from balance sheet date.
- b. When the performance of an enterprise is significantly affected by the level of its exposure to interest rate price risk or changes in that exposure (e.g. banks), more detailed information is desirable such as separate groupings of the carrying amounts of financial instruments contracted to mature or be repriced:
 - i. within one month of balance sheet date;
 - ii. more than one and less than three months from balance sheet date; and
 - iii. more than three and less than twelve months from balance sheet date.
- c. A table indicating the aggregate carrying amount of groups of floating rate financial assets and financial liabilities maturing within various future time periods.
- d. Disclosure of interest rate information for individual financial instruments or weighted average rates or a range of rates for each class of financial instrument.

Credit Risk

For each class of financial asset, both recognized and unrecognized, disclose information about exposure to credit risk, including the amount that best represents its maximum credit risk exposure at the balance sheet date, without taking account of the fair value of any collateral, in the event other parties fail to perform their obligations under financial instruments; and significant concentrations of credit risk. The information about the existence and the effect of legal rights of set-off is to be reported. Where an enterprise has entered into one or more master netting arrangements that serve to mitigate its exposure to credit loss but do not meet the criteria for offsetting, the terms of the master netting arrangements that determine the extent of the reduction in credit risk are to be disclosed.

The maximum loss that could be incurred in respect of unrecognized financial assets when it differs substantially from the principal or other similar contractual amount of the instrument is to be disclosed. Where a securitization transaction in which an enterprise remains exposed to credit risk associated with financial assets have been removed from its balance sheet, the nature of assets removed, the amount and timing of the future cash flows contractually due from the assets, the terms of the recourse obligation and the maximum loss that could arise under that obligation will have to be disclosed. Other disclosures will include concentrations of credit risk when they are not apparent from other disclosures about the nature and financial position of the business and they result in a significant exposure to loss in the event of default by other parties; a description of the shared characteristic that identifies each concentration and the amount of the maximum credit risk exposure associated with all recognized and unrecognized financial assets sharing that characteristic.

Fair Value

For each class of financial asset and financial liability, both recognized and unrecognized, information about fair value; or when it is not practicable within constraints of timeliness or cost to determine the fair value of a financial asset or financial liability with sufficient reliability, such fact with information about the principal characteristics of the underlying financial instrument that are pertinent to its fair value, and the method adopted to determine fair value and any significant assumptions made in its application, are to be disclosed. When disclosure of fair value information is omitted because it is not practicable to determine fair value with sufficient reliability, information is provided to assist users in making their own judgments about the extent of possible differences between the carrying amount of financial assets and financial liabilities and their fair value. In addition to the above, information is provided about the market for the instruments.

When an enterprise carries one or more financial assets at an amount in excess of their fair value, the disclosures will be:

- a. the carrying amount and the fair value of either the individual assets or appropriate groupings of those individual assets; and
- b. the reasons for not reducing the carrying amount, including the nature of the evidence that provides the basis for management's belief that the carrying amount will be recovered.

When an enterprise has accounted for a financial instrument as a hedge of risks associated with anticipated future transactions, the disclosures will be:

- a. a description of the anticipated transactions, including the period of time until they are expected to occur;
- b. a description of the hedging instruments; and
- c. the amount of any deferred or unrecognized gain or loss and the expected timing of recognition as income or expense.

All accrued gains and losses on financial instruments designated as hedges of anticipated future transactions have to be disclosed without regard to whether those gains and losses have been recognized in the financial statements.

Appendix 3

Summary of IAS 39

This standard titled '*Financial Instruments: Recognition and Measurement*' establishes principles for recognizing and measuring financial assets, financial liabilities and some contracts to buy and sell non-financial items.

The standard does not apply to

- i. interests in subsidiaries, associates, and joint ventures that are accounted for under IAS 27, IAS 28 and IAS 31;
- ii. rights and obligations under leases, to which IAS 17 applies; however the derivatives embedded in the leases, and lease receivables recognized on a lessor's balance sheet to which the provisions of derecognition applies, fall under the purview of this Standard;
- iii. employers' rights and obligations under employee benefit plans to which IAS 19 applies;
- iv. rights and obligations under insurance contracts as defined in IAS 32. However, financial guarantee contracts, even if such contracts meet the definition of insurance contract fall within the purview of this standard.
- v. equity instruments issued by the enterprise including options, warrants, and other financial instruments that are classified as shareholders' equity of the enterprise (the holder of such instruments is required to apply IAS 39 to those instruments);
- vi. contracts for contingent consideration in a business combination; and
- vii. contracts that require a payment based on climatic, geological, or other physical variables, but IAS 39 does apply to other types of derivatives that are embedded in such contracts.

However, the standard applies to loan commitments that the entity designates as financial liabilities at fair value through profit and loss account and also applies to commodity-based contracts that give either party the right to settle in cash or some other financial instrument, with the exception of commodity contracts that:

- a. were entered into and continue to meet the enterprise's expected purchase, sale, or usage requirements;
- b. were designated for that purpose at their inception; and (c) are expected to be settled by delivery.

Embedded Derivatives

An embedded derivative is separated from the host contract and accounted for as a derivative under this standard if all of the following conditions are met: (a) the economic characteristics and risks of the embedded derivative vis-à-vis its host contract are not closely related (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value reported in net profit or loss.

The separated host contract itself is accounted for: under this standard if it is, itself, a financial instrument; and in accordance with other appropriate IAS if it is not a financial instrument.

If an enterprise is required to separate an embedded derivative from its host contract but is unable to separately measure the embedded derivative either at acquisition or at a subsequent financial reporting date, the entire combined contract is treated as a financial instrument held for trading.

Recognition and Initial Measurement

All financial assets and financial liabilities are recognized on the balance sheet if and only if the enterprise becomes a party to the contractual provisions of the instrument. They are initially measured at its fair value. In case of financial asset or financial liability not at fair value through profit or loss, the transaction costs directly attributable to the acquisition or issue is also to be included. In this context, financial asset or financial liability at fair value through profit or loss is defined as a financial asset or liability that is either classified as held for trading or upon initial recognition; it is designated by the entity as at fair value through profit or loss.

A regular way purchase or sale of financial assets are to be recognized using either at trade date accounting or settlement date accounting. In this context, a *regular way purchase or sale* is defined as a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame. A trade date accounting refers to recognition of an asset to be received and the liability to pay for it on the trade date as against settlement date accounting which refers to recognizing the asset on the day it is received by the entity.

Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition, shall be continued to be recognized as an asset in its entirety and the entity shall recognize the financial liability for the consideration received.

Subsequent Measurement

Financial Assets including derivatives that are assets after their initial recognition shall be measured subsequently at their fair values (without deduction for transaction costs). However, loans and receivables, held-to-maturity investments as defined by the standard are measured subsequently at amortized cost using the effective interest method.

Financial Liabilities after their initial recognition shall be measured subsequently at amortized cost using effective interest method with the exception of financial liabilities at fair value through profit and loss which shall be measured at fair value.

In the case of financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition, in the subsequent periods, the entity shall recognize any income on the transferred asset and any expense incurred on the financial liability.

Derecognition of a Financial Asset

The removal of a previously recognized financial asset or financial liability from an entity's balance sheet is called derecognition. An entity shall derecognize a financial asset when either the contractual rights to the cash flows from the financial asset expire or when the entity transfers the financial asset and such transfer qualifies for derecognizing.

An asset is said to be transferred when either it results in transfer of contractual right to receive the cash flows of a financial asset or retains the contractual right to receive the cash flows but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement. However, a transfer of financial asset qualifies for derecognition only in the following circumstances.

- i. If the entity transfers substantially all the risks and rewards of the ownership of the financial asset.
- ii. Where the entity neither transfers nor retains substantially all the risks and rewards of ownership but has not retained control of the financial asset.

In the above circumstances the entity shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.

On derecognition of a financial asset in its entirety the difference between the carrying amount of the financial asset and the consideration received and the cumulative gain or loss that had been recognized directly in equity shall be recognized in profit and loss. Where however, the asset transferred is a part of a larger financial asset, which qualifies to be derecognized then the difference between the carrying amount (allocation based on fair value) of the part derecognized and the consideration received for the part derecognized and the cumulative gain or loss that is recognized directly in equity shall be recognized in profit and loss account.

A transfer of a financial asset does not qualify for derecognition, because the entity retains substantially all risks and rewards of ownership, shall be continued to be recognized as an asset in its entirety and the entity shall also recognize the financial liability for the consideration received. The associated financial asset and the liability shall not be offset. Similarly, the income from the transferred asset and the expenses in respect of associated liability cannot be offset.

Derecognition of a Financial Liability

An entity shall derecognize a financial liability from its Balance sheet when the liability is extinguished or the obligation is discharged, expires or cancelled. The exchange of a financial liability for another with substantial different terms or the substantial modification of the terms of an existing financial liability shall result in extinguishment of the original financial liability and the recognition of a new financial liability and accordingly accounted for.

If a new financial asset is created or a new financial liability is assumed in the course of transfer of the whole of a financial asset then such new financial asset/liability is recognized at fair value. The gain or loss resulting from the difference between the carrying amount of the financial asset extinguished and the consideration paid + non cash-assets transferred or liabilities assumed, in the transaction will be recognized in profit and loss account.

Reclassification

The intent behind the initial purchase of a financial asset will determine and designate the same as available for sale or held-to-maturity. If an enterprise intends to hold a financial asset for only a period that is not defined; or is prepared to dispose the financial asset due to changes in foreign currency risk or market rates of interest or in the availability of and the yield on alternative investments, or plain fund requirements, the positive intent to hold to maturity an investment in a financial asset with a fixed maturity is violated and hence an enterprise cannot classify the asset as held-to-maturity. If an enterprise lacks the resources to continue to finance the investment until maturity; or if its intention to hold the financial asset to maturity is not rendered possible due to an existing constraint, legal or otherwise, then the enterprise is deemed to be incapable of establishing its ability to hold to maturity an investment in a financial asset with a fixed maturity. The classification of an asset as held-to-maturity is also not permissible when the issuer has a right to settle the financial asset at an amount significantly below its amortised cost.

If, due to a change of intent or ability, it is no longer appropriate to carry a held-to-maturity investment at amortised cost; or on a reliable measure becoming available for a financial asset for which such a measure previously was not available, it is remeasured at fair value. On such remeasurement, a reclassification of a financial asset as held-for-trading is permitted only on the availability of adequate support of an actual pattern of short-term profit making in the immediate past. The difference between its carrying amount and fair value shall yield a gain or loss. A recognised gain or loss arising from a change in the fair value of a financial asset or financial liability held for trading, that is not part of a hedging relationship, is included in net profit or loss for the period in which it arises. A recognized gain or loss on an available-for-sale financial asset is either included in net profit or loss for the period in which it arises; or recognised directly in equity through the statement of changes in equity. But the cumulative gain or loss

previously recognised in equity shall be included in net profit or loss for the period when the financial asset is sold, collected, or otherwise disposed of, or on the impairment of the financial asset.

Hedging

Hedging, for accounting purposes, means designating a derivative or a non-derivative financial instrument as an offset in net profit or loss, in whole or in part, to the change in fair value or cash flows of a hedged item. Hedged items may include a non-financial asset or liability for the purposes of foreign currency risks. The difficulties involved in the recognition and measurement of the changes in cash flows/fair values directly associated with particular risks, excluding foreign currency risks, may make a non-financial asset/liability a hedged item for all risks. If a hedging relationship can be clearly defined, measured and is actually effective, then the Standard allows hedge accounting to be adopted under specified situations. Hedge accounting is permitted only if an enterprise designates a specific hedging instrument as a hedge of a change in fair value or cash flow of a specific hedged item, rather than as a hedge of an overall net balance sheet position. However, the approximate income statement effect of hedge accounting for an overall net position can be achieved, in some cases, by designating part of one of the underlying items as the hedged position.

The conditions for a hedging relationship to qualify for the specific hedge accounting mechanisms given by the Standard can be stated as follows:

- a. a formal documentation of the hedging relationship consisting of identification of the hedging instrument and the related hedged item or transaction; the nature of the risk being hedged; and the methods adopted by the enterprise to assess the hedging instrument's effectiveness in offsetting the exposure to changes in the fair value/cash flows of the hedged item that is attributable to the hedged risk, is to be present at the inception of the hedge with the purpose and strategy for undertaking the hedge;
- b. in consonance with the originally documented strategy for managing risk for that particular hedging relationship, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk;
- c. for cash flow hedges, an exposure to variations in cash flows that ultimately may impact the reported net profit or loss, with a high probability of the anticipated transactions forming the subject of the hedge;
- d. the fair value or cash flows of the hedged item and the fair value of the hedging instrument can be reliably measured; and
- e. the hedge was assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting period.

The three hedging relationships recognized in the Standard are discussed below: -

a. **Fair value hedge**

This can be defined as a hedge of the exposure to changes in the fair value of a recognised asset or liability, or an identified portion of such an asset or liability, that is attributable to a particular risk and that will affect reported net income. If the hedge proves to be effective fulfilling all the conditions necessary for establishing a valid hedging relationship, the gain or loss from remeasuring the hedging instrument at fair value is recognised immediately in net profit or loss of the period; and simultaneously the gain or loss on the hedged item attributable to the hedged risk adjusts the carrying amount of the hedged item and is recognised immediately in net profit or loss of the period. An adjustment to the carrying amount of a hedged interest-bearing financial instrument is amortised to net profit or loss, and is fully amortised by maturity. Such amortisation is to commence as soon as the adjustments for changes in the hedged item's fair value attributable to the risk being hedged ceases.

This treatment is applicable if the hedged item is measured either at cost, or at fair value with the corresponding changes directly recognized in equity. In the event of a sale, exercise, termination or expiration of a hedging instrument; or on the failure of the hedge to comply with the necessary conditions stipulated by the Standard for accounting for hedges to be operational, the hedge accounting is discontinued forthwith on a prospective basis. It is essential to note that an expiration/termination referred above does not include a replacement or a rollover of a hedging instrument provided they constitute the strategy for risk management documented by the enterprise.

b. Cash flow hedge

This can be defined as a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt), or a forecasted transaction (such as an anticipated purchase or sale) and that will affect the reported net profit or loss. A hedge of an unrecognised firm commitment to buy or sell an asset at a fixed price in the enterprise's reporting currency is accounted for as a cash flow hedge even though it has a fair value exposure.

If the hedge proves to be effective fulfilling all the conditions necessary for establishing a valid hedging relationship during the financial reporting period, then the gain or loss attributable to the effective portion of the hedging instrument is recognised directly in equity through the statement of changes in equity. As regards the balance portion of the hedging instrument determined as ineffective, the gain/loss is either recognized immediately in net profit or loss if the hedging instrument is a derivative. If the hedging instrument is not a derivative, then such gain or loss is either included in net profit or loss for the period in which it arises; or recognised directly in equity through the statement of changes in equity. The amount that was so recognised in equity during the current period and the amount that was removed from equity and reported in net profit or loss for the period are to be disclosed. For hedges of forecasted transactions that result in the recognition of an asset or liability by virtue of an anticipated operation or a hedged firm commitment, the gain or loss on the hedging instrument will adjust the carrying amount or cost of acquisition of the acquired asset or liability, and the associated gains/losses previously recognized in equity will be eliminated. The amount thus removed from equity and clubbed with the initial measurement of the acquisition cost or other carrying amount of the asset or liability in the current period will have to be reported. But if no asset/liability is recognized, as mentioned above, the associated gains/losses previously recognized in equity are to be considered in the net profit/loss of the period in which the anticipated transaction or hedged firm commitment influences the reported profit/loss.

As in the case of a fair value hedge, in the event of a sale, exercise, termination or expiration of a hedging instrument; or on the failure of the hedge to comply with the necessary conditions stipulated by the Standard for accounting for hedges to be operational, the hedge accounting is discontinued forthwith on a prospective basis. If such events lead to discontinuance, the related accumulated gain/loss initially directly recognized in equity while the hedge was effective remains separately in equity until the forecasted transaction actually takes place. After the transaction occurs, the treatment is similar to the treatment given for gains/losses arising during the recognition of an asset/liability resulting due to a forecasted transaction or a hedged firm commitment. It is essential to note that an expiration/termination referred above does not include a replacement or a rollover of a hedging instrument provided they constitute the strategy for risk management documented by the

enterprise. Discontinuance may result because of an unreasonably low probability of the incidence of a committed or a forecasted transaction. In such case, the net profit or loss for the period shall include the cumulative gain or loss earlier reported directly in equity.

c. **Hedges of a net investment in a foreign entity**

The broad provisions concerning a net investment in a foreign entity are discussed in IAS 21.

The accounting for the hedges of a net investment in a foreign entity is not different from that adopted for cash flow hedges. The gain or loss attributable to the effective portion of the hedging instrument is recognised directly in equity through the statement of changes in equity, and classified as a gain/loss arising on translation of foreign currency. As regards the balance portion of the hedging instrument determined as ineffective, the gain/loss is either recognized immediately in net profit or loss if the hedging instrument is a derivative. If the hedging instrument is not a derivative, then such exchange gain or loss arising on a foreign currency liability accounted for as a hedge of an enterprise's net investment in a foreign entity are classified as equity in the enterprise's financial statements until the disposal of the net investment. On disposal of a foreign entity, in the same period in which the gain or loss on disposal is recognized, the cumulative amount of the exchange differences which have been deferred and which relate to that foreign entity are recognised as income or expense.

Whether it be designated fair value hedges or cash flow hedges or hedges of a net investment in a foreign entity, the broad disclosures will include a description of the hedge and the financial instruments designated as hedging instruments for the hedge with their fair values at the balance sheet date, and the the nature of the risks being hedged. Additional disclosures will include a description of any forecasted transaction for which hedge accounting had previously been used but that is no longer expected to occur, the periods in which the forecasted transactions are expected to occur; and the time at which they shall be considered for the ascertainment of net profit/loss for the period.

Transition

The transition to this standard is as follows:

- a. a financial instrument is to be classified as equity or liability at the beginning of the financial year in which this standard becomes applicable for the first time;
- b. the financial statements that had followed recognition, derecognition, measurement and hedge accounting policies are not restated with corresponding reversals for periods prior to adopting this standard;
- c. as retrospective accounting changes (including securitisation & transfer) for conformity with the Standard or retrospective designation as hedges of earlier transactions are disallowed, the recognition, derecognition and measurement provisions should be applied prospectively in the case of transactions previously designated as hedges that had been entered into prior to the commencement of the financial year in which the Standard is first applied. Hedge accounting is not permissible if such hedges, that continue to be held, do not comply with the necessary conditions espoused earlier for an effective hedge;
- d. the criteria as given in the Standard has to be applied at the commencement of the financial year in which this standard is adopted for the first time for the purpose of identifying which financial assets/liabilities should be measured at amortised cost and which is to be remeasured at fair value, with the related adjustments being recognized in the balance of retained earnings at the beginning of the financial year in which this standard is initially applied;

- e. on first application of the Standard, all derivatives, excepting a derivative which is to be settled by delivery of an unquoted equity instrument whose fair value defies a reliable measurement, in its balance sheet are to be recognized as either assets or liabilities and measured at fair value. The adjustments to bring derivatives and other financial assets and liabilities onto the balance sheet and adjustments to remeasure certain financial assets and liabilities from cost to fair value will be made by directly adjusting retained earnings directly at the beginning of the financial year in which this standard is initially applied;
- f. the balance sheet positions in fair value hedges of existing assets and liabilities are accounted for by adjusting their carrying amounts to reflect the fair value of the hedging instrument at the beginning of the financial year in which the Standard is initially applied;
- g. if the conditions for the existence of a hedging relationship are fulfilled, the deferred gains and losses are reclassified as distinct constituent of equity when the accounting policies for hedges before the application of this Standard included deferral of gains or losses on cash flow hedges at the beginning of the financial year in which the Standard is adopted initially;

The disclosures in the financial statements include:

The significant items of income, expense, and gains and losses resulting from financial assets and financial liabilities are disclosed, whether included in net profit or loss or as a separate component of equity. Interest income/expense with the distinctions, and the interest accrued but not received on impaired loans will be disclosed.

If the enterprise has entered into a securitisation or repurchase agreement, the derecognition of any financial assets, and the nature and extent of such transactions are to be disclosed distinguishing those incident in the current period and those retained interests pertaining to prior periods. A description of any collateral and other statistical data regarding the assumptions taken into account for computing fresh and retained interests are also to be appended to the disclosures.

Appendix 4

FAS 133

Accounting for Derivative Instruments and Hedging Activities

Introduction

This statement lays down the rules for accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value.

Before this statement, hedging activities relating to changes in foreign exchange rates were discussed in FASB Statement No. 52 and accounting for various hedging activities were discussed in Emerging Issues Task Force (EITF)

This standard is developed based on the following four fundamental.

- a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.
- b. Fair value is the most relevant measure for financial instruments and derivative instruments should be measured at fair value. Any adjustments to the carrying amount of hedge items should reflect changes in their value that are attributable to the risk being hedged and that arise while the hedge is in effect.
- c. Only items that are assets or liabilities should be reported as such in financial statements.
- d. Special accounting for items designated, as being hedged should be provided only for qualifying items.

If certain conditions are satisfied, an entity may elect to designate a derivative instrument as a fair value hedge or a cash flow hedge or a foreign currency hedge.

Fair Value Hedge

An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk. An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following conditions are satisfied.

- a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.
- b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated.
- c. If a written option is designated as hedging a recognised asset or liability, the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favourable change in the fair value of the combined instruments as exposure to losses from an unfavourable change in their combined fair value.
- d. The hedged item is specifically identified as either all or a specific portion of a recognised asset or liability or of an unrecognized firm commitment.
- e. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings.

- f. The hedged item is not
 - i. An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings
 - ii. An investment accounted for/by the equity method
 - iii. An equity investment in a consolidated subsidiary
 - iv. A firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary, a minority interest, or an equity method investee
 - v. An equity instrument issued by the entity and classified in stockholder's equity in the statement of financial position
- g. If the hedged item is all or a portion of a debt security that is classified as a held-to-maturity, the designated risk being hedged is the risk of changes in its fair value attributable to changes in the obligor's creditworthiness or if the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component.
- h. If the hedged items is a non financial asset or liability, the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability.
- i. If the hedged item is a financial asset or liability, the designated risk being hedged is
 - i. The risk of changes in the overall fair value of the entire hedged item
 - ii. The risk of changes in its fair value attributable to changes in market interest rates
 - iii. The risk of changes in its fair value attributable to change in the related foreign currency exchange rates, or
 - iv. The risk of changes in its fair value attributable to changes in the obligor's creditworthiness.

Cash Flow Hedges

An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognised asset or liability or a forecasted transaction. Designated hedging instruments and hedged items or transactions qualify for cash flow hedge accounting if all of the following conditions are satisfied.

- i. At inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.
- ii. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedge risk during the term of the hedge, except as indicated in (d) below.
- iii. If a written option is designated as hedging the variability in cash flows for a recognised asset or liability, the combination of the hedged item and the written option provides at least as much potential for favourable cash flows as exposure to unfavourable cash flows.
- iv. If a hedging instrument is used to modify the interest receipts or payments associated with a recognised financial asset or liability from one variable rate to another variable rate, the hedging instrument must be a link between an existing designated asset with variable cash flows and an existing designated liability with variable cash flows and be highly effective at achieving offsetting cash flows.

A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following conditions are satisfied.

- a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions.
- b. The occurrence of the forecasted transaction is probable.
- c. The forecasted transactions a transaction with a party external to the reporting entity and presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.
- d. The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.
- e. If the variable cash flows of the forecasted transaction relate to a debt security, the risk being hedged is the risk of changes in its cash flows attributable to default or changes in the obligor's creditworthiness. For those variable cash flows, the risk being hedged cannot be the risk of changes in its cash flows attributable to changes in market interest rates.
- f. The forecasted transaction does not involve a business combination.
- g. If the hedged transaction is the forecasted purchase or sale of a non-financial asset, the designated risk being hedged is
 - i. The risk of changes in the functional currency equivalent cash flows attributable to changes in the related foreign currency exchange rates.
 - ii. The risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset, not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient.
- h. If the hedged transactions is the forecasted purchase of sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is
 - i. The risk of changes in the cash flows of the entire asset or liability.
 - ii. The risk of changes in its cash flows attributable to changes in market interest rates.
 - iii. The risk of changes in the functional currency equivalent cash flows attributable to changes in the related foreign currency exchange rates.
 - iv. The risk of changes in its cash flows attributable to default or changes in the obligor's creditworthiness.

Foreign Currency Hedges

Foreign currency hedge is a hedge of the foreign currency exposure of

- i. An unrecognized firm commitment (a foreign currency fair value hedge)
- ii. An available for sale security (a foreign currency fair value hedge)
- iii. A forecasted transaction (a foreign currency cash flow hedge)
- iv. A net investment in a foreign operation.

Foreign Currency Fair Value Hedges

UNRECOGNIZED FIRM COMMITMENT

A derivative instrument or a non-derivative financial instrument that may give rise to a foreign currency transaction gain or loss is referred as unrecognized firm commitment. This type of hedge should satisfy the conditions relating to fair value hedge.

AVAILABLE FOR SALE SECURITY

A non-derivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale security. A derivative instrument can be designated as hedging the changes in the fair value of an available-for-sale debt security attributable to changes in foreign currency exchange rates. This type of hedge should satisfy the conditions relating to fair value hedge.

Foreign Currency Cash Flow Hedges

A non-derivative financial instrument shall not be designated as a hedging instrument in a foreign currency cash flow hedge. A derivative instrument designated as hedging the foreign currency exposure to variability in the functional currency equivalent cash flows associated with either a forecasted foreign currency denominated transaction or a forecasted inter company foreign-currency denominated transaction qualifies for hedge accounting if the following conditions are satisfied.

- a. The operating unit that has the foreign currency exposure is a party to the hedging instrument.
- b. The hedged transaction is denominated in a currency other than that unit's functional currency.
- c. All of the conditions mentioned in cash flow hedges should satisfy.

If the hedged transaction is a group of individual forecasted foreign currency denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

A Net Investment in Foreign Operation

A derivative instrument or a non-derivative financial instrument that may give rise to a foreign currency transaction gain or loss under statement 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation.

Embedded Derivative Instrument

Contracts that do not in their entirety meet the definition of a derivative instrument such as bonds, insurance policies, and leases, may contain "embedded" derivative instruments – implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this statement if and only if all of the following are satisfied.

- a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The contract that embodies both the embedded derivative instrument and the host contract are not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative instrument would be a derivative instrument subject to the requirements of this statement.

Recognition and Measurement of Derivatives and Hedged Items

An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. All derivatives instruments shall be measured at fair value. If expected future cash flows are used to estimate fair value, those expected cash flows should be the best estimate based on reasonable and supportable assumptions and projections. The accounting for changes in the fair value (i.e., gains or losses) of a derivative depends on whether it has been designated and qualifies as a part of a hedging relationship and if so, on the reason for holding it. The proportion must be expressed as a percentage of the entire derivative so that the profile of risk exposures in the hedging portion of the derivative is the same as that in the entire derivative.

Accounting for Gains and Losses on Derivative Instruments

NO HEDGING DESIGNATION

The gain or loss on a derivative instrument not designated, as hedging instrument shall be recognised currently in earnings.

FAIR VALUE HEDGE

The gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on hedged item attributable to the hedged risk shall be recognised currently in earnings in the same periods in the manner specified below:

- a. The gain or loss on the hedging instrument shall be recognised currently in earnings.
- b. The gain or loss on account of the change in fair value on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised currently in earnings.
- c. If a hedge item is otherwise measured at fair value with changes in fair value reported in other comprehensive income, the adjustment of the hedged items carrying amount shall be recognised in earnings rather than in other comprehensive income.

CASH FLOW HEDGE

The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings as specified in the following manner.

- a. The gain or loss on the hedging instrument shall be recognised currently in earnings.
- b. Amounts in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the hedged forecasted transactions affects earnings.

FOREIGN CURRENCY HEDGE

The gain or loss on a derivative instrument or non-derivative financial instrument designated and qualifying as a foreign currency hedging instrument shall be accounted for as follows

- a. The gain or loss on the hedging derivative or non-derivative instrument in a hedge of a foreign-currency-denominated firm commitment and the offsetting loss or gain on the hedged firm commitment shall be recognised currently in earnings in the same accounting period as the manner specified for fair value hedges.

- b. The gain or loss on the hedging derivative instrument in a hedge of an available-for-sale security and the offsetting loss or gain on the hedged available-for-sale security shall be recognised currently in earnings in the same accounting period, as the manner specified for fair value hedges.
- c. The effective portion of the gain or loss on the hedging derivative instrument in a hedge of a forecasted foreign currency denominated transaction shall be reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as the manner specified for cash flow hedges.
- d. The gain or loss on the hedging derivative or non-derivative instrument in a hedge of a net investment in a foreign operation shall be reported in other comprehensive income.

Disclosures

An entity that holds or issues derivative instruments shall disclose its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. The description shall distinguish between different types of derivative instruments. The description shall also indicate the entity's risk management policy for each of those types of hedges.

SCOPE

This statement applies to all entities. An entity that does not report earnings as a separate caption in a statement of financial performance shall recognize the gain or loss on a hedging instrument and non-hedging derivative instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In that case the net investment in a foreign operation shall be reported in the same manner as a translations adjustment to the extent it is effective as a hedge.

This standard defines certain terms like derivative instruments, underlying, notional amount and payment provisions, initial net investment and net settlement. However, certain contracts like "Regular Way" securities trades, normal purchases and normal sales, certain insurance contracts like traditional life insurance, certain financial guarantee contracts, certain contracts that are not traded on an exchange and derivatives that serves as impediments to sales accounting are not subject to the requirements of this statement.

EFFECTIVE DATE

This statement shall effective for all fiscal quarters of all fiscal years beginning after June 15, 1999. This statement shall not be applied retroactively to financial statements of prior periods.

Section II: International Trade

Chapter I

Trade Blocks

After reading this chapter, you will be conversant with:

- World Trade Organization (WTO)
- International Cartels
- Organization of Petroleum Exporting Countries (OPEC)
- Multinational and Bilateral Treaties
- General Agreement for Tariffs and Trade (GATT)
- European Community (EC)
- North American Free Trade Area (NAFTA)
- United Nations Conference on Trade and Development (UNCTAD)
- US-Russia Bilateral Investment Treaty
- Trade, Aid and Development

The post-second World War period has seen a growing interest in integrating national economies at regional levels. The efforts to form regional groupings, trade blocks and treaties have often floundered due to political differences and unforeseen economic hurdles. The motivation arises out of the realization of the limitations imposed by national frontiers and the expected benefits of a wider market, consisting of several national economies. This resulted increased trade, investment and economic efficiency.

We begin the chapter by discussing about world trade organization which was created to replace the GATT. The WTO is working on the lines of GATT by limiting harmful trade practices.

WORLD TRADE ORGANIZATION (WTO)

The WTO, which began its operations in 1995, is a successor of GATT. The GATT was a forum where the member countries met from time to time to discuss and solve world trade problems. The WTO differs from GATT in the sense that it is a chartered trade organization. The WTO has a legal status and enjoys privileges/immunities on the same footing as the IMF and the World Bank. 76 Governments became members of the WTO on its first day. The membership of WTO increased to 148 by February 2005. India is one of the founder members of WTO. The WTO is based in Geneva, Switzerland. Its main functions are

Administering and implementing the multilateral and plurilateral trade agreements.

- To limit harmful trade practices.
- Acting as a forum for multilateral trade negotiations.
- Cooperating with other international institutes involved in global policy-making.
- Overseeing national trade policies.
- To administer the understanding on rules and procedures governing the settlement of disputes (Dispute Settlement Understanding (DSO)).

Structure of WTO

The structure of the WTO is headed by the Ministerial conference which meets at least once every two years. The Ministerial conference works towards greater coherence in economic policy making at the global level. The Ministerial conference is the supreme authority of the WTO and it takes decisions on all matters under any of the Multilateral Trade Agreements. There is a General Council composed of representatives of all the members to oversee the operations of the WTO Agreement and ministerial decisions on a regular basis. It also acts as a Dispute Settlement Body (DSB) and a Trade Policy Review Body (TPRB), each having its own chairman. There is a council for Trade in Goods, the council for Trade in Services and the council for Trade Related Aspects of Intellectual Property Rights (TRIPs). These councils are headed by the General Council and they can have their subsidiary bodies. The secretariat of the WTO is headed by the Director General, who is appointed by the ministerial conference.

WTO Agreement

The Agreement establishing the WTO consists of the following which embody the results of the Uruguay Round of the Multilateral Trade Negotiations.

MULTILATERAL AGREEMENT ON TRADE IN GOODS

From 1947 to 1994, GATT was the forum for negotiating lower custom duty rates and other trade barriers. The various agreements dealing with different aspects related to trade in goods are:

1. Understanding on Balance of Payment Provisions of GATT

The members imposing restrictions for correcting balance of payment deficits should give preference to price based measures. The various price-based

measures can be import surcharges, import deposits or measures which affect the price of imported goods.

2. **Agreement on Agriculture**

The Agreement on agriculture seeks to open national markets to international competition by replacing non-tariff measures with normal customs duties. The agreement also seeks to check overproduction by progressively reducing government aids. Moreover, it seeks new disciplines on reduction in subsidies along with the volume of subsidized exports. The Agreement on Agriculture relates to the following:

- i. *Domestic Subsidies:* Domestic subsidies fall into two categories viz. the non-product specific subsidies (given for all crops) and product specific subsidies (given for specific crops) for the purpose of calculating total subsidies, both types of subsidies mentioned above must be totaled. The total subsidies should not exceed 10% of the value of total agricultural production in that year.
- ii. *Export Subsidies:* WTO members are required to reduce the value of direct export subsidies to a level of 36% below the 1986-90 base period level and their quantity by 21% over the same period. In developing countries, the reductions are 2/3rds those of developed countries over a ten-year period and there are no reductions for least developed countries.
- iii. *Sanitary and Phytosanitary Measures:* These concern food safety, and animal and plant health measures. The agreement lays down procedures and criteria for the assessment of risk and determination of appropriate levels of phytosanitary or sanitary protection.

3. **Agreement on Textiles and Clothing**

The objective of this agreement is to secure the integration of the textiles and clothing sector into the GATT 1994. The integration would take place in four phases. In the first phase, each party from the specific list which accounted for not less than 16% of its total volume of imports in 1990 would be integrated into the GATT products. In the second phase, products which accounted for not less than 17% of 1990 imports would be integrated. In the third phase, beginning 1st January, 2002, products which accounted for not less than 18% would be integrated. All remaining products would be integrated at the end on 1st January, 2005 in the fourth phase. Integration means that trade in tops and yarns, made-up textile products, fabrics and clothing will be governed by the rules of GATT. As a part of integration process, all member countries should take actions to improve market access and ensure the application of policies relating to fair and equitable trading conditions.

4. **Agreement on Trade Related Aspects of Investment Measures (TRIMs)**

TRIMs calls for the removal of all trade related investment measures within a period of five years. TRIMs requires foreign investment companies to be treated at par with national companies. The Agreement recognizes that certain investment measures restrict and distort trade. Thus, it requires mandatory notification of all non-confirming TRIMs and their removal within two years for developed countries, five years for developing countries and seven years for least developed countries. The WTO has established a committee on TRIMs which will monitor the implementation of these commitments and report to the council of trade in goods annually.

The Multinational Agreement on trade in goods has strengthened various rules and disciplines. The most important of these relate to anti-dumping, subsidies and countervailing measures, safeguards and dispute settlement. Rules concerning dispute settlement have been made time bound, automotive and judicial in approach.

GENERAL AGREEMENT ON TRADE IN SERVICES

The General Agreement on Trade in Services (GATS) is the first multilateral agreement to provide legally enforceable rights to trade in all services. It has a built-in commitment to continuous liberalization through periodic negotiations. And it is the world's first multilateral agreement on investment, since it covers not just cross-border trade but every possible means of supplying a service, including the right to set up a commercial presence in the export market.

The GATS has three basic principles: First it covers all services except those provided in the exercise of governmental authority; second, there should be no discrimination in favor of national providers – the national treatment principle; and third, there should be no discrimination between other members of the agreement – the Most Favored Nation (MFN) principle. These are very powerful principles. No tariff or other generalized protection mechanism is applied in services, but the agreement does provide for important exceptions. First, governments can choose the services in which they make market access and national treatment commitments; second, they can limit the degree of market access they provide; and third, they can take exceptions even from the MFN obligation, in principle only for ten years, in order to give more favorable treatment to some countries than to WTO Members in general.

1. Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs)

The TRIPs Agreement covers seven categories of intellectual property. They are

- i. *Copyright and Related Rights*: The rights of authors of literary and artistic works (such as books and other writings, musical compositions, paintings, sculpture, computer programs and films) are protected by copyright, for a minimum period of 50 years after the death of the author. Also protected through copyright and related (sometimes referred to as “neighboring”) rights are the rights of performers (example: Actors, singers and musicians), producers of phonograms (sound recordings) and broadcasting organizations. The main social purpose of protection of copyright and related rights is to encourage and reward creative work.
- ii. *Trademarks*: Any sign, or combination of signs, capable of distinguishing the goods or services of one undertaking from those of other undertakings constitute a trademark. The owner of a registered trademark has the executive right to prevent third parties from using identical or similar signs for goods or services. The protection of trademarks stimulate and ensure fair competition. The protection may last indefinitely, provided the sign in question continues to be distinctive.
- iii. *Geographical Indications*: This refers to the identity of a good originating in the territory of a member/region/locality where a given quality or reputation is essentially attributed to its geographical origin. Members are required to provide the legal means for interested parties to prevent the use of any indication which misleads the consumer as to the origin of goods.
- iv. *Industrial Designs*: Industrial designs are protected for a period of 10 years. The social purpose is to provide protection for the results of investment in the development of new technology, thus giving the incentive and means to finance research and development activities.
- v. *Patents*: Patents are given for inventions (whether products or processes), in all fields of technology. The invention should be new and capable of industrial application. The patent owners can transfer the patent rights to conclude licensing contracts. The protection for patents is given for a period of 20 years.

- vi *Integrated Circuits*: The Agreement provides protection to layout designs/topographics of integrated circuits for a period of ten years. The protection shall lapse 15 years after creation of the layout design.
- vii. *Trade Secrets*: Trade secrets having commercial value shall be protected against breach of confidence. The test data submitted to governments (in order to obtain marketing approval for pharmaceuticals and agricultural chemicals) shall be protected against unfair commercial use.

Thus, it can be noted that the intellectual property rights are the rights given to persons over the creations of their minds. They give the creator an exclusive right over the use of his/her creation for a certain period of time.

2. **Dispute Settlement System**

The WTO's procedure for resolving trade quarrels under the Dispute Settlement Understanding is vital for enforcing the rules and therefore for ensuring that trade flows smoothly. Countries bring disputes to the WTO if they think their rights under the agreements are being infringed. Judgements by specially appointed independent experts are based on interpretations of the agreements and individual countries' commitments.

The system encourages countries to settle their differences through consultation. Failing that, they can follow a carefully mapped out, stage-by-stage procedure that includes the possibility of a ruling by a panel of experts, and the chance to appeal the ruling on legal grounds. Confidence in the system is borne out by the number of cases brought to the WTO — 167 cases by March 1999 compared to some 300 disputes dealt with during the entire life of GATT (1947–94).

3. **Plurilateral Trade Agreement (PTA)**

The Plurilateral Trade Agreement consists of the following:

- Agreement on Trade in Civil Aircraft
- Agreement on Government Procurement
- International Dairy Agreement
- International Bovine Meat Agreement.

The first agreement was done at Geneva in April 1979. It was subsequently modified, amended and rectified. The latter three agreements were done at Marrakesh on 15 April, 1994.

The WTO is a watchdog of international trade. It regularly examines the trade regimes of individual members. The WTO is also a management consultant for world trade. Its economists keep a close watch on the pulse of the global economy. It is a system that promotes fair and undistorted competition. The rules on non-discrimination are designed to secure fair conditions of trade. WTO encourages development and economic reforms as three-quarters of its members are developing countries and countries in the process of economic reform. Thus, it can be said that WTO has helped in creating a strong and prosperous trading system contributing to unprecedented growth.

INTERNATIONAL CARTELS

The formation of an international cartel means that government or private corporations located in various countries, agree to effectively restrict competition among themselves in an effort to exploit their joint monopoly power. An example of an international cartel is Organization of Petroleum Exporting Countries (OPEC).

The formation of an international cartel is an attempt to reap greater profits by acting as a single profit maximizing monopolist, in this, the cartel members as a group agree to supply (or export) to the rest of the world alternative quantities of

the cartelized commodity (such as oil) at alternative prices. The conditions necessary for a successful cartel are

1. The elasticity of demand for imports by the rest of the world must be low in the relevant price range.
2. The cartel members must adhere to the official set of policies voted by the cartel members.

The first condition is actually a combination of following three conditions.

- The elasticity of demand for total consumption by the rest of the world must be low.
- The cartel must control a very large share of the world market for the cartelized commodity.
- The elasticity of supply of the cartelized commodity by the rest of world must be low.

An international cartel can maintain a high monopoly price if individual cartel members do not selfishly attempt to capture more profits for themselves by behaving competitively. This point can be illustrated with the story of a dog. A dog had stolen a piece of meat and was crossing a river on his way home when he saw his own shadow reflected in the stream below. Thinking that it was another dog with a larger piece of meat, he snapped at the supposed treasure. In the process, he dropped the bone he was carrying and so lost all.

In an international cartel, each cartel member faces such a temptation because at the monopoly equilibrium, the marginal cost is much lower than the price. Each individual cartel member has the illusion that it can increase its own profits by raising its own output. When greedy cartel members behave in this manner, the cartel is not in a position to effectively restrict output and raise the price. This is the most important reason for the eventual collapse of a cartel. Thus, the member countries in the cartel must work in unison for the success of that cartel.

ORGANIZATION OF PETROLEUM EXPORTING COUNTRIES (OPEC)

The Organization of the Petroleum Exporting Countries is a permanent intergovernmental Organization, created at the Baghdad conferences of September 10-14, 1960. OPEC was created by Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. OPEC is dedicated to the stability and prosperity of the petroleum market as enshrined by the OPEC statute. Its membership is open to any country which is a substantial net exporter of oil and which shares the ideas of the organization. The five founding members of OPEC were later joined by eight other members i.e.,

- Qatar in 1961
- Indonesia in 1962
- Socialist People Libyan Arab Jamahiriya in 1962
- United Arab Emirates in 1967
- Algeria in 1969
- Nigeria in 1971
- Ecuador in 1973
- Gabon in 1975.

At present, OPEC has 11 countries as members. Ecuador and Gabon ceased to be its members in 1992 and 1994 respectively. The headquarters of OPEC was at Geneva, Switzerland. But it was shifted to Vienna, Austria on 1st September, 1965. The OPEC member countries currently supply more than 40% of the world's oil and they possess about 78% of the world's total proven crude oil reserves. The member countries of OPEC coordinate their oil production policies in order to help oil producers achieve a reasonable rate of return on their investments. The policy is also designed to ensure that oil consumers continue to receive stable supplies of oil.

The ministers of OPEC meet twice a year to review the status of the international oil market. They also review the future forecasts in order to agree upon appropriate actions which will promote stability in the oil market. The member countries also

conduct meetings and establish committees in order to address environmental affairs. OPEC also conducts research into energy studies, energy finance, economics and technology. It conducts regular meetings to set production quotas and discuss oil prices. Table 1 illustrates the crude oil reserves and the gas reserves of the member countries of OPEC.

Table 1

Country	Crude Reserve (In Thousand Million Tonnes)	Gas Reserve (Trillion Cubic Meters)
Saudi Arabia	35.5	5.3
Iraq	13.4	3.1
Kuwait	13.3	1.5
United Arab Emirates	12.9	6.0
Iran	12.7	20.7
Venezuela	9.1	3.2
Libya	3.0	1.3
Nigeria	2.4	3.4
Algeria	1.2	3.6
Indonesia	0.8	1.8
Qatar	0.5	7.1

The objectives of OPEC are as follows:

- To coordinate and unify petroleum policies among member countries in order to secure fair and stable prices for petroleum producers.
- To provide efficient, economic and regular supply of petroleum to consuming nations
- To provide a fair return of capital to those investing in the industry.

Functioning of OPEC

OPEC provides statistical data of its member countries it can be found in its publications. OPEC publications include:

- OPEC Bulletin (monthly)
- OPEC Review (quarterly)
- Annual Report
- Annual Statistical Review.

Its loan commitments to date exceed \$3.4 billion. OPEC also provides financial assistance to developing countries through its OPEC fund for International Development. This agency was formed in 1976 by OPEC member countries to assist developing states through financial cooperation and funding of projects.

Initially, OPEC functioned quietly. But the serenity of the world oil markets was shattered in 1973 by the Arab-Israeli “Yom Kippur War.” In a few months’ time, the OPEC quadrupled the dollar price of crude oil, from US\$ 2.59 to US\$ 11.65 a barrel. The oil-exporting countries became rich almost overnight and the industrial oil-consuming countries sank into their deepest depression since the 1930s. The “economic miracles” of superfast growth in oil hungry Japan and Brazil slowed down.

The second “oil shock” i.e., the second wave of OPEC price hikes was in 1979-80. During this period, there was Iranian revolution and the Iranian oil exports (about one fifth of all OPEC exports) disappeared completely and the price of oil took another upward bound. The upward trend was further enhanced by the Iran-Iraq war, which caused yet another reduction in oil exports. By 1981, Saudi Arabia Light crude oil was priced at US\$ 32 a barrel.

MULTINATIONAL AND BILATERAL TREATIES

A bilateral treaty is a written agreement concluded between two parties usually referring to matters of peace, aviation and trade. For example, the United States has signed over 130 treaties of Friendship, Commerce and Navigation (FCN)

since the eighteenth century. The FCN treaties deal with the rights of citizens of two countries to trade and invest in the foreign country. These generally guarantee non-discriminatory treatment on a reciprocal basis. The United States also enter into bilateral tax treaties with other industrial nations.

Treaties also deal with many other commercial issues. For example, the United States and Britain have signed a treaty aimed at increasing cooperation to regulate the global markets in commodities and securities. Both, Britain and US are planning to negotiate treaties with other interested countries.

A multinational treaty is an agreement between more than two parties (many countries). The multilateral treaties also play an important role. For example, the GATT agreement established rules of conduct in international trade and provided for a resolution process for trade disputes. Regional cooperation and economic integration are generally based upon a multilateral treaty. For example, the treaty of Rome in case of the European community (EC).

The various multilateral and bilateral treaties are discussed below.

General Agreement for Tariffs and Trade (GATT)

GATT was a multilateral treaty that came into force in January 1948. Its basic aim was to lay down rules for conducting international trade. GATT also provided a forum in which countries could discuss their trade problems and thus enhance their international trading opportunities.

Trade Negotiations Under the GATT

Eight major trade negotiations took place under the GATT auspices. They are

- The first round in 1947 (Geneva) – This round saw the creation of GATT.
- The second round in 1949 (Annecy, France) – The principal emphasis of this round was tariff reduction.
- The third round in 1951 (Torkquay, England) – The tariff reduction negotiations were continued in this round.
- The fourth round in 1956 (Geneva).
- The fifth round in 1960-61 (Geneva, Dillon Round).
- The sixth round in 1964-67 (Geneva, Kennedy Round).
- The seventh round in 1973-79 (Geneva, Tokyo Round).
- The light round in 1986-94 (Uruguay Round).

The fourth, fifth, sixth and seventh rounds involved revision of GATT rules and the addition of more countries. The talks of the uruguay round were the most ambitious and complex so far. The negotiations covered new areas such as Trade Related Intellectual Property Rights (TRIPs), Trade Related Investment Measures (TRIMs) and Trade in Services and Agriculture.

The estimates made by World Bank, OECD and the GATT secretariat show that the income effects of the implementation of the Uruguay Round package will add between 213 and 274 billion US dollar annually to the world income. The largest resources will be in the areas of clothing (60%); agriculture, forestry and fishery products (20%) and processed food and beverages (19%).

The important aspects of market access in the Uruguay Round relate to the following.

- *Tariffs*: The industrial tariffs were reduced and bound at very low levels (an average of 5%). The developing countries have also been reducing their tariffs. The tariff reductions were to be carried out in six equated annual installments from March 1, 1995.
- *Textiles and Clothing*: A major achievement in their area has been the commitment to integrate this sector into a multilateral framework. The ten-year transition period in the textiles agreement will enable countries to devise policies and allow strategic reaction on the part of the industry, in order to reap the greatest benefits from the integration.
- *Agriculture*: On agricultural tariffs, developing countries have the flexibility of indicating maximum ceiling bindings. India had indicated ceiling bindings

of 100% on primary products, 150% on processed products and 300% on edible oils. The final act classifies that the operation in the public distribution system will not be affected by the provisions of the agreement.

The Uruguay Round had also strengthened multilateral rules and disciplines. The most important of these relate to anti dumping, subsidies and countervailing measures, safeguards and dispute settlement.

The Agreement on Trade Related Investment Measures (TRIMs) prohibits investment measures that are inconsistent with national treatment. The developing countries have been given five years and the developed countries are given two years to phase out inconsistent TRIMs.

The Agreement on Trade Related Intellectual Property rights (TRIPs) provide norms and standards for:

- Copyright and related rights.
- Patents.
- Trade secrets.
- Trademarks.
- Industrial designs.
- Layout designs of integrated circuits.
- Protection of undisclosed information.

The agreement allowed 1 year for developed countries, 5 years for developing countries and 11 years for least developed countries to change their laws for implementation of TRIPs. The general agreement on services is a set of multilaterally agreed and legally enforceable rules and disciplines relating to international trade in services. Services include financial services of persons and telecommunications. The GATS requires non-discrimination by governments on the basis of Most Favored Nation (MFN) clause and transparency in the form of publication of laws and regulations relating to services trade.

Given its provisional nature and limited field of action, the success of GATT in promoting and securing the liberalization of much of world trade over 47 years is incontestable. The rush of new members during the Uruguay Round demonstrated that the multilateral trading system was recognized as an anchor for development and an instrument of economic and trade reform. A whole corpus of jurisprudence on trade matters evolved under the aegis of GATT. The WTO is in a large measure built upon the strong foundation provided by the GATT.

European Community (EC)

The European Economics Community or European Common Market (ECM) was founded in 1957. The EEC was formed under the Treaty of Rome by six countries viz.. France, West Germany, Italy, Belgium, Luxembourg and Netherlands. On January 1, 1973, Ireland, Denmark and United Kingdom had become members of the community. The community was further enlarged as Greece had become its member in 1981, followed by Portugal and Spain in 1984.

Article 2 of the Treaty of Rome lays down that “the community shall have as its task, by setting up a common market, to promote throughout the community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability and accelerated raising of the standard of living and closer relations between the member states belonging to it.” The objectives of the community are:

- The elimination of custom duties and quantitative restrictions in exports and imports, as well as other measures having equivalent effect.
- Establishment of common customs tariff and common commercial policy.
- The abolition of obstacles to freedom of movement for persons, services and capital.
- The establishment of a common policy in the sphere of agriculture.
- Establishment of a system ensuring that competition in the common market is not distorted.

- Adoption of common policy in the sphere of transport.
- Application of procedures so that the disequilibrium in the balance of payments of member states can be remedied.
- The establishment of a European Investment Bank to facilitate the economic expansion of community.
- The association of overseas countries and territories with a view to increase trade and to promote jointly economic and social development.

The principal objective of the EC was the creation of a customs union. In customs union, there are no internal tariff barriers on intra-union trade. The member countries give up their individual tariff schedules and erect a common external tariff barrier for trade with non-union members. The working and achievements of the community include the following:

COMMON AGRICULTURAL POLICY (CAP)

Before the creation of common market, each member country followed its own separate agricultural policy. After prolonged negotiations, the EC agreed upon the CAP. The CAP machinery varies from product to product, but the basic features are the same. For each member country there is a "Green Rate" at which the support prices are converted into national prices. Trade barriers do not exist for the movement of agricultural products from one country to another. If there is excess demand over domestic production of farm products, imports from the outside world are allowed. With the adoption of CAP, EC has become self sufficient in agriculture but it has failed to provide farm products to consumers at reasonable and stable prices because the support prices have been set at high levels.

COMMON FISHERIES POLICY

The Common Fisheries Policy came into force in February 1971. The policy covers marketing of fresh frozen and preserved fish. It provides equal access to fishing areas for all EEC nationals, with provisions for certain kinds of offshore fishing.

The European Monetary Union (EMU)

The European Council decided to establish the European Monetary System (EMS) in 1978, which started functioning in March 1979. The EMS has created an EC currency zone to unify their economies to stimulate growth. It established an Exchange Rate Mechanism (ERM) under which each country works to prevent wide shifts in the value of its currency. The currency of each country could fluctuate between the wide 6% band to the narrow 2.25% up to August 1993. The EMS established the European Currency Unit (ECU) which is the means of settlement between the EC currencies and central banks. The ECU is the weighted basket of all EC currencies and is calculated daily by the European Commission.

The EMS member countries extend credit facilities to each other to help deficit countries defend their exchange rate parities. There are three types of credit facilities. They are

- Very short-term financing (45 days).
- Short-term financing (3 months renewable up to 2 times).
- Mid-term financial assistance (2 to 5 years).

The ERM and EMS worked smoothly and were successful in bringing international monetary cooperation. But, in 1992, there was EC currency crisis in which Italian Lira was devalued by 7.5% and Pound Sterling by 10%. To save the EMS from collapsing, a two-tier system was introduced in ERM. In the first tier, the fluctuation bands for seven weak currencies had been widened to 15%. The seven currencies belonged to France, Belgium, Spain, Portugal, Ireland, Luxembourg and Denmark. In the second tier, the currencies of Germany and the Netherlands remained linked to either side of the central rate of 2.25.

FACTOR MOBILITY

One of the objectives of the European Community was the free movement of persons, services and capital. Presently, workers and their families can move from one member country to another without a permit. They have the same rights to work and are subject to the same taxation as nationals of the concerned country. The capital mobility is obstructed by international monetary disturbances.

REGIONAL DEVELOPMENT POLICY

The regional development policy aims at reducing the differences between the various regions and mitigating the backwardness of the less favored. EC aimed at the promotion of balanced expansion by providing financial help to the backward areas of the member countries. The community provides regional aid through the European Investment Bank (EIB), the European Social Fund (ESF) and the European Regional Development Fund (ERDF). Despite these measures, the EC's regional development policy has failed to iron out income disparities.

COMMON TRANSPORT POLICY

The common transport policy had three objectives.

- Elimination of obstacles which transport may put in the way of the establishment of common market.
- Free movement of transport services within the member countries.
- General organization of the transport system with the EC.

Only the first objective has been achieved by the EC. The failure of the other two objectives has been due to the problems involved in infrastructure pricing, entry/rate controls of the individual member states relating to the hauling of goods by road and rail transport.

INDIA AND THE EC

India has entered into a commercial and economic cooperation agreement with the European Community. The EC's share in Indian Foreign Trade has not changed over the years. India's exports to the community in 1970-71 were 18.4% of the total exports, which increased to 23.8% in 2003-2004.

Though, the Indian exports to the EC have increased, yet they amount to 0.6% of imports of the community. There are two elements in the community's relations with India.

- *Trade Cooperation:* The EC has entered into a commercial agreement with India for the import of textiles under the Multi Fibre Agreement (MFA). Under this, India exports textiles and clothing to EC.
- *Development Aid:* This includes cooperation in science and technology, energy and human resources. The aim of the EC is to help Indian industry improve its technology, reduce production costs, produce to standards acceptable to European buyers and acquire greater familiarity with European business center. For this, EC has funded a number of training programs and programs for trade promotion of Indian products.

The EC has passed a legislation, whereby the following export products are required to meet EC standard and certification.

- Food and food products
- Drugs and pharmaceuticals
- Durable consumer good including electrical equipment.

Manufacturers whose products do not conform to these standards will be barred from entering the EC. The EC experts are visiting India to advice manufacturers as well as testing laboratories.

CRITICAL APPRAISAL

The European Community has achieved its objectives relating to the removal of obstacles to the free movement of goods, services, capital and labor between the member countries. Over the year, the trade has expanded and a vast common market is being created. The member nations have enjoyed high rates and investment and growth in income. The community has been successful in creating ECU as a bulwark against the hegemony of the dollar. The EC has also signed special "association" agreements with East European Countries.

Despite its achievement, the EC has not been successful in achieving a complete economic and political union. There has been no harmonization of fiscal measures and it has failed to evolve a common transport policy. Regional disparities within member countries persist. But the trade creation effects have been much stronger because of which total trade of the community with the outside world has increased manifold.

NORTH AMERICAN FREE TRADE AREA (NAFTA)

NAFTA was initiated by the government of President George Bush, but it was concluded by the Clinton Administration. The NAFTA came into being on January 1, 1984 and it consists of USA, Canada and Mexico. The three countries have agreed to phase out tariffs over a period of 15 years. The Free Trade Area between USA and Canada was established in 1988 and they had close trading ties. With the inclusion of Mexico, some labor intensive industries might do well.

It is fundamentally a trade and investment agreement created with a view to reduce barriers in the flow of goods, services and people among these three countries. The argument covers goods and services that are either produced in North America or that meet certain local content requirements. For example, a German company manufacturing its products in North America and meeting these standards will qualify for the same benefits as any American company. The areas covered by the agreement are:

- Tariff reduction
- Freer movement of professionals among the three countries
- Financial and direct investment matters
- Consumer safety
- Specific issues relating to protection of labor
- Specific issues relating to protection of the natural environment.

The Objectives of NAFTA are

- i. Protection for investment in the sense that no investment can be expropriated without full compensation.
- ii. The creation of a special fund for worker retraining and financial support in industries adversely affected by the passage of NAFTA.
- iii. The creation of US-Mexico border environmental commission that could spend up to \$8 billion to address water and air pollution and clean up toxic waste dumps.
- iv. Substantial tariff reductions over a ten-year period. For example, the US will eliminate tariffs on automobile assembled in Mexico and Mexico will reduce its tariffs on US-built cars and trucks.
- v. Lowering barriers for easier movement of goods across borders.
- vi. More access to financial services. For example, NAFTA will dismantle Mexico's ban on US banks and brokerage services. Also, US banks will be allowed up to 25% of the Mexican market and brokerage up to 30% of the Mexican market.
- vii. The creation of North American Development Bank to assist in environmental cleanups and to provide trade adjustment assistance to communities adversely affected by NAFTA.
- viii. The creation of special offices to investigate environmental abuses and labor abuses are based in Canada and the US respectively. Both the offices can impose fines/trade restrictions for countries or industries that fail to enforce their own laws.

In summary, NAFTA is an attempt to move the economies of North America towards a scenario whereby a company that is based in any one of the three countries can freely conduct its business across all three borders, as long as certain basic standards are met. The long-term objective of the agreement is to bring into its fold, the countries of North and South America.

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD)

The United Nations Conference on Trade and Development (UNCTAD) was established in 1964 in order to provide a forum where the developing countries could discuss the problems relating to their economic development. The primary objective of UNCTAD is to formulate policies relating to developmental aspects including:

- Trade
- Aid
- Transport
- Finance
- Technology.

The Conference ordinarily meets once in four years. The UNCTAD I was held at Geneva in 1964. Since then such conferences are being held every four years. The UNCTAD IX was held at Midrand, South Africa in 1996. The conference has its permanent secretariat at Geneva. The UNCTAD has the following functions laid down by the UN General Assembly.

- To promote international trade between countries, especially for accelerating the economic development of LDCs.
- To formulate principles and policies of international trade.
- To facilitate the coordination of activities of other international within the UN system in the field of international trade and related problems of economic development.
- To make proposals for putting the said principles and policies into effect.
- To act as a center for harmonious trade related development policies of governments and regional economic groupings.

The UNCTAD is supposed to fulfill the following objectives that have been evolved gradually of the various conferences.

Trade in Manufactured Goods (GSP)

Under GSP, the exports of manufacturers, semi manufacturers and some agricultural items from the developing countries enter duty-free or at reduced rates in the developed countries. For example, suppose United States imposes 25% customs duty on import of handtools. Under GSP, export of hand tools from India to US will not be subjected to that duty, whereas exports from Japan will be subject to a 25% customs duty. Initially the GSP scheme was introduced for a period of ten years but this period has been extended.

There are now 14 GSP schemes in operation in 29 preference giving countries (including the 15-member European Union). The three major importing areas – the EU, Japan and the US, account for more than 90% of total preferential imports. Even after two decades of operation of GSP schemes, the preferential imports account for less than one-fourth of the durable imports of the OECD countries.

Trade in Primary Commodities

The prices of primary products undergo high level of fluctuations in the international markets. This causes hardship to many developing countries, as their total foreign exchange realization from the export of primary products becomes uncertain. UNCTAD has suggested the creation of a common fund in order to stabilize the prices of primary products through buffer stocks. By this, the exporters of primary products will be able to realize higher prices and the importance of such primary products will not be subjected to the uncertainty of price fluctuations (which sometimes are the result of speculative activity).

Development Finance

Right from the UNCTAD III, LDCs have been voicing their concern over their balance of payments deficits and indebtedness. Over the years, the UNCTAD meetings have failed to solve the problems of debt and development of LDCs. These meetings have been forums for exchanging ideas rather than getting things done. According to the Economist – UNCTAD has lost the initiative on debt to the IMF and on development to the World Bank. The IMF has the confidence of western bankers and governments. The debt issue has been taken over by the IMF because it acts as a bank itself and the World Bank has both money and effective advice to promote development.

Economic Cooperation among LDCs

UNCTAD II held at New Delhi in 1968 emphasized the need for promoting international cooperation and self-reliance among the LDCs. The first step towards economic cooperation among LDCs was taken at the ministerial meeting of G-77 (held in New York) where it decided to launch the Global System of Tariff Preferences (GSTP). The UNCTAD VI recommended the initiation of a number of cooperative measures such as

- Harmonization of LDCs policies, rules, regulations and practices governing technology in all aspects.
- Training and exchange of personnel.
- Establishment of preferential agreements, for the transfer and development of technology.
- Technological cooperation in specific areas and sectors of critical importance.

There are many factors, which stand in the way of economic cooperation among the LDCs. The economies of LDCs are highly competitive in nature but their problems can be overcome by mutual help and trust among themselves. The LDCs need to work in close cooperation among themselves. UNCTAD is a forum where they can meet, discuss and formulate plans for regional economic cooperation.

At UNCTAD IX, the member states felt that the impact of globalization and liberalization on developing countries has been uneven as various countries enter this system from different starting points. The LDCs, especially in Africa, a large number of people continue to live in dire poverty. They are constrained by weak supply capabilities and are unable to benefit from trade. In order to achieve its objectives, the conference will strengthen its cooperation with WTO and other multilateral institutions in order to ensure that the developing countries participate in the global economy on a more equitable basis.

The major problem with the UNCTAD has been that it is trying to tackle too many issues at the same time. This is due to the widely divergent interests of the developing member countries and due to the lack of any specific focus. Thus, the conference has not been able to achieve any tangible results. During the UNCTAD IX, it was feared that the developed countries may attempt to prune the work program of UNCTAD. During its ninth conference, the developed countries concentrated on making UNCTAD a more focused organization with work program in the areas where it had comparative advantage over other international organizations. As such, the UNCTAD reflects the sentiments, hopes and aspirations of LDCs in a world still dominated by the developed countries, both politically and economically.

US-RUSSIA BILATERAL INVESTMENT TREATY

On June 17, 1992, representatives of the Russian Federation and the United States signed a Bilateral Investment Treaty (BIT). The treaty was ratified by the US on October 13, 1993, but remains to be ratified by the Russian Duma. Consideration of the Treaty is on the Duma's legislative agenda for June of 1997. The US government, through the Embassy and the Chamber, is attempting to raise the awareness of both investors and members of the Duma about the importance of ratification of this treaty for the increase of investment flows between the United States and Russia. The US government has concluded such investment treaties with

38 countries, 28 of which are in force. These treaties are designed to reduce the risks to investors associated with governmental discrimination; they are not meant to remove the normal commercial risks associated with any investment. BITs with Ukraine, Estonia, Latvia, Kyrgystan, Kazakstan, Moldova and Armenia are all in force.

In the covering message conveying the Treaty to the US President and the Senate for ratification, the Secretary of State wrote: "The Treaty is an integral part of the US effort to assist Russia in its transition to a market economy. It will create favorable conditions for US investment in Russia and, by attracting US private investment, will help the further development of the Russian private sector." The provisions of the Treaty are reciprocal and reflect the basic tenet that US investment abroad and foreign investment in the U.S. should receive fair, equitable and non-discriminatory treatment. In drafting the Treaty, US and Russian negotiators were determined to produce a document whose implementation would facilitate increased foreign investment in the Russian economy. For that reason, they agreed to set relatively high standards of protection for foreign investors and obligations to be undertaken by host governments. The Soviet Union had previously signed investment protection agreements with other countries.

Russia, since 1991, has negotiated and ratified agreements with several others, including OECD countries. These are generally less comprehensive in their investor protections and government obligations and, we note, have not generated substantial, new investment flows from these countries to Russia. The US, Russia BIT provides investors with six basic guarantees:

- i. The BIT ensures that companies from each country will be treated as favorably as their competitors.
- ii. Clear limits are established on the expropriation of investments and ensure that investors will be fairly compensated.
- iii. The BIT guarantees that US and Russian investors have the right to transfer funds into and out of the countries in which the investment is located without delay using a market rate of exchange.
- iv. The BIT limits the ability of host government to require that investors from the other country adopt inefficient and trade distorting practices.
- v. The BIT gives investors the right to submit an investment dispute with the treaty partner's government to international arbitration. There is no requirement to use that country's domestic courts.
- vi. The BIT gives investors the right to engage the top managerial personnel of their choice, regardless of nationality.

The Treaty allows for sectoral exceptions to the general principle of national treatment. US exceptions are designed to protect government regulatory interests and to accommodate derogation from national treatment in existing federal and state laws. The Russian exceptions generally relate to land and natural resources and other matters, for example, power production, state loans, banking and the mass media.

Foreign direct investment in Russia is at relatively low levels and is modest in comparison with foreign investment in the new market economies of Central Europe, such as Poland and the Czech Republic, with which the US has entered into bilateral investment treaties. Among the reasons for Russia's poor performance in attracting investment has been the absence of the types of protections and commitments contained in the US, Russia Treaty. Moreover, these are precisely the favorable conditions that domestic, as well as foreign, investors require before they will invest their capital in the productive economy.

Germany-India Bilateral Treaty

The German government will soon ratify its bilateral treaty with India to enhance investment in both countries. The Indian government last year approved the agreement for the "Promotion and Protection of Investment." The move will encourage German companies to invest in India.

The pact aims at creating favorable conditions to foster greater investment by individuals and companies of either country in the other's territory. It also guarantees

reciprocal protection of such investments in order to stimulate business initiatives from both nations. Germany has this promotion of investment treaty with most of its trade partners. Once ratified, the agreement between India and Germany will apply to earlier investments. Its scope broadly covers the objectives such as:

- National treatment and most favored nation treatment to the other country.
- Guarantee against nationalization of investments made by the investor from the other country.
- Compensation for losses, repatriation of investment and returns.

The agreement, which is immune to bilateral diplomatic relations, will initially be for ten years from the date of ratification.

The pact also discusses in detail the norms for settlement of disputes between the two contracting parties and indemnity against non-commercial risks in respect of investments made by a company or individual in the territory of the other contracting party. The indemnity clause is, however, applicable only in those cases where the two contracting parties have clearly defined the conditions for non-commercial risks. In case of dispute, the rights and claims shall not exceed the original rights or claims of investors.

The clause suggests that disputes be referred to an arbitral tribunal which should have three arbitrators, including two nominated by the two contracting parties and a mutually agreed chairman from the third state, which has diplomatic relations with the governments of the parties to the dispute.

The pact, however, stipulates that the investment protection does not prevent either contracting party from applying prohibitions or restrictions to the extent necessary for protection of its essential security interests.

The agreement is in line with similar ones Germany has signed with other countries. The existence of this treaty makes German investors more comfortable, especially those from small and medium companies who cannot afford to take big risks.

TRADE, AID AND DEVELOPMENT

The term aid is read to encompass military aid, commercial transactions, food aid and development assistance. The five main objectives served by aid are:

- Humanitarian – relieving human suffering.
- Development – promoting economic growth.
- Security – stabilizing societies.
- Military – improving the defense capabilities of allied governments.
- Political – buying influence for the donor government.

The real world is complex and so are the motivations for granting (or withholding) aid to the third world countries. In the past, financial help had been offered to aid the newly independent states. The 'soft' credits were offered at preferential rates of interest and were 'tied' in the sense that they were available for the purchase of certain items only. In a shrinking world market situation, rivalry among the leading industrialized nations has helped to curb the practice of trade related aid. There has also been the development of external sources of financing, example: World Bank, IMF, Bank for European Reconstruction, Bank for International Settlements and Eurodollar market. Development has also progressed through the active agencies of the United Nations viz. UNCTAD, UNIDF, GATT, UNICEF, ILO, etc.

These organizations have been responsible for establishing management development centers and programs in many parts of the developing world. As development advances, there would be fewer contracts for infrastructure development (such as highways) and more for higher technology and manufacturing production know-how. It has also been indicated that the trade between developed and developing countries is only a small percentage of total world trade. The bulk of world trade takes place between the developed industrialized nations. For example, the combined exports of USA, Canada and Germany are higher than the total for all developing countries taken together. In

order to initiate development in the developing countries, the United Nations formed the Generalized System of Preferences (GSP) in 1977. GSP was set to allow developing countries certain benefits from trade preference, enabling them to attain economic self-sufficiency by means of trade liberalization. The GSP involved certain restrictions such as:

- Not all developing countries receive preferential treatment.
- Not all industrial products subjected to tariffs are included in the GSP.
- With many products, the individual developing countries may be excluded or the supply that is tariff free may be limited.

There is a growing international awareness that “poverty anywhere is a danger to prosperity everywhere and prosperity anywhere must be shared everywhere.” The developed countries should consider it as their moral duty to help their less fortunate brethren in underdeveloped countries. But this realization on the part of the developed countries has never been spontaneous.

Aid or Trade?

Of late, the idea has been gaining ground among the LDCs that trade and not aid is essential for their rapid development. It is contended that the developed countries have failed to meet the aid requirements of the developing countries. An UNCTAD resolution made obligatory for the developed countries to contribute to LDCs at least 1% of their national income. But they failed to contribute even 0.5% of their national income. Foreign aid has provided crucial support to the development plans of LDCs, but the developed countries are not prepared to supply aid to the extent required by them. Moreover, LDCs do not want tied aid because of the strict conditions laid down by the donors. Thus, the LDCs and the developing countries should make efforts to boost their exports in order to have a trade surplus. Larger exports are needed to pay for increasing imports and for direct service payments.

A policy that favors trade and not aid can be successful only if there is an increase in the domestic savings equal to the rise in export earnings. Developing countries like India, Brazil, etc., are able to utilize their export earnings for further capital formation but no developed country would be prepared to buy at prices higher than the world market. Trade can substitute aid admirably when the price levels in the developing economies are stabilized. Countries that are in the early phase of development should not think of substituting trade for aid because they can develop only through aid over the long run. Thus, development requires both trade and aid.

DOHA Conference 2001

The 4th WTO ministerial conference was held in Doha, Qatar from 9th to 13th November, 2001. During the course of this Ministerial Conference, 142 governments participated to shape the future of the global trading system in the 21st century. The agenda of the conference was the negotiations on agriculture and services that began in the year 2000. Later on other issues were also added. Some of the issues under negotiation can be summarized as follows:

- Agriculture
- Market Access for Non-Agricultural Products
- Trade-related Aspects of Intellectual Property Rights (TRIPS)
- Transparency in Government Procurement
- Trade Facilitation
- Trade and Investment
- Disputes Settlement System
- Trade and Environment
- Electronic Commerce
- Trade, Debt and Finance, etc.

AGRICULTURE

The WTO committee recognizes the work already undertaken in the negotiations initiated in early 2000 including the large number of negotiating proposals submitted on behalf of a total of 121 members. It recalls the long-term objective referred to in the agreement to establish a fair and market-oriented trading system. Building on the work carried out to date and without prejudging the outcome of the negotiations it ensures improvements in market access, reductions of all forms of export subsidies; and substantial reductions in trade-distorting domestic support. It takes note of the non-trade concerns reflected in the negotiating proposals submitted by members and confirm that non-trade concerns will be considered in the negotiations as provided for in the agreement on agriculture.

MARKET ACCESS FOR NON-AGRICULTURAL PRODUCTS

It agrees to negotiations, which shall aim to reduce or eliminate tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products having export potential in the developing countries. The negotiations shall fully take into account the special needs and interests of developing and least-developed country participants in accordance with the relevant provisions of GATT 1994. Thus, the agreement includes appropriate studies and capacity-building measures to assist least-developed countries to participate effectively in the negotiations.

TRADE RELATED ASPECTS OF INTELLECTUAL PROPERTY RIGHTS (TRIPS)

It stresses the significance to implement the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS Agreement) by promoting access to both existing medicines and research and development into new medicines. It agrees to negotiate the establishment of a multilateral system of notification and registration of geographical indications for wines and spirits by the Fifth Session of the Ministerial Conference.

TRANSPARENCY IN GOVERNMENT PROCUREMENT

The agreement recognizes the need of a multilateral agreement on transparency in government procurement. The negotiations will build on the progress made in the working group on transparency in government procurement by the time and take into account participants' development priorities, especially those of least-developed countries. Negotiations shall be limited to the transparency aspect and therefore will not restrict the countries to give preferences to domestic supplies and suppliers. It also ensures adequate technical assistance and support for competence both during the negotiations and implementation thereafter.

TRADE FACILITATION

It recognizes the need for release and clearance of goods, including goods in transit, and the need for increased technical assistance in this area. It agrees that negotiations will take place after the Fifth Session of the Ministerial Conference. In the period until the Fifth Session, the council for trade in goods shall review, clarify and improve relevant aspects of the GATT 1994 and identify the trade facilitation needs and priorities of developing and least-developed countries.

TRADE AND INVESTMENT

It recognizes the case for a multilateral framework to secure transparent and stable conditions for long-term cross-border investment, particularly foreign direct investment that will contribute to the expansion of trade and the need for increased technical assistance in this area. It also recognizes the needs of developing and least-developed countries for development.

DISPUTE SETTLEMENT SYSTEM

It agrees to negotiations on improvement and clarification of the Dispute Settlement Understanding. The negotiations should be based on the work done so far as well as any additional proposals by members, and aim to agree on improvements before May 2003 so that it will take steps to ensure that the results enter into force soon after.

TRADE AND ENVIRONMENT

With a view to increase the mutual supportiveness of trade and environment, it agrees to:

- i. The relationship between existing WTO rules and specific trade obligations set out in Multilateral Environmental Agreements (MEAs).
- ii. Procedures for regular information exchange between MEA Secretariats and the relevant WTO committees, and the criteria for the granting of observer status.
- iii. The reduction or, as appropriate, elimination of tariff and non-tariff barriers to environmental goods and services.

ELECTRONIC COMMERCE

It takes note of the work that has been done in the General Council and other relevant bodies since the Ministerial Declaration of 20th May, 1998 and agrees to continue the Work Program on Electronic Commerce. The work to date demonstrates that electronic commerce creates new challenges and opportunities for trade for members at all stages of development, and it recognizes the importance of creating and maintaining an environment which is favorable to the future development of electronic commerce. It declares that members will maintain their current practice of not imposing customs duties on electronic transmissions until the Fifth Session.

TRADE, DEBT AND FINANCE

It agrees to examine the relationship between trade, debt and finance, and of any possible recommendations on steps that might be taken within the consent and competence of the WTO in order to boost the capacity of the multilateral trading system. Moreover it also looks ahead to contribute a long-term solution to the problem of external indebtedness of developing and least-developed countries, and to strengthen the rationality of international trade and financial policies, with a view to protect the multilateral trading system from the effects of financial and monetary instability.

Work Program

The declarations had set 1st January, 2005 as the last date for completing all the negotiations in general and May 2003 for dispute settlement system, 5th ministerial conference 2003 for stock taking and registration system for geographical indications in particular. The negotiations were open to all WTO members and to observer governments negotiating or intending to negotiate membership but only the members could take decisions on the outcomes. The negotiations had to consider the principle of special and differential treatment for developing and least-developed countries. When the results of the negotiations in all areas have been identified, a special session of the ministerial conference will be held to implement those results. A Trade Negotiations Committee under the authority of the general council shall supervise the overall conduct of the negotiations. The Trade Negotiations Committee shall hold its first meeting before 31st January, 2002 and ascertain proper negotiating mechanisms as required and oversee the progress of the negotiations.

Cancun Conference 2003

The conference at Cancun, Mexico from 10th to 14th September, 2003 marks the 5th Ministerial meet of WTO. The main objective was to take stock of progress in negotiations and other work under the Doha Development Agenda. Moreover the

issues proposed to be included in the agenda were poverty reduction and sectoral initiative in favor of cotton. It confirmed the declarations and the decisions made at Doha. It also noted the progress that has been made while carrying out the Work Program agreed at Doha, and ensured its completion.

Box 1: Insight to Cancun 2003
<p>Agreement on Agriculture (AOA)</p> <ul style="list-style-type: none"> • Was a part of GATT • Market Access • Domestic Support • Export Subsidy. <p>Market Access</p> <ul style="list-style-type: none"> • Objective is to reduce the tariff barriers • 36% slash in the import duties of developed nations • 24% slash in that of developing nations • Time limit for developed nations is over and for the developing nations it is 2004. <p>Export Subsidy</p> <ul style="list-style-type: none"> • To ensure fair competition in the international agri market • Developed countries – to reduce export subsidy expenditure by 36% and volume by 21% in six years, in equal installments (from 1986-1990 levels) • Developing countries the percentage cuts are 24% and 14% respectively in equal installments over 10 years. <p>Domestic Support</p> <ul style="list-style-type: none"> • Domestic support for farmers fall under three categories • Green box – subsidy for research, training, pest and disease control, Internal Food Security, Internal Food Aids, Natural Calamities and Environment Conservation etc. • Blue box – those subsidies provided when production restrictions are imposed and aids for conserving rural environment, it is applicable only to developed nations • Amber box – includes two types of aids <ul style="list-style-type: none"> – Aids given to the Agriculture product – Aids given to Agriculture inputs viz. seeds, fertilizers irrigation, electricity • The above two categories together form the Aggregate Measure of Support • Only the Amber box subsidies have to be reduced • Total Aggregate Measure of Support (total AMS), should be reduced by 20% in developed countries in six years • For developing countries AMS should come down by 13.3% • In absolute terms developed nations can give up to 5% of its agriculture GDP and developing nations up to 10% as domestic support. <p>Current Status</p> <ul style="list-style-type: none"> • The developed countries have not fulfilled the commitment. Subsidies remain more or less static • The recent ‘US Farm Bill 2002’ and Common Agricultural Policy (CAP) review in the EU supports high subsidy regime • They are trying to move the amber box subsidies to green and blue boxes • Many developed countries including India keep their subsidies within the limit.

Proposal of the Developing Countries

- Take five years balancing period from 2005
- Steep tariff cuts using the Swiss (higher tariff cuts for high tariffs) rather than the linear (proportionate) formula
- Completely remove export subsidy, blue and amber box subsidy
- 5% of the total agri production can be given as green box subsidy.

What did Rich Nations Offer?

- Ready to phase out export subsidy selectively for certain products
- Not to cut in domestic subsidies
- Adamant in tariff barriers.

India & AOA

- Except in rice market, India is a negligible force in International Agricultural market because of flawed domestic policies
- So, the domestic subsidies of the rich nations will not affect India
- Many Indian agricultural produce are cost effective in the domestic market
- So, no fear of cheap import from developed nations flooding the country.

The View from the Other Side

- Domestic subsidies are politically sensitive in both USA and Europe
- Europe – Since the cost of production is very high, agreeing to subsidy cut will lead to flooding of food products imports
- USA – Only 3% of the population is employed in agriculture. Removal of subsidy cut will lead to demise of agriculture sector.

Where does it go from here?

- Draft declaration to be prepared before January 2005. Deadline may be missed
- The free trade zones will get momentum. But India will be at a disadvantage as SAFTA is a non-starter
- Developing countries has proved their ability to fight together
- The third world nations have ensured that they cannot be taken for granted.

Source: A paper presented by Mr. S Subramanian-Research Scholar, on "The Agriculture Issues in WTO" in a workshop organized by ICFAI Institute of Management Teachers, Hyderabad, India.

Highlights**SINGAPORE ISSUES**

The Singapore issues are trade and investments; trade and competition policy; transparency in government procurement; and trade facilitation. After seven years of the Singapore conference these issues were taken up to arrive at some consensus but the attempt proved to be futile. There were lots of controversies among the member countries since, two of them strongly supported all the four negotiations but several other countries proposed to take up only trade facilitation and transparency in government procurement. Thus, the mindset of all the member countries could not focus on a single decision and in spite of substantial efforts the issue remained unresolved till the last day of the conference.

THE COTTON PROPOSAL

This issue was raised in the General Council and Agriculture Committee by Benin, Burkina Faso, Chad and Mali. It explains the harm that the four believe has been caused to them by cotton subsidies in richer countries, calls for the subsidies to be eliminated, and for compensation to be paid to the four while the subsidies are being paid out to cover economic losses caused by the subsidies. The proposal received support from Canada, Australia, Argentina, Cameroon, Guinea, South

Africa, Bangladesh, Senegal and India. The US was of the view that industrial policies that support production of synthetic fiber are also responsible for falling cotton and hence it proposed discussions how to deal with problems throughout the production process. At last the committee decided that the issue would be discussed in the informal meetings of ministers over the coming days.

CAMBODIA AND NEPAL MEMBERSHIP

In a formal session on 11th September, 2003 the ministers approved the membership agreements of Cambodia and Nepal. Cambodia and Nepal are set to become the WTO's 147th and 148th members, and first least-developed countries to join the WTO through a full working party negotiation.

END WITHOUT CONSENSUS

Most of the ministers criticized the points they disliked for bridging some of the gaps. For example, they found the agriculture text either too ambitious or not motivated enough. They differed over whether to launch negotiations on the Singapore issues or whether there is no agreement to do so. They had comments on the non-agricultural market access text, including the description of the tariff cutting formula and whether sectoral deals should be compulsory for all members. Several said the text on the cotton initiative did not reflect the proposal to cut subsidies and for subsidizing countries to compensate the African producers in the interim. And a number of African and Caribbean countries in particular said the draft does too little on special and differential treatment for developing countries. A few countries expressed concern that the negative sentiments would wipe out what they described as possible significant results in areas such as agriculture. Thus the chairperson - Mr. Derbez - asked the ministers to arrive at an agreement in order to boost the world economy. He also warned that if Cancun fails, the negotiations might take a long time to recover. While working for an acceptable overall outcome it undertook to maintain, in the areas where it had reached a high level of convergence on texts. In spite of this setback, it confirmed all the Doha Declarations and Decisions towards their implementation.

SUMMARY

- In this chapter we have discussed the decisions of WTO (erstwhile GATT) relating to International Business and their implications to the world economy.
- One can say that WTO is a watchdog of international trade as it regularly examines the trade regimes of individual members.
- The chapter has further discussed the formation of international cartels in general and OPEC in particular. The OPEC is dedicated to the stability and prosperity of the international petroleum market.
- The multilateral and the bilateral treaties such as GATT, US, Russia Bilateral Investment Treaty has been discussed.
- The chapter further gives an insight in the working of European community and NAFTA.
- The European community was established with the objective of creation of customs Union and this objective has been achieved to a certain extent.
- The chapter is concluded with a discussion on trade, aid and development.

Chapter II

Foreign Trade Policy

After reading this chapter, you will be conversant with:

- The Historical Perspective and the Rationale behind Trade Regulations in India
- Objectives of the Foreign Trade Policy (2004-2009)
- Foreign Trade Policy (2004-2009)
- Trade Regulation Governing Exports/Imports

Till a decade back, imposition of trade barriers for one reason or the other has been the trend all over the globe. This was affected in two ways viz. Tariff and Non-Tariff measures. Tariff, being a revenue source for the Government was the most preferred measure to discourage imports in order to increase demand for domestic goods or to restrict export of goods that is in short supply locally. Non-tariff measures include all kinds of rules and regulations in the form of quotas, embargos, etc., restricting free movement of goods from and into the country. Various theories have been adduced for and against these measures. However, with the advent of liberalization process all over the globe, there was a sudden shift in this stance and countries have started opening their markets to outside goods and India is no exception to this phenomenon. Countries have started realizing the benefits of free trade and are slowly moving away from quotas and embargos towards positive and growth oriented economic policies to encash one's own unique potential/competency vis-à-vis the trading partners. Our recent trade policy is a pointer in that direction. To have a better appreciation of this fast changing scenario, let us take a look at the genesis of trade restrictions as they evolved in the last five to six decades in our country.

HISTORICAL PERSPECTIVE

The origin of import trade control in India dates back to the Second World War, when for the first time restrictions under the Defense of India Rules (DIR), were imposed on imports into India. However, at that time the main aim was to reduce the pressure on the limited available shipping space. Starting with consumer goods, the restrictions were gradually extended to cover unmanufactured as well as semi-finished goods. In September 1946, with the lapse of the DIR, import trade control continued under the Emergency Provisions (Continuance) Ordinance, 1946. The ordinance was replaced by the Imports and Export (Control) Act, 1947 that was also replaced by the Foreign Trade (Development and Regulation) Act, 1992. Presently, import trade control is administered in India under the purview of Foreign Trade (Development and Regulation) Act, 1992, Foreign Trade (Regulations) Rules, 1993 and Foreign Trade (Exemption from application of rules in certain cases) Order, 1993.

For many years the accent of trade policies was on maintaining the level of imports within the available foreign exchange. This was done with the intention of protecting domestic industry and achieving price stability. However, these measures were not successful in containing the trade deficit. It was then that the Government of India realized the importance of export promotion.

The import export policy of 1985 can be considered as the first bold and dynamic policy initiative in this direction. Keeping in mind the importance of exports, the 1985 policy was announced incorporating the objectives of export promotion, import substitution and technological upgradation.

In the years 1990-1991 drastic measures (like pledging of gold by RBI to borrow foreign exchange) were introduced to tide over the severe balance of payments crisis, which had reached dangerous levels because of the Gulf crisis. Even though the crisis was resolved, a need was felt to be better equipped for any such future recurrences. As a corollary, the Liberalized Exchange Rate Management System (LERMS) was introduced. The scheme came into effect on 1st March, 1992. As per this scheme, 40% of current account receipts were required to be converted/surrendered to RBI at official rate prescribed by RBI and the balance at market determined exchange rates. The success of this scheme led to the introduction of Unified Exchange Rate System that came into effect from 1st March 1993. Since then, all foreign exchange transactions are being put through by authorized dealers at market-determined rates.

The other notable fall out of this crisis was the launching of economic and financial reforms by the Government of India. The main objective of the liberalization process was to increase the wealth of the nation by higher economic

growth that would bring about better income and living standards to the population. In the interdependent world of the 90s, it was felt that economic growth could only be achieved by integrating the Indian economy with global economy in terms of free movement of goods, services and capital.

The liberalization process was aimed at

- Freeing Industry from Licenses, Permits and Government Control
- Reforming Fiscal and Monetary Policies
- Reforming the Banking and Financial Sectors and the Capital Market
- Creating vital infrastructure such as telecommunication, power and roads to facilitate economic growth
- Removing foreign exchange control barriers to the movement of Investment and Capital
- Removing quantitative and tariff barriers on International Trade and rationalizing Tariffs.

As a sequence to the liberalization process, the Government of India had introduced significant changes in the import export policy also. The export-import policy 1992-1997 was born in this context where an attempt was made to align India's international trade policies and practices to the overall liberalization process and getting closer to free international trade. The trade policy that was hitherto called import export policy was rechristened as export import policy. The long-term export import policy for a period of five years was announced synchronizing with the 8th five-year plan. The Exim policy 1992-1997 saw the introduction of numerous changes and modifications.

Exports and Imports come under the purview of the Ministry of Commerce and it is the Director General of Foreign Trade functioning under the commerce ministry who is empowered to exercise control over exports/imports. Previously, the policy was being announced on an annual basis. However, in order to bring about continuity and stability in the policy, there was a shift from the usual annual policy to a three-year policy from April 1985. Beginning from 1st April, 1992 the policy is being announced on a five-year basis and the policy currently in effect is the export and import policy 1st April, 2002 to 31st March, 2007. Revisions during the five-year period generally are published on 1st April of subsequent years during the five-year period, although changes may be made and announced by means of public notices/amendment orders at any time.

On 31st August, 2004 government announced a new policy i.e., Foreign Trade Policy (2004-2009) which would replace the existing policy i.e., Exim Policy 2002-2007

OBJECTIVES OF THE FOREIGN TRADE POLICY (2004-2009)

For India to become a major player in world trade, an all encompassing, comprehensive views need to be taken for the overall development of the country's foreign trade. While increase in exports is of vital importance, we have also to facilitate those imports, which are required to stimulate our economy. Coherence and consistency among trade and other economic policies is important for maximizing the contribution of such policies to development. Thus, while incorporating the existing practice of enunciating an annual trade policy, it is necessary to go much beyond and take an integrated approach to the developmental requirements of India's foreign trade. This is the context of the new Foreign Trade Policy. The principal objectives of the foreign trade policy are:

- i. To double our percentage share of global merchandise trade within the next five years.
- ii. To stimulate sustained economic growth by providing access to essential raw materials, intermediates, components, consumables and capital goods required for augmenting production and providing services.

- iii. To enhance the technological strength and efficiency of Indian agriculture, industry and services, there by improving their competitive strength while generating new employment opportunities and to encourage the attainment of internationally accepted standards of quality.
- iv. To provide consumers with good quality goods and services at internationally competitive prices while at the same time creating a level playing field for the domestic producers.

FOREIGN TRADE POLICY 2004-2009

In exercise of the powers confirmed under Section 5 of The Foreign Trade (Development and Regulation) Act, 1992 the central government has notified on 31st August, 2004 the first National Foreign Trade Policy for the period 2004-09 incorporating the export and import policy for the period 2002-07. This policy came into force with effect from 1st September, 2004 and shall remain in force up to 31st August, 2009. The Policy has for the first time tried to integrate the trade policy with the process of Country's Economic development.

The new trade policy replaces the five-year Export-Import Policy of 2002-07. The most important factor that proves the similarity between the new and existing policy is the implication of WTO agreement and the Free Trade Agreement between India and other countries.

The new initiatives announced for agriculture and other thrust areas such as handicrafts, handlooms, gems and jewelry, and leather and footwear are appreciable.

Further, in the new trade policy export-oriented units will be exempted from the service tax and biotechnology parks in the country would get all the facilities of 100% export-oriented units.

In addition to the above, the government has liberalized the EPCG benefits, the permission to transfer capital equipment to group companies, the extension of duty-free entitlement benefits to some more sectors, duty relief on fuel consumed by exporting units, and determination to double exports and keep a special focus on agriculture, all as a part of focusing on the new policy.

Foreign Trade Policy (2004-2009) Highlights

1. Strategy

- It is for the first time that a comprehensive Foreign Trade Policy is being notified. The Foreign Trade Policy takes an integrated view of the overall development of India's foreign trade.
- The objective of the Foreign Trade Policy is two-fold:
 - i. To double India's percentage share of global merchandise trade by 2009; and
 - ii. To act as an effective instrument of economic growth by giving a thrust to employment generation, especially in semi-urban and rural areas.
- The key strategies are:
 - i. Unshackling of controls;
 - ii. Creating an atmosphere of trust and transparency;
 - iii. Simplifying procedures and bringing down transaction costs;
 - iv. Adopting the fundamental principle that duties and levies should not be exported;
 - v. Identifying and nurturing different special focus areas to facilitate development of India as a global hub for manufacturing, trading and services.

2. **Special Focus Initiatives**

- Sectors with significant export prospects coupled with potential for employment generation in semi-urban and rural areas have been identified as thrust sectors, and specific sectoral strategies have been prepared.
- Further sectoral initiatives in other sectors will be announced from time to time. For the present, Special Focus Initiatives have been prepared for Agriculture, Handicrafts, Handlooms, Gems & Jewelry and Leather and Footwear sectors.
- The threshold limit of designated. Towns of Export Excellence is reduced from Rs.1,000 crore to Rs.250 crore in these thrust sectors.

3. **Package for Agriculture**

The Special Focus Initiative for Agriculture includes:

- A new scheme called Vishesh Krishi Upaj Yojana has been introduced to boost exports of fruits, vegetables, flowers, minor forest produce and their value added products.
- Duty free import of capital goods under EPCG scheme.
- Capital goods imported under EPCG for agriculture permitted to be installed anywhere in the Agri Export Zone.
- ASIDE funds to be utilized for development for Agri Export Zones also.
- Import of seeds, bulbs, tubers and planting material has been liberalized.
- Export of plant portions, derivatives and extracts has been liberalized with a view to promote export of medicinal plants and herbal products.

4. **Gems & Jewelry**

- Duty free import of consumables for metals other than gold and platinum allowed up to 2% of FOB value of exports.
- Duty free re-import entitlement for rejected jewelry allowed up to 2% of FOB value of exports.
- Duty free import of commercial samples of jewelry increased to Rs.1 lakh.
- Import of gold of 18 carat and above shall be allowed under the replenishment scheme.

5. **Handlooms & Handicrafts**

- Duty free import of trimmings and embellishments for Handlooms and Handicrafts sectors increased to 5% of FOB value of exports.
- Import of trimmings and embellishments and samples shall be exempt from CVD.
- Handicraft Export Promotion Council authorized to import trimmings, embellishments and samples for small manufacturers.
- A new Handicraft Special Economic Zone shall be established.

6. **Leather & Footwear**

- Duty free entitlements of import trimmings, embellishments and footwear components for leather industry increased to 3% of FOB value of exports.
- Duty free import of specified items for leather sector increased to 5% of FOB value of exports.
- Machinery and equipment for Effluent Treatment Plants for leather industry shall be exempt from Customs Duty.

7. Export Promotion Schemes**a. Target Plus**

A new scheme to accelerate growth of exports called Target Plus has been introduced. Exporters who have achieved a quantum growth in exports would be entitled to for duty free credit based on incremental exports substantially higher than the general actual export target fixed. (Since the target fixed for 2004-05 is 16%, the lower limit of performance for qualifying for rewards is pegged at 20% for the current year). Rewards will be granted based on a tiered approach. For incremental growth of over 20%, 25% and 100%, the duty free credits would be 5%, 10% and 15% of FOB value of incremental exports.

b. Vishesh Krishi Upaj Yojana

Another new scheme called Vishesh Krishi Upaj Yojana (Special Agricultural Produce Scheme) has been introduced to boost exports of fruits, vegetables, flowers, minor forest produce and their value added products. Export of these products shall qualify for duty free credit entitlement equivalent to 5% of FOB value of exports. The entitlement is freely transferable and can be used for import of a variety of inputs and goods.

c. Served from India Scheme

To accelerate growth in export of services so as to create a powerful and unique “Served from India” brand instantly recognized and respected the world over, the earlier DFEC scheme for services has been revamped and re-cast into the Served from India scheme. Individual service providers who earn foreign exchange of at least Rs.5 lakhs, and other service providers who earn foreign exchange of at least Rs.10 lakhs will be eligible for a duty credit entitlement of 10% of total foreign exchange earned by them. In the case of standalone restaurants, the entitlement shall be 20%, whereas in the case of hotels, it shall be 5%. Hotels and Restaurants can use their duty credit entitlement for import of food items and alcoholic beverages.

d. EPCG

- Additional flexibility for fulfillment of export obligation under EPCG scheme in order to reduce difficulties of exporters of goods and services.
- Technological upgradation under EPCG scheme has been facilitated and incentivized.
- Transfer of capital goods to group companies and managed hotels now permitted under EPCG.
- In case of movable capital goods in the service sector, the requirement of installation certificate from Central Excise has been done away with.
- Export obligation for specified projects shall be calculated based on concessional duty permitted to them. This would improve the viability of such projects.

e. DFRC

Import of fuel under DFRC entitlement shall be allowed to transfer to marketing agencies authorized by the Ministry of Petroleum and Natural Gas.

f. DEPB

The DEPB scheme would be continued until replaced by a new scheme to be drawn up in consultation with exporters.

8. New Status Holder Categorization

- A new rationalized scheme of categorization of status holders as Star Export Houses has been introduced as under:
Category Total performance over three years
One Star Export House 15 crores
Two Star Export House 100 crores
Three Star Export House 500 crores
Four Star Export House 1500 crores
Five Star Export House 5000 crores
- Star Export Houses shall be eligible for a number of privileges including fast-track clearance procedures, exemption from furnishing of Bank Guarantee, eligibility for consideration under Target Plus Scheme, etc.

9. EOUs

- EOUs shall be exempted from Service Tax in proportion to their exported goods and services.
- EOUs shall be permitted to retain 100% of export earnings in EEFC accounts.
- Income tax benefits on plant and machinery shall be extended to DTA units, which convert to EOUs.
- Import of capital goods shall be on self-certification basis for EOUs.
- For EOUs engaged in Textile & Garments manufacture leftover materials and fabrics up to 2% of CIF value or quantity of import shall be allowed to be disposed off on payment of duty on transaction value only.
- Minimum investment criteria shall not apply to Brass Hardware and Handmade Jewelry EOUs (this facility already exists for Handicrafts, Agriculture, Floriculture, Aquaculture, Animal Husbandry, IT and Services).

10. Free Trade and Warehousing Zone

- A new scheme to establish Free Trade and Warehousing Zone has been introduced to create trade-related infrastructure to facilitate the import and export of goods and services with freedom to carry out trade transactions in free currency. This is aimed at making India into a global trading-hub.
- FDI would be permitted up to 100% in the development and establishment of the zones and their infrastructural facilities.
- Each zone would have minimum outlay of Rs.100 crores and five lakh sq. mts. built up area.
- Units in the FTWZs would qualify for all other benefits as applicable for SEZ units.

11. Services Export Promotion Council

An exclusive Services Export Promotion Council shall be set up in order to map opportunities for key services in key markets, and develop strategic market access programs, including brand building, in co-ordination with sectoral players and recognized nodal bodies of the services industry.

12. Common Facilities Center

Government shall promote the establishment of Common Facility Centers for use by home based service providers, particularly in areas like Engineering and Architectural design, Multi-media operations, software developers etc., in State and District-level towns, to draw in a vast multitude of home-based professionals into the services export arena.

13. Procedural Simplification & Rationalization Measures

- Import of second-hand capital goods shall be permitted without any age restrictions.
- Minimum depreciated value for plant and machinery to be re-located into India has been reduced from Rs.50 crores to Rs.25 crores.
- All exporters with minimum turnover of Rs.5 crores and good track record shall be exempt from furnishing Bank Guarantee in any of the schemes, so as to reduce their transactional costs.
- All goods and services exported, including those from DTA units, shall be exempt from Service Tax.
- Validity of all licenses/entitlements issued under various schemes has been increased to a uniform 24 months.
- Number of returns and forms to be filed has been reduced. This process shall be continued in consultation with Customs & Excise.
- Enhanced delegation of powers to Zonal and Regional offices of DGFT for speedy and less cumbersome disposal of matters.
- Time bound introduction of Electronic Data Interface (EDI) for export transactions. 75% of all export transactions to be on EDI within six months.

14. Pragati Maidan

In order to show case our industrial and trade prowess to its best advantage and leverage existing facilities, Pragati Maidan will be transformed into a world-class complex. There shall be state-of-the-art, environmentally controlled, visitor friendly exhibition areas and marts. A huge Convention Center to accommodate 10,000 delegates with flexible hall spaces, auditoria and meeting rooms with high-tech equipment, as well as multi-level car parking for 9,000 vehicles will be developed within the envelope of Pragati Maidan.

15. Legal Aid

Financial assistance would be provided to deserving exporters, on the recommendation of Export Promotion Councils, for meeting the costs of legal expenses connected with trade-related matters.

16. Grievance Redressal

A new mechanism for grievance redressal has been formulated and put into place by a Government Resolution to facilitate speedy redressal of grievances of trade and industry.

17. Quality Policy

- DGFT shall be a business-driven, transparent, corporate-oriented organization.
- Exporters can file digitally signed applications and use Electronic Fund Transfer Mechanism for paying application fees.
- All DGFT offices shall be connected via a central server making application processing faster. DGFT HQ has obtained ISO 9000 certification by standardizing and automating procedures.

18. Board of Trade

The Board of Trade shall be revamped and given a clear and dynamic role. An eminent person or expert on trade policy shall be nominated as President of the Board of Trade, which shall have a Secretariat and separate Budget Head, and will be serviced by the Department of Commerce.

TRADE REGULATIONS GOVERNING IMPORTS/EXPORTS

The trade policy announced by the Commerce Minister lays down various trade regulations governing exports and imports. These regulations have to be mandatory complied with, by exporters, importers, authorized dealers and all other market players engaged in the business of exports/imports transactions. Hence, it is necessary for these players to familiarize themselves with the trade regulations. Furthermore, they are also required to keep a constant watch on any modifications/amendments to trade regulations effected by the concerned authorities from time to time in order to ensure strict compliance.

Given this fact, we shall now discuss trade regulations governing both exports and imports in detail.

Trade Regulations Governing Imports

FEMA defines 'import' as bringing into India, any goods or services. Imports to India can be classified into two categories:

- a. **Freely Importable Items or the Open General License (OGL):** The OGL includes those items, which are freely importable, and do not require import licenses.

For instance the following items does not require import license:

- Microfilm Camera
- Paraffin Wax
- Video Echo Sounder
- Collator Machine
- Asbestos Fiber, etc.

- b. **The Negative List:** Import of those items, which are not regulated by the OGL fall under the negative list category. These categories of items are broadly grouped under 3 heads: Prohibited, Restricted and Canalized.

- i. Banned or prohibited items have not permitted to be imported at all. They include tallow fat, animal rennet and unprocessed ivory.
- ii. Restricted items are generally those for which demand can be adequately satisfied, in normal circumstances, by local production in India. These are permitted to be imported only against a license, and include certain categories of consumer goods, precious stones, seeds, animals, insecticides, certain electronic items, drugs and chemicals.
- iii. Canalized items are those items, which are importable only by government trading monopolies. They are mostly commodity imports and any import of these items must be channeled through these agencies. Some of the canalized items include petroleum products to be imported only by the Indian Oil Corporation, Nitrogenous Phosphatic, potassic and complex chemical fertilizers by the Minerals and Metals Trading Corporation and cereals by the Food Corporation of India.

Import trade control is exercised by the director general of foreign trade functioning under the ministry of commerce. Some of the trade regulations governing imports are discussed below.

IMPORT LICENSES

Import license means a license granted specifically for import of goods, which are subject to import control. Items, which require a license, can imported only by an actual user, unless the actual user condition is specifically dispensed with by the licensing authority.

The Foreign Trade Policy defines “Actual User” as an actual user who may be either industrial or non-industrial user. “Actual User (Industrial)” is defined as “a person who utilizes the imported goods for manufacturing in his own unit or manufacturing for his own use in another unit including a jobbing unit.” “Actual User (Non-Industrial)” is defined as “a person who utilizes the imported goods for his own use in (i) any commercial establishment carrying on any business, trade, or profession; or (ii) any laboratory, Scientific or Research and Development (R&D) institution, university or other educational institution or hospital; or (iii) any service industry.”

Every license has a validity period, which is specified therein. For example, the validity of the Export Promotion Capital Goods license (EPCG) is 24 months. Only those items or category of items mentioned on the license can be imported under that license. A license is issued subject to the provisions of the policy applicable as on date of issue of the license. Every license bears the security seal of the office of issue as well as the signature of the issuing authority. As per the present rules import licenses issued under various provisions of the policy indicate the value in Indian rupees and in foreign currency at the exchange rate prevailing on the date of issue of the license.

CATEGORIES OF LICENSE

There are different categories of licenses.

Regular License

These are licenses issued for the import of goods, which fall under the normal import policy. These can be issued to any body entitled for issuance as per the policy provision.

Advance License

Advance licenses are issued under the duty exemption scheme. Under advance licenses, duty free imports of inputs are permitted on fulfillment of value addition and export obligation within a certain time frame. Such licenses (other than those for deemed exports) are exempted from payment of basic customs duty, surcharge, additional customs duty, anti dumping duty and safeguard duty, if any.

Under a value based advance license, any of the inputs specified in the license may be imported within the total CIF value indicated for those inputs, except inputs specified as sensitive items. Under such a license, both the quantity and the FOB value of the exports to be achieved shall be specified. It shall be obligatory on the part of the license holder to achieve both the quantity and FOB value of the exports specified in the license.

In case of quantity-based license, each item of inputs for import will be restricted in terms of quantity (or value where restrictions cannot be put in quantity terms).

The Exim policy 1997-2002 has done away with value based advance licenses. However, quantity based advance licenses will continue to remain in force. Quantity based advance licenses indicate the individual item, along with quantity and the aggregate CIF value of imports.

Licenses with Export Obligations

Certain licenses are issued with a rider, like ‘export obligation’ which means importers of capital goods are required to export to a place outside India, a certain proportion of goods manufactured by the use of imported capital goods. In case of importers rendering services, export obligation means receiving payments in freely convertible foreign currency for services, rendered through the use of such capital goods. License where export obligation is imposed, indicates value of export obligation both in free convertible currency and Indian Rupees equivalent thereof at the exchange rate prevailing on the date of issue of the license. It also indicates exchange rate used for arriving at the rupee value of license. Value indicated on import licenses is always for CIF (Cost, Insurance and Freight) value of goods authorized to be imported.

Special Import License

A Special Import License (SIL) may be used to import, among other items, certain consumer goods. The SIL is like an import permit and is traded in the market, at a premium on its value. It is issued to Indian exporters as an export incentive, and its value is tied to export earnings. SIL licenses are freely transferable and thus can be easily procured in the market by any prospective importer. The Special Import License shall be valid for import of items appearing in the ITC (HS) classification of Export and Import items. ITC (HS) refers to Indian Trade Classification (Harmonized System). The ITC (HS) classification of export and import items contains 99 chapters and each chapter covers information in five columns: the 8-digit code i.e. the Exim code, the item description, the applicable policy (prohibited, restricted, canalized or free); any conditions relating to the Export and Import Policy (these conditions appear either indicated with the particular item or in licensing notes at the end of the HS Chapter or section thereof); and an indication of whether the product can be imported under a Special Import License. The eight digit code can be interpreted as follows: the first two digits represent the chapter number, the next two digits the heading of goods in that chapter, and the last four digits refers to the sub heading. Each chapter is divided into various headings depending on different types of goods belonging to the same class of products. For instance, raw cotton has a code of 5201, while soft cotton waste/hard cotton waste has a code of 5202 and cotton yarn has a code of 5205. This means, the said items are in chapter 52 and occupy the first, second and fifth place respectively in that particular group. Similarly, the code for exotic birds is 0106 indicating that it falls under chapter one and occupies the sixth place in that chapter. The policy applicable to exotic birds is “Prohibited” and the nature of restriction is “Not Permitted to be Exported”. Another example would be calcium ammonium nitrate. The code for calcium ammonium nitrate is 31029009. The first two digits represent the chapter number, the next two digits the place it occupies in the chapter and the remaining four digits the sub classification under that chapter.

Import licenses are issued in duplicate. One copy is marked for “Customs Purposes” and has to be presented to the customs authorities at the time of clearance of goods. The other copy is marked for “Exchange Control Purposes” and has to be presented by the importer to the authorized dealer while opening a Letter of Credit (L/C) or making payment for import of goods.

TRANSFERABILITY OF LICENSES

After the fulfillment of export obligation and other conditions laid down, the holder of a transferable license may transfer it to a third party. However, a request for endorsement of transferability should be made to the licensing authority within 36 months of the date of issuance of license. When the import license is so endorsed, the license holder may transfer the license in full in case he has not made any imports or where imports have already been made, the license may be transferred in part excluding the value and quantity of imports already made or the materials or the balance already imported.

Issue of duplicate license, increase in the C.I.F value or any other amendments will not be permitted once the endorsement of transferability is made on the license.

The license transferred will be valid for the balance period of its validity or six months from the date of endorsement whichever is later.

ENDORSEMENT OF IMPORT LICENSE

Where a license is transferable, the fact of transferability will be indicated on the body of the license. In such case the license holder may affect part or full transfer of the license to other eligible importers in conformation with the various provisions of the policy.

VALIDITY OF IMPORT LICENSE/CERTIFICATES/PERMISSION/CCPS

The validity of import licence/certificate/ permission from the date of issue of licence/ certificate/ permission shall be as follows:

(i)	Advance Licence (including Advance Licence for Annual Requirement), DFRC and Replenishment licence for Gem & Jewellery	24 months
(ii)	EPCG licence (other than spares)	36 months
(iii)	EPCG Licence for Spares, refractories, catalyst and consumables	Co-terminus with the Export Obligation Period of the EPCG Licence.
(iv)	Others including CCP and Duty Entitlement Passbook Scheme, unless otherwise specified	24 months
(v)	Advance Licence for deemed export (including Advance Licence for Annual Requirement)	24 months or Co-terminus with the contracted duration of execution of the project whichever is later.

DUTY ENTITLEMENT PASS BOOK SCHEME (DEPB)

The objective of Duty Entitlement Passbook Scheme is to neutralize the incidence of customs duty on the import content of the export product. The neutralization shall be provided by way of grant of duty credit against the export product.

Under the Duty Entitlement Passbook Scheme (DEPB), an exporter may apply for credit, as a specified percentage of FOB value of exports, made in freely convertible currency. DEPB credit is available on export of goods. However, only those goods specified in the list of goods notified by the Director General of Foreign Trade by way of a public notice issued in this behalf will be eligible for credit. It thus becomes clear that unless the item is specified in the list notified by the DGFT, no DEPB credit can be availed of. The exim policy 1997-02 had introduced a new duty entitlement pass book scheme in place of the old pass book scheme.

Under this scheme, the exporter is issued a passbook, which has validity for a period of 12 months from the date of its issue. The holder of DEPB shall have the option to pay additional custom duty, if any, in cash as well and the DEPB and/or the items imported against it are freely transferable.

DIAMOND, GEM AND JEWELRY EXPORT PROMOTION SCHEME

To give a boost to exports of diamond, gem and jewelry for which India enjoys a special advantage of skilled labor, exporters under these sectors have been offered two special schemes viz:

- Replenishment (REP) licenses, and
- Diamond Imprest Licenses.

For importing their inputs like raw/cut and polished diamonds, gold, etc. A brief summary of the provisions under these schemes is discussed hereunder.

Replenishment License

Eligibility: The exporter of gem and jewelry products listed in Appendix-26 of the handbook (Vol. I) shall be eligible to import and replenish their input.

Procedure for Obtaining REP Licenses:

- The Gem REP licenses are available as per the scale given in Appendix-26A.
- An application for the Gem REP license may be given to the license authority in Appendix 25 in the form given in Appendix-13A along with the documents prescribed therein.
- In case EP copy of the shipping bill and custom attested invoice is submitted to the nominated agencies, the exporter shall furnish a self certified photocopy of the same along with a certificate from the nominated agency certifying the carat/value of studdings in case of studded jewelry and excess the value addition achieved in the case of plain jewelry and articles.
- Such applications are to be made within 6 months following the month/quarter in which export proceeds were realized.
- A consolidated application is to be made for all the exports realized in a month/quarter.
- To claim REP licenses against third party exports, the EP copy of the shipping bill must show the names of both i.e. the name of the manufacturer and the 3rd party through whom it was exported. Secondly, a disclaimer should be furnished from the third party.

DIAMOND IMPREST LICENSE

Under this scheme, diamond exporters can obtain Diamond Imprest License in advance, for import of rough diamonds from any source. Such licenses, however, carry an export obligation, which the licensee has to fulfill.

Eligibility: An exporter of cut and polished diamonds who is status holder may be issued a license for import of cut and polished diamonds up to 5% of the export performance of the preceding year of cut and polished diamonds.

Procedure: Application has to be made in the prescribed format to the Regional licensing authority along with name and address of his banker and bankers certificate to the effect that there are no overdue export bills beyond a period of six months.

Export Obligation: The export obligation against each consignment shall be fulfilled within a period of five months from the date of clearance of such consignment through customs.

BANK GUARANTEE AND LEGAL UNDERTAKING (LUT)

The licensee is required to execute a bank guarantee/legal undertaking before the first consignment of import is cleared. However, this requirement will be waived in case the export obligation is fulfilled before any imports are made. LUT/Joint LUT limits for different categories of exporters is indicated in the table below.

Table 1

Type of Exporter	Limits
1. Super Star Trading House and Units within the same group/public sector undertaking and units within the same group.	Unlimited
2. Export House/Trading House/Star Trading House and units within the same group.	Up to five times of FOB value of exports effected in the preceding licensing year/current year.
3. Exporters having performance of past exports but not covered under S.No. 1 and 2 above.	Up to two times of FOB value of exports made during the preceding licensing year.
4. Any overseas company with its branch office in India with an annual average turnover in diamonds during preceding three licensing years not less than Rs.150 crores.	Up to 50% of annual average turnover of the preceding three licensing years.

If a licensee does not have LUT limit he is required to execute Bank Guarantee for 50% of the CIF value of the license in the prescribed form.

EXTENSION OF EXPORT OBLIGATION PERIOD

The licensing authority shall allow one extension for a period of six months from the date of expiry of the original export obligation period to the licensee subject to payment of composition fee of 1% of the unfulfilled FOB value of export obligation with reference to CIF value of imports made for which extension is being sought. The request for further extension may be considered by the authorities, subject to payment of composition fee of 5% of the unfulfilled FOB value of export obligation with reference to CIF value of imports made for which extension is being sought. Such extension shall however not exceed a period of six months from the date of expiry of earlier extension.

DIAMOND DOLLAR ACCOUNT

Diamond exporters enjoy several benefits including the right to open diamond dollar accounts, which was introduced in the Exim policy 1997-2002. Diamond dollar accounts allow exporters to retain their proceeds in dollars. However, opening of this account is optional, and diamond exporters can continue to use their rupee accounts if required.

The criteria specified by RBI for operating diamond dollar accounts include:

- Firms/companies should be dealing in the purchase/sale of rough or cut and polished diamonds.
- A track record of at least 3 years in import or export of diamonds.
- An average annual turnover of Rs.5 crores or above during the preceding three licensing years.

Firms and companies maintaining foreign currency accounts, excluding Export Earners' Foreign Currency (EEFC) accounts, with banks in India or abroad, are not eligible to maintain Diamond Dollar Accounts. Eligible firms or companies may be allowed to open not more than 5 Diamond Dollar accounts with their banks.

Trade Regulations Governing Exports

FEMA defines 'export' as the taking or sending out of goods by land, sea or air, on consignment or by way of sale, lease, hire purchase, or under any other arrangement by whatever name called, and in the case of software, also includes transmission through any electronic media.

Exports may be of different types. They could be

CASH EXPORTS

Cash Exports are those exports where the proceeds are realized within 6 months from the date of shipment or the due date for payment whichever is earlier. As per FEDAI rules, the normal transit period and the notional due date of the bill will be taken into consideration to determine the due date of payment.

PROJECT EXPORTS

Export of engineering goods on deferred payment terms and execution of turnkey projects and civil construction contracts abroad are collectively referred to as 'Project Exports'. These contracts are usually of very high value.

DEEMED EXPORTS

Goods under this kind of export do not leave the shore of the country. Any such supply to be eligible for labeling as deemed exports should comply with the following:

- a. Supply of goods is to a project that funded by multilateral/bilateral agencies like IBRD/ADB/OPEC, etc. and any other such projects notified by the Government of India from time to time.
- b. Goods are supplied against an order received under international competitive bidding and to this effect the supplier of goods should submit a certificate from his buyer.

The central idea of this arrangement is that supply of goods has indeed facilitated inflow/retention of forex into/within the country.

The current trade policy allows for the free exportation of all goods, except to the extent such exports are regulated by the ITC (HS) classification of export and import items or any other provision of the policy or any other law for the time being in force. Exports from India are categorized into two (i.e. the open general license and the negative list) on the same lines as imports. The negative list consists of those goods which are (a) Permitted for export under license (restricted) or (b) Canalized or (c) Prohibited.

Some of the goods which are included under the restricted list are cattle, deoiled groundnut cakes containing more than 1% oil, fur of domestic animals excluding lamb fur skin, fodder including wheat and rice straw, etc. Canalized exports include export of petroleum products, mica waste, mineral ores, onions, etc. The prohibited list includes all forms of wild life, exotic birds, human skeletons, etc.

The Director General of Foreign Trade lays down conditions according to which certain items may be exported without licenses. Such terms and conditions generally include minimum export price, registration with specific authorities, quantitative ceilings and compliance with other laws. A person wishing to export an item on the negative list of exports must have a registration and membership certificate from the relevant export promotion council. He should also be in possession of a license issued by the licensing authority for the said purpose. An export license contains all the terms and conditions laid down by the licensing authority. Some of the details which are included in an export license are the quantity, description and value of the goods, actual user condition, export obligation, value addition to be achieved by the exporter, and the minimum export price. It should be noted that an export license cannot be claimed as a right. The licensing authority has the power to refuse, grant or renew a license as per the provisions of the Act. All export contracts must be denominated in freely convertible currencies.

In addition to possessing an export license, exporters are also required to register themselves with any one of the Export Promotion Councils (EPC) and obtain Registration and Membership Certificate (RCMC). Export promotion councils help in promoting and developing the exports of the country. Each council is responsible for promotion of a particular group of products, projects and services. EPCs are non-profit organizations registered under the Indian Companies Act or the Societies Registration Act as the case may be and are supported by financial assistance from the Government of India. An exporter who wishes to avail of the various Exim benefits will have to mandatorily register with the export promotion council. The RCMC issued by the Export Promotion Council is valid for a period of 5 licensing years.

Prior to any export, an exporter is required to give a declaration that the full export value of the goods or if the value is not ascertainable at the time of export, the value which the exporter expects to receive from the export has been or will be paid within the stipulated time and in the prescribed manner.

Also, the export of goods to countries other than Nepal and Bhutan can be made only if a declaration in the prescribed form is furnished to the prescribed authority.

However, declaration forms are not required in certain cases. Exports where declaration form is not required are:

- a. Trade samples supplied free of payment.
- b. Personal effects of travelers, whether accompanied or unaccompanied.
- c. Ships stores, transshipment cargo and goods shipped under the orders of the Central Government or of such officers as may be appointed by the Central Government in this behalf or of the military, naval or air force authorities in India for military, naval or air force requirements.

- d. Goods or software accompanied by a declaration by the exporter that they are not more than twenty five thousand rupees in value.
- e. By way of gift of goods accompanied by a declaration by the exporter that they are not more than one lakh rupees in value.
- f. Aircrafts or aircraft engines and spare parts for overhauling and/or repairs abroad subject to their re-import into India after overhauling/repairs within a period of six months from the date of their export.
- g. Goods imported free of cost on re-export basis.
- h. Goods not exceeding US\$ 1000, or its equivalent in value per transaction exported to Myanmar under the Barter Trade Agreement between the Central Government and the Government of Myanmar.
- i. The following goods which are permitted by the Development Commissioner of the Export Processing Zones or Free Trade Zones to be re-exported namely:
 - i. Imported goods found defective for the purpose of their replacement
 - ii. by the foreign suppliers/collaborators.
 - iii. Imported goods, which were imported from foreign collaborator on loan basis.
 - iv. Surplus goods, which were earlier, imported from foreign suppliers or collaborators free of cost, after production operations.
- j. Replacement goods exported free of charge in accordance with the provisions of the Exim policy in force, for the time being.

SUMMARY

- The Gulf crisis in the early 90s was the precursor for introduction of economic reforms in India.
- With the focus having shifted to opening up of the economy, a number of incentives aimed at giving a fillip to the export sector announced by the Government of India.
- The Exim policy also issues the trade regulations governing exports and imports. It lays down the trade procedures to be followed by exporters and importers.
- Every person/firm or organization engaged in this field should be aware of these regulations and strictly comply with the same. These trade regulations may be amended from time to time depending on the circumstances.

Chapter III

Documentary Credits

After reading this chapter, you will be conversant with:

- What is a Letter of Credit?
- Parties to a Letter of Credit
- How a Letter of Credit Operates?
- Different Kinds of Letters of Credit
- Documents under a Letter of Credit

International trade involves various complexities and problems. This may be due to various reasons. The parties to a sale contract are located in different countries and are governed by different legal systems. Also, the currencies of the two countries are different. Further, the trade and exchange regulations applicable to both the parties may differ. In such a situation, a seller who ships goods will be apprehensive whether he will receive payment from the buyer. The buyer, on the other hand, will be concerned whether the seller will ship the goods ordered for and deliver them in time. Given these complexities, a need for an ideal method of settling international trade payments was felt and so came the usage of documentary credits, commonly known as LC into vogue.

Even this arrangement, initially created discomfiture as parties involved in the transaction have been using different terminologies/interpreting the arrangement in different ways. Subsequently, ICC came up with a set of guidelines in the name of Uniform Customs and Practice for Documentary Credits to facilitate uniform interpretation of terminology used under documentary credit by all the concerned. The UCP first appeared in 1933 and since then is getting refined with the experiences gained from time to time. The latest revision under this, took place during 1993 and the document issued under publication no. 500 is currently in force. The UCPDC has thus attained universal acceptance and the local courts too are referring to these articles while settling trade disputes.

WHAT IS A LETTER OF CREDIT?

A documentary/letter of credit may be defined as “an arrangement by means of which a bank (Issuing Bank) acting at the request of a customer (Applicant), undertakes to pay to a third party (Beneficiary) a predetermined amount by a given date according to agreed stipulations and against presentation of stipulated documents”. In simple terms an LC may be defined as an arrangement where payment is made against documents. Under documentary credits, all the parties concerned deal with documents and not with goods, services or performances to which the documents may relate.

The Uniform Customs and Practice for Documentary Credits (UCPDC) guidelines which govern the operations of letters of credit defines documentary credit as “any arrangement, however named or described, whereby a bank (the “Issuing Bank”), acting at the request and on the instructions of a customer (the “Applicant”) or on its own behalf:

- i. Is to make a payment to or to the order of a third party (the “Beneficiary”), or is to accept and pay bills of exchange (“Draft”(s) drawn by the Beneficiary)
OR
- ii. Authorizes another bank to effect such payment, or to accept and pay such bills of exchange (Draft(s))
OR
- iii. Authorizes another bank to negotiate against stipulated documents, provided that the terms and conditions of the credit are complied with.

PARTIES TO A LETTER OF CREDIT

From the definition given above it can be deduced that the principal parties to a letter of credit are

- The Applicant (Opener of the LC/Importer)
- The Issuing Bank (The bank which opens the LC)
- The Beneficiary (Who is the Seller/Exporter) of the underlying LC
- The Advising Bank
- Confirming Bank
- Nominated Bank
- Reimbursement Bank.

The Applicant

The applicant of an LC is normally the buyer of the goods who is to make payment to the seller. It is at his request and instructions that the issuing bank opens the LC. Incidentally, an LC issuing bank could itself be an applicant (For its own use, it can be an applicant, as well as an issuer).

The Issuing Bank

The Issuing bank is the bank, which opens the LC in favor of the beneficiary. By opening the LC, the issuing bank undertakes the responsibility to make payment to the seller on compliance of required terms and conditions.

The Beneficiary

The Beneficiary is the seller of goods who is to receive payment from the buyer. The LC is opened in his favor to enable him to receive payment on submission of the stipulated documents.

The Advising Bank

The Advising Bank advises the credit to the beneficiary. Advising of credit is done only after verifying the authenticity of the credit. When a bank advises a credit, it implies that it authenticates the signatures of the issuing bank. The advising bank is usually situated in the country of the beneficiary.

Confirming Bank

The advising bank or any other bank so authorized by the issuing bank may assume the role of a confirming bank and add its confirmation to the LC opened by an issuing bank. The bank which has been asked to confirm an LC is under no obligation to confirm it. It can independently choose either to confirm or not, but it should advise its decision to the issuing bank immediately. A confirming bank, for all practical purposes enters into the shoes of the issuing bank and assumes primary responsibility of effecting payment under the LC to the beneficiary, upon his complying with the terms of the LC.

Nominated Bank

Nominated bank is the bank that is nominated and authorized by the issuing bank to

- Pay if the LC is a payment LC
- Incur a deferred payment undertaking
- Accept drafts, if the credit stipulates so
- Negotiate.

Where a credit is specified as freely negotiable, any bank can negotiate the documents under such an LC. However, where credit is restricted for negotiation, the issuing bank specifies the banks which are the nominated banks and to whom documents have to be presented for negotiation, etc. Bills under an LC with “restricted for negotiation” clause cannot be negotiated by any bank other than nominated bank in the LC.

Reimbursement Bank

Reimbursement bank is the bank, which is authorized to honor the reimbursement claim in settlement of negotiation/acceptance/payment lodged with it by the paying, negotiating or accepting bank. It is normally the bank with which the issuing bank has account, from which payment is to be made.

RIGHTS AND RESPONSIBILITIES OF PARTIES TO AN LC

The rights and responsibilities of every party associated with an LC have been defined in the UCPDC 500. It is necessary that every party dealing with an LC keep himself informed about these responsibilities. A brief summary of these rights is as under:

- All parties dealing with an LC are dealing only with documents and not with goods/services, or performances to which the documents may relate.
- Exporter/Beneficiary of LC has a right to receive payment against submission of prescribed documents under the LC. It is the exporter's duty to ship the goods as per the LC and submit the documents within the stipulated time for negotiation.
- **Negotiating Bank:** Once documents under the LC are submitted, the negotiating bank has to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit and if found agreeable, should effect payment as per the LC terms and dispatch documents to the opening bank as instructed. Once the amount under the LC is paid to the beneficiary, the negotiating bank is entitled to get reimbursement from the opening bank for the payment, provided documents are in conformity with LC terms.
- **Opening Bank:** Once documents under the LC are received from the negotiating bank, it should scrutinize them, within 7 days from the date of receipt. If it finds any discrepancy in the documents, it must convey the same to the negotiating bank through the fastest means available advising, that it is holding documents in want of disposal instructions.
- **Advising Bank:** Once LC opening instructions are received from the opening bank, the advising bank should, if it so desires to act as advising bank, verify the veracity of the LC and advise the beneficiary about the LC and its terms. It is entitled to receive advising charges for having advised the LC from the LC opening bank.
- **Confirming Bank:** If, at the request of the issuing bank, the advising bank chooses to add its conformity to the LC, it is taking upon itself, the responsibility of paying the beneficiary against presentation of stipulated documents. Upon payment, it is entitled to receive reimbursement from the issuing bank. It is also entitled to receive confirmation charges.
- **Applicant to the LC:** The importer is responsible for making payment under the LC, against release of stipulated documents, to the opening bank.

HOW A LETTER OF CREDIT OPERATES?

In order to make payment to the overseas supplier, the buyer of goods approaches his bank for opening a letter of credit in favor of the supplier.

After considering the request of the buyer and fulfillment of the necessary formalities, the issuing bank (i.e. the buyer's bank) opens the letter of credit in favor of the supplier.

The letter of credit is transmitted to the advising bank (usually an intermediary bank located in supplier's country) with a request to advise the credit to the beneficiary. After being satisfied with the authenticity of the credit, the advising bank advises the credit to the beneficiary (i.e. the supplier).

The beneficiary verifies the letter of credit and checks for any discrepancies vis-à-vis, the sale contract. If any discrepancies are noticed, the buyer is asked to incorporate the necessary changes/amendments to the LC. The supplier then proceeds to ship the goods.

Shipment of goods is followed by submission of necessary documents by the supplier to the negotiating bank in order to obtain payment for the goods. The negotiating bank, upon receipt of commercial documents and the bill of lading from the exporter, scrutinizes the documents in relation to the LC and if found to be in order, negotiates the bill and makes payment to the supplier.

The negotiating bank then claims reimbursement from the issuing bank by mailing the documents to it or any other bank authorized for the said purpose.

The commercial invoice and other documents are presented by the issuing bank to the buyer of goods, who, on receipt of the same, checks the documents and accepts/pays the bill. On acceptance/payment, the shipping documents covering the goods purchased are handed over to him.

DIFFERENT KINDS OF LETTERS OF CREDIT

Various types of LCs are in operation depending upon the need. Based on the nature and function, LCs may be categorized as under:

Based on Scope for Cancellation

- a. **Revocable Letter of Credit:** A revocable letter of credit is one which can be revoked (either canceled or amended) by the issuing bank without giving notice to any of the parties concerned. Here the issuing bank reserves the right of revocation. A revocable letter of credit is disadvantageous from the exporter's point of view. By opening a revocable letter of credit, the issuing bank does not make a definite undertaking to effect payment to the exporter. However, if a nominated bank has made payment to the beneficiary, prior to receipt of the notice of cancellation or amendment, then the issuing bank will be responsible to reimburse the claim that has been presented to it.

Every letter of credit should clearly specify whether it is revocable or irrevocable. According to the UCPDC guidelines, if no such indication is observed, the credit will be deemed to be an irrevocable letter of credit.

- b. **Irrevocable Letter of Credit:** Almost all LCs opened in the course of international trade are irrevocable letters of credit. Cancellation or any amendment to such an LC cannot be made without the prior acceptance of all the parties to the said LC like the applicant, the confirming bank, if any and the beneficiary. It is important to note that cancellation or amendment can be made only if all the parties consent to the same. An irrevocable letter of credit is more desirable from the exporter's point of view.
- c. **Confirmed Letter of Credit:** Here, in addition to the issuing bank, another bank will add its confirmation to the LC. In other words, a confirmed letter of credit will have the guarantee of not only the issuing bank but also of the confirming bank. It should be noted that only irrevocable letters of credit can be confirmed. The confirming bank will add its confirmation only if requested by the issuing bank. Confirming banks are usually located in the country of the beneficiary.

This works to the convenience of the beneficiary, as he will have to deal with a local bank rather than a bank situated in another country. A confirmed letter of credit is slightly costlier, owing to the charges that will have to be paid to the confirming bank for confirmation.

Based on Mode of Payment

- a. **Payment Credit:** Under this credit, payment will be made to the beneficiary on submission of the required documents provided they are in compliance with the LC terms. Payment credits do not usually call for drawing of bills. Under payment credit, the issuing bank, nominates a bank in the exporter's country to effect payment on its behalf if the documents are in conformity with the LC. The bank which paid the amount under the LC gets reimbursement from the issuing bank.

- b. **Deferred Payment Credit:** This type of credit is a usance credit, where payment is made on the due dates specified in the credit. The beneficiary may or may not be required to draw drafts. However, under this credit, the maturity dates at which payment has to be made and how such maturity should be determined should be clearly indicated. The drawee bank itself may draw promissory notes and pass on to the beneficiary for claiming payments on the due date.
- c. **Acceptance Credit:** This credit is a usance credit, where it is mandatory for the beneficiary to draw a draft on the drawee/specified bank for a specified tenor. The drawee bank will accept such drafts and make payment on the respective due dates on presentation of the relevant bill of exchange.
- g. **Negotiation Credit:** This credit may be a sight credit or a usance credit. Under a sight credit, payment is made immediately, while under a usance credit payment is made after a specified tenor. A negotiation credit may be freely negotiable in which case the beneficiary may approach any bank for presentation of documents. This implies that when a credit is freely negotiable, any bank is a nominated bank.

On the other hand, when a credit is restricted for negotiation, the issuing bank authorizes certain specified banks as the nominated banks. In such case, the beneficiary is required to present the stipulated documents only to such banks as they alone are authorized to negotiate the documents under LC.

When a bank nominated to make payment refuses to do so, then it is the responsibility of the issuing bank to make such payment. Hence, in a negotiation credit, under all circumstances, it is the responsibility of the issuing bank to pay, and it cannot avoid its responsibility by stating that the negotiating bank is required to pay. A nominated bank, which effectively negotiates documents, buys the same from the beneficiary, thus becoming a holder in due course.

Based on Tenor

- a. **Sight Credit:** Where payment is made on sight (either on demand or presentation), such credit is called a sight credit. Drawing of drafts is not compulsory under sight credit. Under a sight payment credit (if drawing a draft is not required) payment can be made against submission of stipulated documents.
- b. **Usance Credit:** Also referred to as Term credit, this credit requires drafts to be drawn on the drawee/specified bank indicating the tenor. Such drafts will be accepted by the drawee and paid for at the end of the usance period.

Based on Availability Style

- a. **Revolving Credit:** A letter of credit whereby the credit available to the beneficiary gets reinstated to the original amount once a drawing is made, is called revolving credit. The amount under this credit may revolve in relation to time or value. Revolving credit may be of two types. In the first type, the amount gets reinstated immediately when the beneficiary makes a drawing. In the second type, the amount will be revived only when the issuing bank gives a confirmation. This may take place after the issuing bank receives documents and payment is made, or the issuing bank confirms the fact of receipt of documents. Bankers should be cautious while opening revolving credits, as there is a tendency to lose track of the amount, which they are committing under this credit.
- b. **Installment Credit:** It stipulates that shipments may be made in installments at specified periods of time. Installment credit differs from simple credit, which permits partial shipments in the sense that under installment credit, the

time as well as the quantity is stipulated. On the other hand, under a simple credit, which permits partial shipments, there is no stipulation as to time and quantity.

While availing credit under an installment letter of credit, the exporter should be aware of the implications of Article 41 of the UCPDC guidelines. As per this article, if for any reason, the beneficiary is not able to ship the goods within the stipulated period and does not draw the installment on time, then the LC ceases to be available not only for that installment but also for any subsequent installments. This can be prevented only if the beneficiary sees to it that a provision specifically stipulating that credit will be available for subsequent installments despite any failure of earlier shipment or drawings is incorporated in the text of the LC. This credit calls for shipment of full value of goods.

- c. **Deferred Credit:** This credit is mostly used in those trades where a portion of goods is paid for by the buyer after verification of goods or after assessing the value of the goods taking into account the quality, shortages, etc. Date for payment of the undrawn balance may or may not be specified. Hence such type of credit is called as deferred credit.
- d. **Transit Credit:** Normally, when an LC is opened, it will be advised to the beneficiary by a bank that is based in the beneficiary's country. However, in a transit credit, the services of a bank situated in a third country will be used. In such credit, the advising bank will be situated in a country other than the beneficiary's. Such a requirement may be called for, in cases where the opening bank has no correspondent relations with any bank in the beneficiary's country. Transit credit may also be opened by countries whose credit may not be readily accepted in the beneficiary's country. In such a case, a bank in a third country may be requested to open the LC.
- e. **Reimbursement Credit:** When a credit is denominated in the currency of a third country, such credit is termed as reimbursement credit. This is in contrast to the normal letters of credit, which are denominated in the currency of either the applicant's country or the beneficiary's country. Sometimes, credits where a paying/accepting/negotiating bank is reimbursed in a manner other than by debit to the Vostro Account of the opening bank or by credit to the Nostro account of the paying/accepting/negotiating bank held with the opening bank are also referred to as reimbursement credits.
- f. **Anticipatory Credit:** Payment under a letter of credit is usually made at the post shipment stage (i.e., on submission of relevant shipping documents). However, under anticipatory credit, payment is made to the exporter at the pre-shipment stage in anticipation of export of goods and submission of bills at a later stage. The advances so made will be recovered from the proceeds of bills to be submitted under the letter of credit. Where the bills are not presented, recovery will be made from the opening bank.

Anticipatory credits are of two types:

- Red clause credit.
- Green clause credit.

Under the red clause credit, advance payment is made to the beneficiary for purchasing raw materials/processing and/or packing the goods.

In addition to the purpose specified under the red clause credit, the green clause credit provides for payment of advance towards warehousing and insurance charges at the port where the goods are stored pending availability of ship/shipping space.

These two types are, as of now, outdated and are rarely being used.

Others

- a. **Stand by Letter of Credit:** In a standby letter of credit, the credit is payable upon certification of a party's nonperformance of the agreement, of course upon adducing evidence to the effect that payment has indeed been defaulted. Standby LC are mostly used in countries, where financial guarantees are prohibited by law, like in the USA.
- b. **Transferable Credit:** A transferable credit is one, which can be transferred (i.e. from the First Beneficiary to a Second Beneficiary). It should be noted that such credit can be transferred only once. The second beneficiary cannot in turn transfer the same to a third beneficiary. A transferable credit will be subject to the original terms and conditions of the credit, excepting the amount of credit, unit prices, percentage of insurance terms, period of validity and shipment.

According to Article 48(b) of the UCPDC, a credit will be rendered as transferable, only if it is specifically stipulated as such in the credit.

- c. **Back-to-Back Credit:** This credit is one that is opened against the security of another credit called the main credit. Under this credit, when an LC is opened by the buyer in favor of the first beneficiary (who is usually not the actual supplier or manufacturer), such a beneficiary will open another identical LC in favor of his actual supplier/manufacturer against the security of the main credit. By doing so, the first beneficiary can obtain reimbursement by presenting documents received under back-to-back credit under the main LC.

Situations where the need for back-to-back letters of credit arises are:

- Where the buyer is not willing to open a transferable letter of credit.
- Where the beneficiary does not want to reveal the source of supply to the buyer.
- Where the actual supplier wants payment against documents for goods but the beneficiary of credit is short of funds.

Bankers may not find a back-to-back credit as safe as a transferable credit. This is because there is likelihood that once payment is made against the documents received under the back-to-back LC, the opener of the back-to-back LC may not be able to submit the same documents under the main LC to obtain reimbursement leading to credit risk to the opening bank of the back to back LC. Hence, bankers should exercise due caution while opening a back-to-back letter of credit.

DOCUMENTS UNDER A LETTER OF CREDIT

In case of shipment under Letter of Credit, the supplier should prepare documents strictly in accordance with the terms and conditions of the Letter of Credit and submit them to his bank for negotiation. The negotiating bank will examine these documents and if found in order, negotiate the same.

If there are any discrepancies in the documents presented by the exporter, the negotiating bank

- May return the documents to the exporters for rectification of defects.
- May refuse to negotiate the documents and advise the exporter to send them on collection basis or
- Contact the issuing bank for authorization for negotiation in case of minor discrepancies or
- Make payment 'under' reserve against exporter's indemnity and send the bills to the issuing bank.

The documents to be submitted by the exporter to his banker would include a commercial invoice, transport document which is usually the bill of lading (or seaway bill or airway bill), insurance document, certificate of inspection, packing list and in some cases a certificate of origin of goods as well.

Before submitting the documents to the bank, the exporter should follow certain safeguards, which are indicated below:

- Documents called for should be submitted and in the requisite number.
- Documents should be issued by persons required to issue.
- Documents should be dated wherever required.
- Documents should be manually signed wherever stipulated.
- Any material alterations to the documents should be properly authenticated.
- Documents should be consistent with each other.
- Shipment should take place within the time stipulated in the LC. In case of installment credit, the requisite quantity should be shipped within the stipulated time.
- If partial shipment is effected, the same should be permitted under the LC.
- Documents should be presented at the place stipulated.
- Documents should be presented within the expiry date of the LC.

Documents should be presented within the time stipulation indicated in the LC or the provisions of the UCPDC.

Guidelines to be kept in mind with respect to individual documents are enumerated below.

Invoice

A commercial invoice is prima facie evidence of the contract of sale and purchase. It is a document made by the exporter on the importer indicating details like description of the goods consigned, consignor's name, consignee's name, name of the steamer, number and date of bill of lading, country of origin, price, terms of payment, amount of freight, etc.

- The invoice should be made out in the name of the applicant.
- It should be signed by the maker. Description of goods specified in the invoice should correspond to the description given in the letter of credit. Similarly, other conditions like quantity of goods, unit price, delivery terms, etc. should conform to those stipulated in the Letter of Credit.
- The invoice should be drawn in the same currency of LC unless otherwise specified.
- The invoice should not include any charges not stipulated in the LC. Also, the gross value of invoice should not exceed the credit amount.
- The invoice should show deductions towards advance payment made, agency commission payable, etc. as applicable.
- Final amount of invoice or the percentage of drawing as permitted in the LC should correspond with the draft amount.
- If partial shipments are effected, amount of drawings should preferably correspond to proportionate quantities shipped (where only quantity is mentioned without unit price).
- If invoice is issued for an amount in excess of the amount permitted by the credit, the drawings should not exceed the amount of credit.
- Details stated on the invoice should correspond to details specified in all other documents. Also, the invoice should certify to facts like origin of goods, etc. as stipulated in the LC.

Bill of Lading

A bill of lading is a document issued by the shipping company or its agent, acknowledging the receipt of goods for carriage which are deliverable to the consignee or his assignee in the same condition as they were received.

There is a close relationship between bills of lading and the letter of credit. The possession of the original bill of lading enables the holder to claim the goods from the carrier.

The bill of lading must satisfy certain requirements. Every bill of lading must:

- Show the name of the carrier and must be issued by a named carrier or his agent. The bill of lading must also be signed by the named carrier or his agent.
- Bear a distinct number.
- Indicate the date and place of issuance.
- Indicate the name of consignor and consignee.
- Indicate a brief description of goods being carried.
- Indicate port of loading or taking incharge (in case of marine bill of lading it must show a definite port of loading and in other cases it can be shown as an “intended” port).
- Indicate port of discharge (in case of a marine bill of lading it must indicate a definite port of discharge and in other cases it can be shown as an intended port).
- Be presented in full set of originals (full set comprises of two or more originals issued to consignor of goods, all of which are made as “originals” and signed. The number of copies of originals is indicated on the bill of lading itself).
- Meet all other stipulations of the credit.
- Must indicate whether freight is prepaid or is payable.

A bill of lading should not unless otherwise specified by the terms of the LC:

- Be a chartered party bill of lading.
- Indicate that the carrying vessel is propelled by sail only.
- Be issued by a freight forwarder (unless he himself is acting as a carrier or agent).
- Indicate that the goods are or will be loaded on “DECK”.
- Be a claused bill of lading.

A bill of lading can (unless otherwise prohibited):

- Bear title such as “combined transport B/L” “Combined Transport Document or Combined Transport B/L” or “Port to Port B/L”.
- Be a short form or blank backed bill of lading.
- Indicate a place of taking incharge different from the port of loading and or place of final destination as different from the port of discharge.
- Indicate that the goods are carried in containers, pallets, etc.
- Be a FIATA Combined Transport B/L known as FIATA FBL approved by ICC issued by the freight forwarder.
- Be issued by a freight forwarder provided it is issued in his capacity as a carrier or his agent.
- Contain a notation that the goods may be carried on deck provided it does not specifically state that they are or will be loaded on deck.

- Indicate that the goods will be transshipped provided the same B/L covers the entire carriage.
- Be a “freight payable” bill of lading.
- Evidence freight prepayment by a stamp or otherwise on bill of lading to that effect like “Freight Prepaid”.
- Bear a reference by stamp or otherwise to cost additional to freight charges.
- Show clauses such as “shippers load and count” or “said by shipper to contain” etc. with reference to goods covered by bill of lading
- Show shipper as third party other than the beneficiary.
- Be deemed as “clean on board” if it is an on board bill of lading without any super imposed clauses or notations expressed in declaring the defective conditions of the goods and or the packagings.

Other Aspects of Bill of Lading

If a bill of lading is issued as an “on board” bill of lading it must indicate the name of the carrying vessel.

A charter party bill of lading need not show the name of the carrier.

A FIATA FBL can be accepted as a “Marine Bill of Lading” provided it meets with all the requirements of a marine bill of lading.

A bill of lading issued by even a Non-Vessel Owning Common Carrier (NVOCC) can be accepted as “Marine B/L” provided NVOCC has issued the B/L in his capacity as a carrier or his agent and all other requirements of “Marine B/L” are met with.

Bill of lading received for shipment can be treated as an “on board” bill of lading; if received for shipment. Bill of Lading is affixed with “on board” notation duly signed or initialed and dated by the carrier or his agent.

If LC calls for a “marine B/L” without specifying whether it should be “on board” or “received for shipment” only “on board B/L” will be accepted.

Date of issue of B/L or “on board” notation should be dated prior to the shipment date permitted under the LC.

Shipping marks, gross/net weight, etc., specified on bill of lading must correspond to those specified in other documents.

Insurance Document

In international trade, when goods are in transit they are exposed to marine perils. Insurance is effected to protect the insured against risk of loss or damage to goods due to marine perils.

Insurance documents should be issued and signed only by insurance companies or underwriters or their agents.

Cover notes issued by brokers will not be accepted unless specifically authorized by the credit.

The insurance document should be signed by the issuer and dated. Date of the issuance must be on or before the date of shipment or it must be evidence by specific notation that the cover is effective from the date of shipment.

The insurance document must be expressed in the same currency as the letter of credit.

The insurance document must indicate the name of the assured and also give brief details of the goods insured.

The mode of conveyance of goods should also be indicated. Further, it should also indicate the nature of risks covered which should be those specified in the LC.

The insurance document should be in a negotiable form.

Unless otherwise specified, it should be issued for an amount of 110% of CIF/CIP value of the goods. If such value is not determinable from the documents on their face it should be for a minimum amount of negotiation requested for or the amount of invoice value whichever is higher.

If the insurance document is issued in more than one negotiable copy, all copies must be submitted.

The document should be endorsed in blank by the assured if required as per the terms of the LC.

It should indicate the port of shipment and destination or point of insurance coverage and point of termination of insurance coverage.

It should not contain any clause affecting the interest of the assured/assignees.

It must cover all the additional risks as specified in the LC.

If the goods are on "DECK", deckshipment should be covered.

Other Documents

In addition to the above mentioned documents, a letter of credit may call for additional documents like bill of exchange, health certificate, preshipment inspection certificate, packing list, shipping company's certificate, beneficiary's declaration/undertaking, etc. Whenever such documents are called for under LC the following aspects should be taken care of:

- The documents called for should be issued by the person or authority specified in the credit. If no such person is specified or authorized, the banker may accept documents issued by any person.
- The documents should be dated and signed by the person/authority concerned.
- The documents should certify the facts required as per the LC.
- It should be checked whether the documents contain wordings or data content as specified in the LC or not.
- Bankers should check whether the details mentioned in such certificates/documents are consistent with other documents.

Certificate of Origin

Many countries require a certificate from the supplier of goods stating the origin of the goods and certified by the Chamber of Commerce or any other recognized authority in the exporter's country. Certificate of origin is an important document in case of imports into India to determine the origin of goods for methods of payment purpose as required by the Exchange Control Authorities.

- It must be issued and signed by an independent authority such as chamber of commerce, etc., indicating the origin of goods.
- The country of origin certified must be as per the LC requirement and consistent with the declaration given by the beneficiary in his invoice/other documents.
- It must indicate the description of goods and should be consistent with other documents.
- It must indicate the name of the consignor/seller and name of consignee/buyer.

Details appearing in the documents must be consistent with the details in other documents.

INCOTERMS

Incoterms – an acronym for International Commercial Terms – are a series of 13 trade terms used in international sales contracts to clearly divide the risks and responsibilities of buyers and sellers with regard to the movement of goods between both parties. They were first introduced in 1936 in Europe to prevent misunderstandings and disputes that may arise because of different trading practices among countries. They have been revised periodically to reflect current trading practices and the most recent is the Incoterms 2000.

EXW Ex Works (... named place)

It means that the seller has delivered if he places the goods at the disposal of the buyer either at the seller's premises or any other named place (works, factory, warehouse, etc.). This term represents the minimum obligation for the seller. All the expenses and risks involved in taking the goods from the seller's premises will have to be borne by the buyer.

FCA Free Carrier (... named place)

"Free Carrier" (FCA) means that the seller fulfills his obligation to deliver when he has handed over the goods, cleared for export, into the charge of the carrier named by the buyer at the named place or point. If no precise point is indicated by the buyer, the seller may choose within the place or range stipulated where the carrier shall take the goods into his charge.

FAS Free Alongside Ship (... named port of shipment)

Free Alongside Ship means that the seller delivers when the goods are placed alongside the vessel at the named port of shipment. This means that the buyer has to bear all costs and risks of loss of or damage to the goods from that moment. Free alongside ship does not include charges for loading the goods on board the vessel. It also does not include ocean freight charges and marine insurance premium. The FAS term requires the seller to clear the goods for export. This is in contrast to the earlier requirement where the buyer was required to arrange for clearance of the goods.

FOB Free on Board (... named port of shipment)

The seller is said to have delivered once the goods cross the ship's rail at the named port of shipment. From that point onwards all the risks and expenses are to be borne by the buyer. The FOB price is inclusive of ex-works price, packing charges, transportation charges up to the place of shipment, wharfage and portage, customs dues, export duties, cost of checking of quality measure, weight or quantity, if any which an exporter incurs while delivering the goods to the buyer on board the ship.

CFR Cost and Freight (... named port of destination)

"Cost and Freight" (CFR) means that the seller must pay the costs and freight necessary to bring the goods to the named port of destination but the risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered on board the vessel, is transferred from the seller to the buyer when the goods pass the ship's rail in the port of shipment.

CIF Cost, Insurance and Freight (...named port of destination)

"Cost, Insurance and Freight" (CIF) means that in addition to the obligations under Cost and Freight (CFR) the seller has to procure marine insurance against the buyer's risk of loss of or damage to the goods during the carriage. The seller contracts for insurance and pays the insurance premium.

CPT Carriage Paid To (... named place of destination)

"Carriage Paid To ..." (CPT) means that the seller pays the freight for the carriage of the goods to the named destination. The risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered to the carrier, is transferred from the seller to the buyer when the goods have been delivered into the custody of the carrier.

"Carrier" means any person who, in contract of carriage, undertakes to perform or to procure the performance of carriage, by rail, road, sea, air, inland waterway or by a combination of such modes.

If subsequent carriers are used for the carriage to the agreed destination, the risk passes when the goods have been delivered to the first carrier.

CIP Carriage and Insurance Paid To (... named place of destination)

“Carriage and Insurance Paid to ...” (CIP) means that the seller has the same obligations as under CPT (Carriage Paid To), but with the addition that the seller has to procure cargo insurance against the buyer’s risk of loss of or damage to the goods during the carriage. The seller contracts for insurance and pays the insurance premium. The buyer should note that under the CIP term the seller is only required to obtain insurance on minimum coverage. The CIP term requires the seller to clear the goods for export. This term may be used for any mode of transport including multimodal transport.

DAF Delivered at Frontier (... named place)

“Delivered at Frontier” (DAF) means that the seller fulfills his obligation to deliver when the goods have been made available, cleared for export, at the named point and place at the frontier, but before the customs border of the adjoining country. The term “frontier” may be used for any frontier including that of the country of export. Therefore, it is of vital importance that the frontier in question be defined precisely by always naming the point and place in the term. The term is primarily intended to be used when goods are to be carried by rail or road, but it may be used for any mode of transport.

DES Delivered Ex Ship (... named port of destination)

“Delivered Ex Ship” (DES) means that the seller fulfills his obligation to deliver when the goods have been made available to the buyer on board the ship uncleared for import at the named port of destination. The seller has to bear all the costs and risks involved in bringing the goods to the named port of destination. This term can only be used for sea or inland waterway transport.

DEQ Delivered Ex Quay (... named port of destination)

“Delivered Ex Quay (duty paid)” (DEQ) means that the seller fulfills his obligation to deliver when he has made the goods available to the buyer on the quay (wharf) at the named port of destination, cleared for importation. The seller has to bear all risks and costs including duties, taxes and other charges of delivering the goods thereto.

DDU Delivered Duty Unpaid (... named place of destination)

“Delivered Duty Unpaid” (DDU) means that the seller fulfills his obligation to deliver when the goods have been made available at the named place in the country of importation. The seller has to bear the costs and risks involved in bringing the goods thereto (excluding duties, taxes and other official charges payable upon importation as well as the costs and risks of carrying out customs formalities). The buyer has to pay any additional costs and to bear any risks caused by his failure to clear the goods for import in time.

DDP Delivered Duty Paid (... named place of destination)

“Delivered Duty Paid” (DDP) means that the seller fulfills his obligation to deliver when the goods have been made available at the named place in the country of importation. The seller has to bear the risks and costs, including duties, taxes and other charges of delivering the goods thereto, cleared for importation. While the EXW (ex works) term represents the minimum obligation for the seller, DDP represents the maximum obligation.

SUMMARY

- International trade involves dealings between parties who are located in two distinctly located countries. Their trade practices, exchange regulations, legal systems, etc. differ from each other. Under such circumstances, it is but natural for a seller of goods to be apprehensive about the buyer’s willingness to pay for goods in time and the buyer to harbor a nagging doubt about the exporter’s ability to ship the goods in time. He even wonders, whether the exporter would dispatch the goods if he makes advance payment.

- Against these mutual apprehensions of buyer and seller, a mechanism often called as documentary credit or Letter of Credit came into existence to smoothen these irregularities and to ensure that an exporter, upon his shipping the goods gets his payment from middlemen like a bank against his submitting the title to goods to the bank. By this mechanism, the importer is assured that payment is made only after the intended goods have been shipped and the seller is sure of getting payment, once he ships the goods.
- International Chamber of Commerce (ICC) has taken upon itself the responsibility of designing bylaws governing these transactions so as to ensure uniformity across the trading partners. The guidelines issued by the ICC are commonly known as Uniform Customs and Practice for Documentary Credits and the regulations that are currently in force are prescribed in the booklet UCPDC-500.
- LCs are opened by the buyer's bank and advised to the beneficiary (exporter) through a bank located in the exporter's country, commonly known as the advising bank. Documents under the LC can be negotiated by a bank located in the exporter's country if it is not restricted and reimbursement can be claimed from the issuing bank.
- There are different kinds of LCs that are used for achieving different objectives of importer/exporter. All the parties associated with a LC deal only in documents, but not with the underlying goods. Documents like commercial invoice, bill of lading, insurance documents are the prime documents under LC. These documents have to comply with the specifications mentioned against each item in the LC.
- It is only upon confirmation that the documents submitted by the exporter, comply with the terms and conditions of the LC, that payment is made available under the LC. Each party endowed with the responsibility of submitting documents is provided with 7 working days to scrutinize the documents and ascertain if they comply with the terms.
- Documentary credits, one of the important mechanisms, are ensuring smooth flow of international trade.

Appendix 1

Uniform Customs and Practice for Documentary Credits

A. GENERAL PROVISIONS AND DEFINITIONS

Article 1

Application of UCP

The Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No.500 shall apply to all Documentary Credits (including to the extent in which they may be applicable, Standby Letter(s) of Credit where they are incorporated into the text of the credit. They are binding on all parties thereto, unless otherwise expressly stipulated in the credit.

Article 2

Meaning of Credit

For the purposes of these Articles, the expressions “Documentary Credit(s)” and “Standby Letter(s) of Credit” (hereinafter referred to as Credits), mean any arrangement, however, named or described, whereby a bank (the “Issuing Bank”) acting at the request and on the instructions of a customer (the “Applicant”) or on its own behalf.

- i. Is to make a payment to or to the order of a third party (the “Beneficiary”), or is to accept and pay bills of exchange (Drafts) drawn by the Beneficiary, or
- ii. Authorizes another bank to effect such payment, or to accept and pay such bills of exchange (Drafts), or
- iii. Authorizes another bank to negotiate against stipulated document(s), provided that the terms and conditions of the credit are complied with.

For the purpose of these Articles, branches of a bank in different countries are considered another bank.

Article 3

Credits v Contracts

- a. Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay draft(s) or negotiate and/or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from his relationships with the issuing bank or the beneficiary.
- b. A Beneficiary can, in no case, avail himself of the contractual relationships existing between the banks or between the applicant and the issuing bank.

Article 4

Documents v Goods/Services/Performance

In credit operations all parties concerned deal with documents and not with goods, services and/or other performances to which the documents may relate.

Article 5

Instructions to Issue/Amend Credits

- a. Instructions for the issuance of a credit, the credit itself, instructions for an amendment thereto, and the amendment itself, must be complete and precise.
In order to guard against confusion and misunderstanding, banks should discourage any attempt:
 - i. To include excessive detail in the credit or in any amendment thereto.
 - ii. To give instructions to issue, advise or confirm a credit by reference to a credit previously issued (similar credit) where such previous credit has been subject to accepted amendment(s), and/or unaccepted amendment(s).

- b. All instructions for the issuance of a credit and the credit itself and, where applicable, all instructions for an amendment thereto and the amendment itself must state precisely the document(s) against which payment, acceptance or negotiation is to be made.

B. FORM AND NOTIFICATION OF CREDITS

Article 6

Revocable v Irrevocable Credits

- a. A credit may be either
 - i. Revocable or
 - ii. Irrevocable.
- b. The credit, therefore, should clearly indicate whether it is revocable or irrevocable.
- c. In the absence of such indication the Credit shall be deemed to be irrevocable.

Article 7

Advising Bank's Liability

- a. A credit may be advised to a beneficiary through another bank (the "Advising Bank") without engagement on the part of the Advising Bank, but that bank, if it elects to advise the Credit, shall take reasonable care to check the apparent authenticity of the Credit which it advises. If the bank elects not to advise the Credit, it must so inform the Issuing Bank without delay.
- b. If the Advising Bank cannot establish such apparent authenticity it must inform, without delay, the bank from which the instructions appear to have been received that it has been unable to establish the authenticity of the credit and if it elects nonetheless to advise the Credit it must inform the beneficiary that it has not been able to establish the authenticity of the credit.

Article 8

Revocation of a Credit

- a. A revocable credit may be amended or cancelled by the Issuing Bank at any moment and without prior notice to the Beneficiary.
- b. However, the Issuing Bank must:
 - i. Reimburse another bank with which a revocable credit has been made available for sight payment, acceptance or negotiation - for any payment, acceptance or negotiation made by such bank - prior to receipt by it of notice of amendment or cancellation, against documents which appear on their face to be in compliance with the terms and conditions of the Credit.
 - ii. Reimburse another bank with which a revocable credit has been made available for deferred payment, if such a bank has, prior to receipt by it of notice of amendment or cancellation, taken up documents which appear on their face to be in compliance with the terms and conditions of the credit.

Article 9

Liability of Issuing and Confirming Banks

- a. An irrevocable credit constitutes a definite undertaking of the issuing bank, provided that the stipulated documents are presented to the nominated bank or to the issuing bank and that the terms and conditions of the credit are complied with:
 - i. If the credit provides for sight payment - to pay at sight;
 - ii. If the credit provides for deferred payment - to pay on the maturity date(s) determinable in accordance with the stipulations of the credit;
 - iii. If the credit provides for acceptance:
 - By the issuing bank - to accept draft(s) drawn by the beneficiary on the issuing bank and pay them at maturity, or;

- By another drawee bank - to accept and pay at maturity draft(s) drawn by the beneficiary on the issuing bank in the event the drawee bank stipulated in the credit does not accept draft(s) drawn on it, or to pay draft(s) accepted but not paid by such drawee bank at maturity;
- iv. If the credit provides for negotiation - to pay without recourse to drawers and/or bonafide holders, draft(s) drawn by the beneficiary and/or document(s) presented under the credit. A credit should not be issued available by Draft(s) on the applicant. If the credit nevertheless calls for draft(s) on the applicant, banks will consider such Draft(s) as an additional document(s).
- b. A confirmation of an irrevocable credit by another bank (the “Confirming Bank”) upon the authorisation or request of the issuing bank, constitutes a definite undertaking of the confirming bank, in addition to that of the issuing bank, provided that the stipulated documents are presented to the confirming bank or to any other nominated bank and that the terms and conditions of the credit are complied with:
 - i. If the credit provides for sight payment - to pay at sight.
 - ii. If the credit provides for deferred payment - to pay on the maturity date(s) determinable in accordance with the stipulation of the credit.
 - iii. If the credit provides for acceptance:
 - By the Confirming bank - to accept (drafts) drawn by the beneficiary on the confirming Bank and pay them at maturity,or
 - By another drawee bank - to accept and pay at maturity draft(s) drawn by the beneficiary on the confirming bank, in the event the drawee bank stipulated in the credit does not accept draft(s) drawn on it, or to pay draft(s) accepted but not paid by such drawee bank at maturity.
 - iv. If the credit provides for negotiation - to negotiate without recourse to drawers and/or bonafide holders, draft(s) drawn by the beneficiary and/or document(s) presented under the credit. A credit should not be issued available by draft(s) on the applicant. If the credit nevertheless calls for a draft(s) on the applicant, banks will consider such draft(s) as an additional document(s).
- c.
 - i. If another bank is authorised or requested by the issuing bank to add its confirmation to a credit but is not prepared to do so, it must so inform the issuing bank without delay.
 - ii. Unless the issuing bank specifies otherwise in its authorisation or request to add confirmation, the advising bank may advise the credit to the beneficiary without adding its confirmation.
- d.
 - i. Except as otherwise provided by Article 48, an irrevocable credit can neither be amended nor cancelled without the agreement of the issuing bank, the confirming bank, if any, and the beneficiary.
 - ii. The issuing bank shall be irrevocably bound by an amendment(s) issued by it from the time of the issuance of such amendment(s). A confirming bank may extend its confirmation to an amendment and shall be irrevocably bound as of the time of its advice of the amendment. A confirming bank may, however, choose to advise an amendment to the beneficiary without extending its confirmation and if so, must inform the issuing bank and the beneficiary without delay.
 - iii. The terms of the original credit (or a credit incorporating previously accepted amendment(s)) will remain in force for the beneficiary until the beneficiary communicates his acceptance of the amendment to the bank that advised such amendment. The beneficiary should give notification of acceptance or rejection of amendment(s). If the beneficiary fails to give such notification, the tender of documents to the nominated bank or issuing bank, that conform to the credit and not yet accepted

amendment(s), will be deemed to be notification of acceptance by the beneficiary of such amendment(s) and as of that moment the credit will be amended.

- iv. Partial acceptance of amendments contained in one and the same advice of amendment is not allowed and consequently will not be given any effect.

Article 10

Types of Credit

- a. All credits must clearly indicate whether they are available by sight payment, by deferred payment, by acceptance or by negotiation.
- b. i. Unless the credit stipulates that it is available only with the issuing bank, all credits must nominate the bank (the “Nominated Bank”) which is authorised to pay, to incur a deferred payment undertaking, to accept draft(s) or to negotiate. In a freely negotiable credit, any bank is a nominated bank.

Presentation of documents must be made to the issuing bank or the confirming bank if any, or any other nominated bank.
- ii. Negotiation means the giving of value for draft(s) and/or document(s) by the bank authorised to negotiate. Mere examination of the documents without giving of value does not constitute a negotiation.
- c. Unless the nominated bank is the confirming bank, nomination by the issuing bank does not constitute any undertaking by the nominated bank to pay, to incur a deferred payment undertaking, to accept draft(s), or to negotiate. Except where expressly agreed to by the nominated bank and so communicated to the beneficiary, the nominated bank’s receipt and/or examination and/or forwarding of the documents does not make that bank liable to pay, to incur a deferred payment undertaking, to accept draft(s), or to negotiate.
- d. By nominating another bank, or by allowing for negotiation by any bank, or by authorising or requesting another bank to add its confirmation, the issuing bank authorises such bank to pay, accept draft(s) or negotiate as the case may be, against documents which appear on their face to be in compliance with the terms and conditions of the credit and undertakes to reimburse such bank in accordance with the provisions of these Articles.

Article 11

Teletransmitted and Pre-advised Credits

- a. i. When an issuing bank instructs an Advising Bank by an authenticated teletransmission to advise a credit or an amendment to a credit, the teletransmission will be deemed to be the operative credit instrument or the operative amendment, and no mail confirmation should be sent. Should a mail confirmation nevertheless be sent, it will have no effect and the advising bank will have no obligation to check such mail confirmation against the operative credit instrument or the operative amendment received by teletransmission.
- ii. If the teletransmission states “full details to follow” (for words of similar effect) or states that the mail confirmation is to be the operative credit instrument or the operative amendment, then the teletransmission will not be deemed to be the operative credit instrument or the operative amendment. The issuing bank must forward the operative credit instrument or the operative amendment to such advising bank without delay.
- b. If a bank uses the services of an advising bank to have the credit advised to the beneficiary, it must also use the services of the same bank for advising an amendment(s).
- c. A preliminary advice of the issuance or amendment of an irrevocable credit (pre-advice), shall only be given by an issuing bank if such bank is prepared to issue the operative credit instrument or the operative amendment thereto. Unless otherwise stated in such preliminary advice by the issuing bank, an issuing bank having given such pre-advice shall be irrevocably committed to issue or amend the credit, in terms not inconsistent with the pre-advice, without delay.

Article 12

Incomplete or Unclear Instructions

If incomplete or unclear instructions are received to advise, confirm or amend a credit, the bank requested to act on such instructions may give preliminary notification to the beneficiary for information only and without responsibility. This preliminary notification should state clearly that the notification is provided for information only and without the responsibility of the advising

bank. In any event, the advising bank must inform the issuing bank of the action taken and request it to provide the necessary information.

The issuing bank must provide the necessary information without delay. The credit will be advised, confirmed or amended, only when complete and clear instructions have been received and if the advising bank is then prepared to act on the instructions.

C. LIABILITIES AND RESPONSIBILITIES

Article 13

Standard for Examination of Documents

- a. Banks must examine all documents stipulated in the credit with reasonable care to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the credit. Compliance of the stipulated documents on their face with the terms and conditions of the credit shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the credit.

Documents not stipulated in the credit will not be examined by banks. If they receive such documents, they shall return them to the presenter or pass them on without responsibility.

- b. The issuing bank, the confirming bank, if any, or a nominated bank acting on their behalf shall each have a reasonable time, not to exceed seven banking days following the day of receipt of the documents, to examine the documents and determine whether to take up or refuse the documents and to inform the party from which it received the documents accordingly.
- c. If a credit contains conditions without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them.

Article 14

Discrepant Documents and Notice

- a. When the issuing bank authorises another bank to pay, incur a deferred payment undertaking, accept drafts(s) or negotiate against documents which appear on their face to be in compliance with the terms and conditions of the credit, the issuing bank and the confirming bank, if any are bound:
- i. To reimburse the Nominated bank which has paid, incurred a deferred payment undertaking, accepted draft(s), or negotiated.
 - ii. To take up the documents.
- b. Upon receipt of the documents the issuing bank and/or confirming bank, if any, or a nominated bank acting on their behalf, must determine on the basis of the documents alone whether or not they appear on their face to be in compliance with the terms and conditions of the credit. If the documents appear on their face not to be in compliance with the terms and conditions of the credit, such banks may refuse to take up the documents.
- c. If the issuing bank determines that the documents appear on their face not to be in compliance with the terms and conditions of the credit, it may in its sole judgement approach the applicant for a waiver of the discrepancy(ies). This does not however extend the period mentioned in Sub-Article 13(b).
- d. i. If the issuing bank and/or confirming bank, if any, or a nominated bank acting on their behalf, decides to refuse the documents, it must give notice to that effect by telecommunication or, if that is not possible by other expeditious means, without delay but no later than the close of the seventh banking day following the day of receipt of the documents. Such notice shall be given to the bank from which it received the documents, or to the beneficiary, if it received the documents directly from him.

- ii. Such notice must state all discrepancies in respect of which the bank refuses the documents and must also state whether it is holding the documents at the disposal of, or is returning them to, the presenter.
- iii. The issuing bank and/or confirming bank, if any, shall then be entitled to claim from the remitting bank refund, with interest, of any reimbursement which has been made to that bank.
- e. If the issuing bank and/or confirming bank if any, fails to act in accordance with the provisions of this Article and/or fails to hold the documents at the disposal of, or return them to the presenter, the issuing bank and/or confirming bank, if any, shall be precluded from claiming that the documents are not in compliance with the terms and conditions of the credit.
- f. If the remitting bank draws the attention of the issuing bank and/or confirming bank, if any, to any discrepancy(ies) in the document(s) or advises such banks that it has paid, incurred a deferred payment undertaking, accepted draft(s) or negotiated under reserve or against an indemnity in respect of such discrepancy(ies), the issuing bank and/or confirming bank, if any, shall not be thereby relieved from any of their obligations under any provision of this Article. Such reserve or indemnity concerns only the relations between the remitting bank and the party towards whom the reserve was made, or from whom, or on whose behalf, the indemnity was obtained.

Article 15

Disclaimer on Effectiveness of Documents

Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document(s), or for the general and/or particular conditions stipulated in the document(s) or superimposed thereon; nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented by any document(s), or for the good faith or acts and/or omissions, solvency, performance or standing of the consignor, the carriers, the forwarders, the consignees or the insurers of the goods, or any other person whomsoever.

Article 16

Disclaimer on the Transmission of Messages

Banks assume no liability or responsibility for the consequences arising out of delay and/or loss in transit of any message(s), letter(s) or document(s), or for delay, mutilation or other error(s) arising in the transmission of any telecommunication. Banks assume no liability or responsibility for errors in translation and/or interpretation of technical terms and reserve the right to transmit credit terms without translating them.

Article 17

Force Majeure

Banks assume no liability or responsibility for the consequences arising out of the interruption of their business by Acts of god, riots, civil commotions, insurrections, wars or any other causes beyond control, or by any strikes or lockouts. Unless specifically authorised, banks will not, upon resumption of their business, pay, incur a deferred payment undertaking, accept draft(s) or negotiate under credits which expired during such interruption of their business.

Article 18

Disclaimer for Acts of an Instructed Party

- a. Banks utilizing the services of another bank or other banks for the purpose of giving effect to the instructions of the applicant do so for the account and at the risk of such applicant.
- b. Banks assume no liability or responsibility should the instructions they transmit not be carried out, even if they have themselves taken the initiative in the choice of such other bank(s).

- c.
 - i. A party instructing another party to perform services is liable for any charges, including commissions, fees, costs or expenses incurred by the instructed party in connection with its instructions.
 - ii. When a credit stipulates that such charges are for the account of a party other than the instructing party, and charges cannot be collected, the instructing party remains ultimately liable for the payment thereof.
- d. The applicant shall be bound by and liable to indemnify the banks against all obligations and responsibilities imposed by foreign laws and usages.

Article 19

Bank to Bank Reimbursement Arrangements

- a. If an issuing bank intends that the reimbursement which a paying, accepting or negotiating bank is entitled, shall be obtained by such bank (the "Claiming Bank"), claiming on another party (the "Reimbursing Bank"), it shall provide such reimbursing bank in good time with the proper instructions or authorisation to honour such reimbursement claims.
- b. Issuing banks shall not require a claiming bank to supply a certificate of compliance with the terms and conditions of the credit to the reimbursing bank.
- c. An issuing bank shall not be relieved from any of its obligations to provide reimbursement if and when reimbursement is not received by the claiming bank from the reimbursing bank.
- d. The issuing bank shall be responsible to the claiming bank for any loss of interest if reimbursement is not provided by the reimbursing bank on first demand, or as otherwise specified in the credit, or mutually agreed, as the case may be.
- e. The Reimbursing Bank's charges should be for the account of the issuing bank. However, in cases where the charges are for the account of another party, it is the responsibility of the issuing bank to so indicate in the original credit and in the reimbursement authorisation. In cases where the Reimbursing Bank's charges are for the account of another party they shall be collected from the claiming bank when the credit is drawn under. In cases where the credit is not drawn under, the Reimbursing Bank's charges remain the obligation of the Issuing Bank.

D. DOCUMENTS

Article 20

Ambiguity as to the Issuers of Documents

- a. Terms such as "first class", "well known", "qualified", "independent", "official", "competent", "local" and the like, shall not be used to describe the issuers of any document(s) to be presented under a credit. If such terms are incorporated in the credit, banks will accept the relative document(s) as presented, provided that it appears on its face to be in compliance with the other terms and conditions of the credit and not to have been issued by the beneficiary.
- b. Unless otherwise stipulated in the credit, banks will also accept as an original document(s), a document(s) produced or appearing to have been produced:
 - i. By reprographic, automated or computerized systems;
 - ii. As carbon copies;

Provided that it is marked as original and, where necessary, appears to be signed.

A document may be signed by handwriting, by facsimile signature, by perforated signature, by stamp, by symbol, or by any other mechanical or electronic method of authentication.
- c.
 - i. Unless otherwise stipulated in the credit, banks will accept as a copy(ies), a document(s) either labelled copy or not marked as an original - a copy(ies) need not be signed.
 - ii. Credits that require multiple document(s) such as "duplicate", "two fold", "two copies" and the like, will be satisfied by the presentation of one original and the remaining number in copies except where the document itself indicates otherwise.
- d. Unless otherwise stipulated in the credit, a condition under a credit calling for a document to be authenticated, validated, legalised, visaed, certified or indicating a similar requirement,

will be satisfied by any signature, mark, stamp or label on such document that on its face appears to satisfy the above condition.

Article 21

Unspecified Issuers or Contents of Documents

When documents other than transport documents, insurance documents and commercial invoices are called for, the credit should stipulate by whom such documents are to be issued and their wording or data content. If the credit does not so stipulate, banks will accept such documents as presented, provided that their data content is not inconsistent with any other stipulated document presented.

Article 22

Issuance Date of Documents v Credit Date

Unless otherwise stipulated in the credit, banks will accept a document bearing a date of issuance prior to that of the credit, subject to such document being presented within the time limits set out in the credit and in these Articles.

Article 23

Marine/Ocean Bill of Lading

a. If a credit calls for a bill of lading covering a port-to-port shipment, banks will, unless otherwise stipulated in the credit, accept a document, however named, which:

- i. Appears on its face to indicate the name of the carrier and to have been signed or otherwise authenticated by:
 - the carrier or a named agent for or on behalf of the carrier, or
 - the master or a named agent for or on behalf of the master.

Any signature or authentication of the carrier or master must be identified as carrier or master, as the case may be. An agent signing or authenticating for the carrier or master must also indicate the name and the capacity of the party, i.e., carrier or master, on whose behalf that agent is acting, and

- ii. Indicates that the goods have been loaded on board, or shipped on a named vessel. Loading on board or shipment on a named vessel may be indicated by pre-printed wording on the bill of lading that the goods have been loaded on board a named vessel or shipped on a named vessel, in which case the date of issuance of the bill of lading will be deemed to be the date of loading on board and the date of shipment.

In all other cases loading on board a named vessel must be evidenced by a notation on the bill of lading which gives the date on which goods have been loaded on board, in which case the date of the on board notation will be deemed to be the date of shipment.

If the bill of lading contains the indication “intended vessel”, or similar qualification in relation to the vessel, loading on board a named vessel must be evidenced by an on board notation on the bill of lading, which in addition to the date on which the goods have been loaded on board, also includes the name of the vessel on which the goods have been loaded, even if they have been loaded on the vessel named as the “intended vessel”.

If the bill of lading indicates a place of receipt or taking in charge different from the port of loading, the on board notation must also include the port of loading stipulated in the credit and the name of the vessel on which the goods have been loaded, even if they have been loaded on the vessel named in the bill of lading. This provision also applies whenever loading on board the vessel is indicated by pre-printed wording on the bill of lading and

- iii. Indicates the port of loading and the port of discharge stipulated in the credit, notwithstanding that it:
 - indicates a place of taking in charge different from the port of loading, and/or a place of final destination different from the port of discharge and/or
 - obtains the indication “intended” or similar qualification in relation to the port of loading and/or port of discharge, as long as the document also states the ports of loading and/or discharge stipulated in the credit, and

- iv. Consists of a sole original bill of lading or, if issued in more than one original, the full set as so issued, and
 - v. Appears to contain all of the terms and conditions of carriage, or some of such terms and conditions by reference to a source or document other than the bill of lading (short form/blank back bill of lading); banks will not examine the contents of such terms and conditions and
 - vi. Contains no indication that it is subject to a charter party and/or no indication that the carrying vessel is propelled by sail only and
 - vii. In all other respects meets the stipulations of the credit.
- b. For the purpose of this Article, transshipment means unloading and reloading from one vessel to another vessel during the course of ocean carriage from the port of loading to the port of discharge stipulated in the credit.
- c. Unless transshipment is prohibited by the terms of the credit, banks will accept a bill of lading which indicates that the goods will be transhipped, provided that the entire ocean carriage is covered by one and the same bill of lading.
- d. Even if the credit prohibits transshipment, banks will accept a bill of lading which:
- i. Indicates that transshipment will take place as long as the relevant cargo is shipped in container(s), Trailer(s) and/or “LASH” barge(s) as evidenced by the bill of lading, provided that the entire ocean carriage is covered by one and the same bill of lading and/or
 - ii. Incorporates clauses stating that the carrier reserves the right to tranship.

Article 24

Non-Negotiable Sea Waybill

- a. If a credit calls for a non-negotiable sea waybill covering a port-to-port shipment, banks will, otherwise stipulated in the credit, accept a document, however named, which:
- i. Appears on its face to indicate the name of the carrier and to have been signed or otherwise authenticated by:
 - the carrier or a named agent for or on behalf of the carrier, or
 - the master or a named agent for or on behalf of the master.

Any signature or authentication of the carrier or master must be identified as carrier or master, as the case may be. An agent signing or authenticating for the carrier or master must also indicate the name and the capacity of the party, i.e carrier or master, on whose behalf that agent is acting, and

- ii. Indicates that the goods have been loaded on board, or shipped on a named vessel. Loading on board or shipment on a named vessel may be indicated by pre-printed wording on the non-negotiable sea way bill that the goods have been loaded on board a named vessel or shipped on a named vessel, in which case the date of issuance of the non-negotiable sea waybill will be deemed to be the date of loading on board and the date of shipment.

In all other cases loading on board a named vessel must be evidenced by a notation on the non-negotiable sea waybill which gives the date on which the goods have been loaded on board, in which case the date of the on board notation will be deemed to be the date of shipment.

If the non-negotiable sea waybill contains the indication “intended vessel” or similar qualification in relation to the vessel, loading on board a named vessel must be evidenced by an on board notation on the non-negotiable sea waybill which, in addition to the date on which the goods have been loaded on board, includes the name of the vessel on which the goods have been loaded, even if they have been loaded on the vessel named as the “intended vessel”.

If the non-negotiable sea waybill indicates a place of receipt or taking in charge different from the port of loading, the on board notation must also include the port of loading stipulated in the credit and the name of the vessel on which the goods have been loaded, even if they have been loaded on a vessel named in the non-negotiable sea

waybill. This provision also applies whenever loading on board the vessel is indicated by pre-printed wording on the non-negotiable sea waybill and

- iii. Indicates the port of loading and the port of discharge stipulated in the credit notwithstanding that it:
 - Indicates a place of taking in charge different from the port of loading, and/or a place of final destination different from the port of discharge and/or
 - Contains the indication “intended” or similar qualification in relation to the port of loading and/or port of discharge, as long as the document also states the ports of loading and/or discharge stipulated in the credit and
- iv. Consists of a sole original non-negotiable sea waybill, or if issued in more than one original, the full set as so issued and
- v. Appears to contain all of the terms and conditions of carriage, or some of such terms and conditions by reference to a source or document other than the non-negotiable sea waybill (short form/bank back non-negotiable sea waybill); banks will not examine the contents of such terms and conditions, and
- vi. Contains no indication that it is subject to a charter party and/or no indication that the carrying vessel is propelled by sail only and
- vii. In all other respects meets the stipulations of the credit.
- b. For the purpose of this Article, transshipment means unloading and reloading from one vessel to another vessel during the course of ocean carriage from the port of loading to the port of discharge stipulated in the credit.
- c. Unless transshipment is prohibited by the terms of the credit, banks will accept a non-negotiable sea waybill which indicates that the goods will be transhipped, provided that the entire ocean carriage is covered by one and the same non-negotiable sea waybill.
- d. Even if the credit prohibits transshipment, banks will accept a non-negotiable sea waybill which
 - i. Indicates that transshipment will take place as long as the relevant cargo is shipped in container(s), Trailer(s) and/or “LASH” barge(s) as evidenced by the non-negotiable sea waybill, provided that the entire ocean carriage is covered by one and the same non-negotiable sea waybill and/or
 - ii. Incorporates clauses stating that the carrier reserves the right to transship.

Article 25

Charter Party Bill of Lading

- a. If a credit calls for or permits a charter party bill of lading, banks will, unless otherwise stipulated in the credit, accept a document, however named, which:
 - i. Contains any indication that it is subject to a charter party, and
 - ii. Appears on its face to have been signed or otherwise authenticated by:
 - the master or a named agent for or on behalf of the master, or
 - the owner or a named agent for or on behalf of the owner.

Any signature or authentication of the master or owner must be identified as master or owner as the case may be. An agent signing or authenticating for the master or owner must also indicate the name and the capacity of the party, i.e. master or owner, on whose behalf that agent is acting, and
 - iii. Does or does not indicate the name of the carrier, and
 - iv. Indicates that the goods have been loaded on board or shipped on a named vessel. Loading on board or shipment on a named vessel may be indicated by pre-printed wording on the bill of lading that the goods have been loaded on board a named vessel or shipped on a named vessel, in which case the date of issuance of the bill of lading will be deemed to be the date of loading on board and the date of shipment.

In all other cases loading on board a named vessel must be evidenced by a notation on the bill of lading which gives the date on which the goods have been loaded on board, in which case the date of the on board notation will be deemed to be the date of shipment, and

- v. Indicates the port of loading and the port of discharge stipulated in the credit and
 - vi. Consists of a sole original bill of lading or, if issued in more than one original, the full set as so issued, and
 - vii. Contains no indication that the carrying vessel is propelled by sail only, and
 - viii. In all other respects meets the stipulations of the credit.
- b. Even if the credit requires the presentation of a charter party contract in connection with a charter party bill of lading, banks will not examine such charter party contract, but will pass it on without responsibility on their part.

Article 26

Multimodal Transport Document

- a. If a credit calls for a transport document covering, at least two different modes of transport (multimodal transport), banks will, unless otherwise stipulated in the credit, accept a document, however named, which:
- i. Appears on its face to indicate the name of the carrier or multimodal transport operator and to have been signed or otherwise authenticated by:
 - The carrier or multimodal transport operator or a named agent for or on behalf of the carrier or multimodal transport operator, or
 - The master or a named agent for or on behalf of the master.

Any signature or authentication of the carrier, multimodal transport operator or master must be identified as carrier, multimodal transport operator or master, as the case may be. An agent signing or authenticating for the carrier, multimodal transport operator or master must also indicate the name and the capacity of the party, i.e. carrier, multimodal transport operator or master, on whose behalf that agent is acting, and
 - ii. Indicates that the goods have been dispatched, taken in charge or loaded on board. Dispatch, taking in charge or loading on board may be indicated by wording to that effect on the multimodal transport document and the date of issuance will be deemed to be the date of dispatch, taking in charge or loading on board and the date of shipment. However, if the document indicates, by stamp or otherwise, a date of dispatch, taking in charge or loading on board, such date will be deemed to be the date of shipment and
 - iii.
 - a. Indicates the place of taking in charge stipulated in the credit which may be different from the port, airport or place of loading, and the place of final destination stipulated in the credit which may be different from the port, airport or place of discharge, and/or
 - b. Contains the indication “intended” or similar qualification in relation to the vessel and/or port of loading and/or port of discharge, and
 - iv. Consists of a sole original multimodal transport document or, if issued in more than one original, the full set as so issued, and
 - v. Appears to contain all the terms and conditions of carriage, or some of such terms and conditions by reference to a source or document other than the multimodal transport document (short form/blank back multimodal transport document); banks will not examine the contents of such terms and conditions, and
 - vi. Contains no indication that it is subject to a charter party and/or no indication that the carrying vessel is propelled by sail only, and
 - vii. In all other respects meets the stipulations of the credit.
- b. Even if the credit prohibits transshipment, banks will accept a multimodal transport document which indicates that transshipment will or may take place, provided that the entire carriage is covered by one and the same multimodal transport document.

Article 27

Air Transport Document

- a. If a credit calls for an air transport document, banks will, unless otherwise stipulated in the credit, accept a document, however named, which:

- i. Appears on its face to indicate the name of the carrier and to have been signed or otherwise authenticated by:
 - The carrier, or
 - A named agent for or on behalf of the carrier.

Any signature or authentication of the carrier must be identified as carrier. An agent signing or authenticating for the carrier must also indicate the name and the capacity of the party i.e carrier, on whose behalf that agent is acting, and
 - ii. Indicates that the goods have been accepted for carriage, and
 - iii. Where the credit calls for an actual date of dispatch, indicates a specific notation of such date, the date of dispatch so indicated on the air transport document will be deemed to be the date of shipment.

For the purpose of this Article, the information appearing in the box on the air transport document (marked “For Carrier Use Only” or similar expression) relative to the flight number and date will not be considered as a specific notation of such date of dispatch.

In all other cases, the date of issuance of the air transport document will be deemed to be the date of shipment, and
 - iv. Indicates the airport of departure and the airport of destination stipulated in the credit and
 - v. Appears to be the original for consignor/shipper even if the credit stipulates a full set of originals, or similar expressions, and
 - vi. Appears to contain all of the terms and conditions of carriage, or some of such terms and conditions, by reference to a source or document other than the air transport document, and banks will not examine the contents of such terms and conditions, and
 - vii. In all other respects meets the stipulations of the credit.
- b. For the purpose of this Article, transshipment means unloading and reloading, from one aircraft to another aircraft during the course of carriage from the airport of departure to the airport of destination stipulated in the credit.
 - c. Even if the credit prohibits transshipment, banks will accept an air transport document which indicates that transshipment will or may take place, provided that the entire carriage is covered by one and the same air transport document.

Article 28

Road, Rail or Inland Waterway Transport Documents

- a. If a credit calls for a road, rail or inland waterway transport document, banks will, unless otherwise stipulated in the credit, accept a document of the type called for, however named, which:
 - i. Appears on its face to indicate the name of the carrier and to have been signed or otherwise authenticated by the carrier or a named agent for or on behalf of the carrier and/or to bear a reception stamp or other indication of receipt by the carrier or a named agent for or on behalf of the carrier.

Any signature, authentication, reception stamp or other indication of receipt of the carrier, must be identified on its face as that of the carrier. An agent signing or authenticating for the carrier, must also indicate the name and the capacity of the party, i.e. carrier on whose behalf that agent is acting and
 - ii. Indicates that the goods have been received for shipment, dispatch or carriage or wording to this effect. The date of issuance will be deemed to be the date of shipment unless the transport document contains a reception stamp, in which case the date of the reception stamp will be deemed to be the date of shipment and
 - iii. Indicates the place of shipment and the place of destination stipulated in the credit and
 - iv. In all other respects meets the stipulations of the credit.

- b. In the absence of any indication on the transport document as to the numbers issued, banks will accept the transport document(s) presented as constituting a full set. Banks will accept as original(s) the transport document(s) whether marked as original(s) or not.
- c. For the purpose of this Article, transshipment means unloading and reloading from one means of conveyance to another means of conveyance, in different modes of transport, during the course of carriage from the place of shipment to the place of destination stipulated in the credit.
- d. Even if the credit prohibits transshipment, banks will accept a road, rail or inland waterway transport document which indicates that transshipment will or may take place, provided that the entire carriage is covered by one and the same transport document and within the same mode of transport.

Article 29

Courier and Post Receipts

- a. If the credit calls for a post receipt or certificate of posting, banks will, unless otherwise stipulated in the credit, accept a post receipt or certificate of posting which:
 - i. Appears on its face to have been stamped or otherwise authenticated and dated in the place from which the credit stipulates the goods are to be shipped or dispatched and such date will be deemed to be the date of shipment or dispatch, and
 - ii. In all other respects meets the stipulations of the credit.
- b. If the credit calls for a document issued by a courier or expedited delivery service evidencing receipt of the goods for delivery, banks will, unless otherwise stipulated in the credit, accept a document, however named, which:
 - i. Appears on its face to indicate the name of the courier/service, and to have been stamped, signed or otherwise authenticated by such named courier/service (unless the credit specifically calls for a document issued by a named courier/service, banks will accept a document issued by any courier/service, and
 - ii. Indicates a date of pick up or of receipt or wording to this effect, such date being deemed to be the date of shipment or dispatch, and
 - iii. In all other respects meets the stipulations of the credit.

Article 30

Transport Documents Issued by Freight Forwarders

Unless otherwise authorised in the credit, banks will only accept a transport document issued by a freight forwarder if it appears on its face to indicate:

- i. The name of the freight forwarder as a carrier or multimodal transport operator and to have been signed or otherwise authenticated by the freight forwarder as carrier or multimodal transport operator, or
- ii. The name of the carrier or multimodal transport operator and to have been signed or otherwise authenticated by the freight forwarder as a named agent for or on behalf of the carrier or multimodal transport operator.

Article 31

“On Deck”, “Shipper’s Load and Count”, Name of Consignor

Unless otherwise stipulated in the credit, banks will accept a transport document which:

- i. Does not indicate, in the case of carriage by sea or by more than one means of conveyance including carriage by sea, that the goods are or will be loaded on deck. Nevertheless, banks will accept a transport document which contains a provision that the goods may be carried on deck, provided that it does not specifically state that they are or will be loaded on deck, and/or
- ii. Bears a clause on the face thereof such as “shipper’s load and count” or “said by shipper to contain” or words of similar effect, and/or
- iii. Indicates as the consignor of the goods a party other than the beneficiary of the credit.

Article 32

Clean Transport Documents

- a. A clean transport document is one which bears no clause or notation which expressly declares a defective condition of the goods and/or the packaging.
- b. Banks will not accept transport documents bearing such clauses or notations unless the credit expressly stipulates the clauses or notations which may be accepted.
- c. Banks will regard a requirement in a credit for a transport document to bear the clause “clean on board” as complied with if such transport document meets the requirements of this Article and of Articles 23, 24, 25, 26, 27, 28 or 30.

Article 33

Freight Payable/Prepaid Transport Documents

- a. Unless otherwise stipulated in the credit, or inconsistent with any of the documents presented under the credit, banks will accept transport documents stating that freight or transportation charges (hereafter referred to as the “freight”) have still to be paid.
- b. If a credit stipulates that the transport document has to indicate that freight has been paid or prepaid, banks will accept a transport document on which words clearly indicating payment or prepayment of freight appear by stamp or otherwise, or on which payment or prepayment of freight is indicated by other means. If the credit requires courier charges to be paid or prepaid banks will also accept a transport document issued by a courier or expedited delivery service evidencing that courier charges are for the account of a party other than the consignee.
- c. The words “freight prepayable” or “freight to be prepaid” or words of similar effect, if appearing on transport documents, will not be accepted as constituting evidence of the payment of freight.
- d. Banks will accept transport documents bearing reference by stamp or otherwise to costs additional to the freight, such as costs of, or disbursements incurred in connection with loading, unloading or similar operations, unless the conditions of the credit specifically prohibit such reference.

Article 34

Insurance Documents

- a. Insurance documents must appear on their face to be issued and signed by insurance companies or underwriters or their agents.
- b. If the insurance document indicates that it has been issued in more than one original, all the originals must be presented unless otherwise authorised in the credit.
- c. Cover rules issued by brokers will not be accepted, unless specifically authorised in the credit.
- d. Unless otherwise stipulated in the credit, banks will accept an insurance certificate or a declaration under an open cover pre-signed by insurance companies or underwriters or their agents. If a credit specifically calls for an insurance certificate or a declaration under an open cover, banks will accept, in lieu thereof, an insurance policy.
- e. Unless otherwise stipulated in the credit, or unless it appears from the insurance document that the cover is effective at the latest from the date of loading on board or dispatch or taking in charge of the goods, banks will not accept an insurance document which bears a date of issuance later than the date of loading on board or dispatch or taking in charge as indicated in such transport document.
- f.
 - i. Unless otherwise stipulated in the credit, the insurance document must be expressed in the same currency as the credit.
 - ii. Unless otherwise stipulated in the credit, the minimum amount for which the insurance document must indicate the insurance cover to have been effected is the CIF (cost,

insurance and freight (... “named port of destination”)) or CIP (carriage and insurance paid to (... “named place of destination”)) value of the goods, as the case may be, plus 10%, but only when the CIF or CIP value can be determined from the documents on their face. Otherwise, banks will accept as such minimum amount 110% of the amount for which payment, acceptance or negotiation is requested under the credit or 110% of the gross amount of the invoice, whichever is the greater.

Article 35

Type of Insurance Cover

- a. Credits should stipulate the type of insurance required and, if any, the additional risks which are to be covered. Imprecise terms such as “usual risks” or “customary risks” shall not be used; if they are used, banks will accept insurance documents as presented, without responsibility for any risks not being covered.
- b. Failing specific stipulations in the credit, banks will accept insurance documents as presented, without responsibility for any risks not being covered.
- c. Unless otherwise stipulated in the credit, banks will accept an insurance document which indicates that the cover is subject to a franchise or an excess (deductible).

Article 36

All Risk Insurance Cover

Where a credit stipulates “insurance against all risks”, banks will accept an insurance document which contains any “all risks” notation or clause, whether or not bearing the heading “all risks”, even if the insurance document indicates that certain risks are excluded, “without responsibility for any risk(s) not being covered.

Article 37

Commercial Invoices

- a. Unless otherwise stipulated in the credit, commercial invoices,
 - i. Must appear on their face to be issued by the beneficiary named in the credit (except as provided in Article 48) and
 - ii. Must be made out in the name of the applicant (except as provided in sub-Article 48(h)) and
 - iii. Need not be signed.
- b. Unless otherwise stipulated in the credit, banks may refuse commercial invoices issued for amounts in excess of the amount permitted by the credit. Nevertheless, if a bank authorised to pay, incur a deferred payment undertaking, accept draft(s), or negotiate under a credit accepts such invoices, its decision will be binding upon all parties, provided that such bank has not paid, incurred a deferred payment undertaking, accepted draft(s) or negotiated for an amount in excess of that permitted by the credit.
- c. The description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the credit.

Article 38

Other Documents

If a credit calls for an attestation or certification of weight in the case of transport other than by sea, banks will accept a weight stamp or declaration of weight which appears to have been superimposed on the transport document by the carrier or his agent unless the credit specifically stipulates that the attestation or certification of weight must be by means of a separate document.

E. MISCELLANEOUS PROVISIONS

Article 39

Allowances in Credit Amount, Quantity and Unit Price

- a. The words “about”, “approximately”, “circa” or similar expression used in connection with the amount of the credit or the quantity or the unit price stated in the credit are to be construed as allowing a difference not to exceed 10% more or 10% less than the amount or the quantity or the unit price to which they refer.

- b. Unless a credit stipulates that the quantity of the goods specified must not be exceeded or reduced, a tolerance of 5% more or 5% less will be permissible, always provided that the amount of the drawings does not exceed the amount of the credit. This tolerance does not apply when the credit stipulates the quantity in terms of a stated number of packing units or individual items.
- c. Unless a credit which prohibits partial shipments stipulates otherwise, or unless sub-article (b), above is applicable, a tolerance of 5% less in the amount of the drawing will be permissible, provided that if the credit stipulates the quantity of the goods, such quantity of goods is shipped in full, and if the credit stipulates a unit price, such price is not reduced. This provision does not apply when expressions referred to in Sub-Article (a) above are used in the credit.

Article 40

Partial Shipments/Drawings

- a. Partial drawings and/or shipments are allowed, unless the credit stipulates otherwise.
- b. Transport documents which appear on their face to indicate that shipment has been made on the same means of conveyance and for the same journey, provided they indicate the same destination, will not be regarded as covering partial shipments, even if the transport documents indicate different dates of shipment and/or different port of loading, places of taking in charge, or despatch.
- c. Shipments made by post or by courier will not be regarded as partial shipments if the post receipts or certificates of posting or courier's receipts or dispatch notes appear to have been stamped, signed or otherwise authenticated in the place from which the credit stipulates the goods are to be dispatched, and on the same date.

Article 41

Installment Shipments/Drawings

If drawings and/or shipments by installments within given periods are stipulated in the credit and any installment is not drawn and/or shipped within the period allowed for that installment, the credit ceases to be available for that and any subsequent installments, unless otherwise stipulated in the credit.

Article 42

Expiry Date and Place for Presentation of Documents

- a. All credits must stipulate an expiry date and a place for presentation of documents for payment, acceptance, or with the exception of freely negotiable credits, a place for presentation of documents for negotiation. An expiry date stipulated for payment, acceptance or negotiation will be construed to express an expiry date for presentation of documents.
- b. Except as provided in Sub-Article 44(a), documents must be presented on or before such expiry date.
- c. If an issuing bank states that the credit is to be available "for one month", "for six months", or the like, but does not specify the date from which the time is to run, the date of issuance of the credit by the issuing bank will be deemed to be the first day from which such time is to run. Banks should discourage indication of the expiry date of the credit in this manner.

Article 43

Limitation on the Expiry Date

- a. In addition to stipulating an expiry date for presentation of documents, every credit which calls for a transport document(s) should also stipulate a specified period of time after the date of shipment during which presentation must be made in compliance with the terms and conditions of the credit. If no such period of time is stipulated, banks will not accept documents presented to them later than 21 days after the date of shipment. In any event, documents must be presented not later than the expiry date of the credit.
- b. In cases, in which Sub-Article 40(b) applies, the date of shipment will be considered to be the latest shipment date on any of the transport documents presented.

Article 44

Extension of Expiry Date

- a. If the expiry date of the credit and/or the last day of the period of time for presentation of documents stipulated by the credit or applicable by virtue of Article 43 falls on a day on which the bank to which presentation has to be made is closed for reasons other than those referred to in Article 17, the stipulated expiry date and/or the last day of the period of time after the date of shipment for presentation of documents, as the case may be, shall be extended to the first following day on which such bank is open.
- b. The latest date for shipment shall not be extended by reason of the extension of the expiry date and/or the period of time after the date of shipment for presentation of documents in accordance with Sub-Article (a) above. If no such latest date for shipment is stipulated in the credit or amendments thereto, banks will not accept transport documents indicating a date of shipment later than the expiry date stipulated in the credit or amendments thereto.
- c. The bank to which presentation is made on such first following business day must provide a statement that the documents were presented within the time limits extended in accordance with Sub-Article 44(a) of the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500.

Article 45

Hours of Presentation

Banks are under no obligation to accept presentation of documents outside their banking hours.

Article 46

General Expressions as to Dates

- a. Unless otherwise stipulated in the Credit, the expression “shipment” used in stipulating an earliest and/or a latest date for shipment will be understood to include the expressions such as “loading on board”, “dispatch”, “accepted for carriage”, “date of post receipt”, “date of pick up”, and the like, and in the case of a credit calling for a multimodal transport document the expression “taking in charge”.
- b. Expressions such as “prompt”, “immediately”, “as soon as possible”, and the like should not be used. If they are used banks will disregard them.
- c. If the expression “on or about” and similar expressions are used, banks will interpret them as a stipulation that shipment is to be made during the period from five days before to five days after the specified date, both end days included.

Article 47

Date Terminology for Periods of Shipment

- a. The words “to”, “until”, “till”, “from” and words of similar import applying to any date or period in the credit referring to shipment will be understood to include the date mentioned.
- b. The word “after” will be understood to exclude the date mentioned.
- c. The terms “first half”, “second half” of a month shall be construed respectively as the 1st to the 15th, and the 16th to the last day of such month, all dates inclusive.
- d. The terms “beginning”, “middle”, or “end” of a month shall be construed respectively as the 1st to the 10th, the 11th to the 20th and the 21st to the last day of such month, all dates inclusive.

F. TRANSFERABLE CREDIT

Article 48

Transferable Credit

- a. A transferable credit is a credit under which the beneficiary (First Beneficiary) may request the bank authorized to pay, incur a deferred payment undertaking, accept or negotiate the “Transferring Bank”, or in the case of a freely negotiable credit, the bank specifically authorized in the credit as a transferring bank, to make the Credit available in whole or in part to one or more other Beneficiary(ies) (Second Beneficiary(ies)).
- b. A credit can be transferred only if it is expressly designated as “transferable” by the issuing bank. Terms such as “divisible”, “fractionable”, “assignable”, and “transmissible” do not render the credit transferable. If such terms are used they shall be disregarded.

- c. The transferring bank shall be under no obligation to effect such transfer except to the extent and in the manner expressly consented to by such bank.
- d. At the time of making a request for transfer and prior to transfer of the credit, the first beneficiary must irrevocably instruct the transferring bank whether or not he retains the right to refuse to allow the transferring bank to advise amendments to the second beneficiary(ies). If the transferring bank consents to the transfer under these conditions, it must, at the time of transfer, advise the second beneficiary(ies) of the first beneficiary's instructions regarding amendments.
- e. If a credit is transferred to more than one second beneficiary(ies), refusal of an amendment by one or more second beneficiary(ies) does not invalidate the acceptance(s) by the other second beneficiary(ies) with respect to whom the credit will be amended accordingly. With respect to the second beneficiary(ies) who rejected the amendment, the credit will remain unamended.
- f. Transferring bank charges in respect of transfers including commissions, fees, costs or expenses are payable by the first beneficiary unless otherwise agreed. If the transferring bank agrees to transfer the credit it shall be under no obligation to effect the transfer until such charges are paid.
- g. Unless otherwise stated in the credit, a transferable credit can be transferred once only. Consequently, the credit cannot be transferred at the request of the second beneficiary to any subsequent third beneficiary. For the purpose of this Article, a retransfer to the first beneficiary does not constitute a prohibited transfer.

Fractions of a transferable credit (not exceeding in the aggregate the amount of the credit) can be transferred separately, provided partial shipments/drawings are not prohibited, and the aggregate of such transfers will be considered as constituting only one transfer of the credit.

- h. The credit can be transferred only on the terms and conditions specified in the original credit, with the exception of:
 - The amount of the credit.
 - Any unit price stated therein.
 - The expiry date.
 - The last date for presentation of documents in accordance with Article 43.
 - The period of shipment.
 - Any or all of which may be reduced or curtailed.

The percentage for which insurance cover must be effected may be increased in such a way as to provide the amount of cover stipulated in the original credit, or these Articles.

In addition, the name of the first beneficiary can be substituted for that of the applicant, but if the name of the applicant is specifically required by the original credit to appear in any document(s) other than the invoice, such requirement must be fulfilled.

- i. The first beneficiary has the right to substitute his own invoice(s) (and draft(s)) for those of the second beneficiary(ies), for amounts not in excess of the original amount stipulated in the credit and for the original unit prices if stipulated in the credit and upon such substitution of invoice(s) (and draft(s)) the first beneficiary can draw under the credit for the difference, if any, between his invoice(s) and the second beneficiary(ies) invoice(s).

When a credit has been transferred and the first beneficiary is to supply his own invoice(s) (and draft(s)) in exchange for the second beneficiary(ies) invoice(s) (and draft(s)) but fails to do so on first demand, the transferring bank has the right to deliver to the Issuing Bank the documents received under the transferred credit, including the second beneficiary(ies) invoice(s) (and draft(s)) without further responsibility to the first beneficiary.

- j. The first beneficiary may request that payment or negotiation be effected to the second beneficiary(ies) at the place to which the credit has been transferred up to and including the expiry date of the credit, unless the original credit expressly states that it may not be made available for payment or negotiation at a place other than that stipulated in the credit. This is without prejudice to the beneficiary's right to substitute subsequently his own invoice(s) (and draft(s)) for those of the second beneficiary(ies) and to claim any difference due to him.

G. ASSIGNMENT OF PROCEEDS

Article 49

Assignment of Proceeds

The fact that a credit is not stated to be transferable shall not affect the beneficiary's right to assign any proceeds to which he may be, or may become, entitled under such credit, in accordance with the provisions of the applicable law. This Article relates only to the assignment of the right to perform under the credit itself.

Appendix 2

ICC Uniform Rules for Collection

A. GENERAL PROVISIONS AND DEFINITIONS

Article 1

Application of URC 522

- a. The Uniform Rules for collections 1995 Revision ICC publication No.522 shall apply to all collections as defined in Article 2 where such rules are incorporated into the text of the “collection instruction” referred to in Article 4 and are binding on all parties thereto unless otherwise expressly agreed or contrary to the provisions of a national state or local law and/or regulation which cannot be departed from.
- b. Banks shall have no obligation to handle either a collection or any collection instruction or subsequent related instructions.
- c. If a bank elects, for any reason, not to handle a collection or any related instructions received by it, it must advise the party from whom it received the collection or the instructions by telecommunication or if that is not possible by other expeditious means, without delay.

Article 2

Definition of Collection

For the purpose of these Articles

- a. Collection means the handling by banks of documents as defined in Sub-Article 2(b), in accordance with instructions received, in order to:
 - i. Obtain payment and/or acceptance.
 - or
 - ii. Deliver documents against payment and/or against acceptance.
 - iii. Deliver documents on other terms and conditions.
- b. Documents - means financial documents and/or commercial documents:
 - i. “Financial Documents” means bills of exchange, promissory notes, cheques, or other similar instruments used for obtaining the payment of money;
 - ii. “Commercial Documents” means invoices, transport documents, documents of title or other similar documents, or any other documents whatsoever, not being financial documents.
- c. “Clean Collection” means collection of financial documents and accompanied by commercial documents.
- d. “Documentary Collection” means collection of
 - i. Financial documents accompanied by commercial documents
 - ii. Commercial documents not accompanied by financial documents.

Article 3

Parties to a Collection

- a. For the purposes of these Articles the “parties thereto” are:
 - i. The “Principal” who is the party entrusting the handling of a collection to a bank;
 - ii. The “Remitting Bank” which is the bank to which the principal has entrusted the handling of a collection;
 - iii. The “Collecting Bank” which is any bank, other than the remitting bank, involved in processing the collection;
 - iv. The “Presenting Bank” which is the collecting bank making presentation to the drawee.
- The “drawee” is the one to whom presentation is to be made in accordance with the collection instruction.

B. FORM AND STRUCTURE OF COLLECTIONS

Article 4

Collection Instruction

- a.
 - i. All documents sent for collection must be accompanied by a collection instruction indicating that the collection is subject to the URC 522 and giving complete and precise instructions. Banks are only permitted to act upon the instructions given in such collection instruction, and in accordance with these rules.
 - ii. Banks will not examine documents in order to obtain instructions.
 - iii. Unless otherwise authorized in the collection instruction, banks will disregard any instructions from any party/bank other than the party/bank from whom they received the collection.
- b. A collection instruction should contain the following items of information, as appropriate.
 - i. Details of the bank from which the collection was received including full name, postal and SWIFT address, telex, telephone, facsimile numbers and reference.
 - ii. Details of the principal including full name, postal address and if applicable telex, telephone and facsimile numbers.
 - iii. Details of the drawee including full name, postal address, or the domicile at which presentation is to be made and if applicable telex, telephone and facsimile numbers.
 - iv. Details of the presenting bank, if any, including full name, postal address, and if applicable telex, telephone and facsimile numbers.
 - v. Amount(s) and currency (ies) to be collected.
 - vi. List of documents enclosed and the numerical count of each document.
 - vii.
 - a. Terms and conditions upon which payment and/or acceptance is to be obtained.
 - b. Terms of delivery of documents against:
 1. Payment and/or acceptance
 2. Other terms and conditions.

It is the responsibility of the party preparing the collection instruction to ensure that the terms for the delivery of documents are clearly and unambiguously stated, otherwise banks will not be responsible for any consequences arising therefrom.
 - viii. Charges to be collected, indicating whether they may be waived or not.
 - ix. Interest to be collected, if applicable, indicating whether it may be waived or not, including:
 - a. Rate of interest.
 - b. Interest period.
 - c. Basis of calculation (for example 360 or 365 days in a year)as applicable.
 - x. Method of payment and form of payment advice.
 - xi. Instructions in case of non-payment, non-acceptance and/or non-compliance with other instructions.
- c.
 - i. Collection instructions should bear the complete address of the drawee or of the domicile at which the presentation is to be made. If the address is incomplete or incorrect, the collecting bank may, without any liability and responsibility on its part, endeavor to ascertain the proper address.
 - ii. The collecting bank will not be liable or responsible for any ensuing delay as a result of an incomplete/incorrect address being provided.

C. FORM OF PRESENTATION

Article 5

Presentation

- a. For the purposes of these Articles, presentation is the procedure whereby the presenting bank makes the documents available to the drawee as instructed.
- b. The collection instruction should state the exact period of time within which any action is to be taken by the drawee.

Expression such as “first”, “prompt”, “immediate”, and the like should not be used in connection with presentation or with reference to any period of time within which documents have to be taken up or for any other action that is to be taken by the drawee. If such terms are used banks will disregard them.
- c. Documents are to be presented to the drawee in the form in which they are received, except that banks are authorised to affix any necessary stamps, at the expense of the party from whom they received the collection unless otherwise instructed, and to make any necessary endorsements or place any rubber stamps or other identifying marks or symbols customary to or required for the collection operations.
- d. For the purpose of giving effect to the instructions of the principal, the remitting bank will utilise the bank nominated by the principal as the collecting bank. In the absence of such nomination, the remitting bank will utilise any bank of its own, or another bank’s choice in the country of payment or acceptance or in the country where other terms and conditions have to be complied with.
- e. The documents and collection instruction may be sent directly by the remitting bank to the collecting bank or through another bank as intermediary.
- f. If the remitting bank does not nominate a specific presenting bank, the collecting bank may utilise a presenting bank of its choice.

Article 6

Sight/Acceptance

In the case of documents payable at sight the presenting bank must make presentation for payment without delay.

In the case of documents payable at a tenor other than sight, the presenting bank must, where acceptance is called for, make presentation for acceptance without delay and where payment is called for, make presentation for payment not later than the appropriate maturity date.

Article 7

Release of Commercial Documents

Documents against Acceptance (D/A) vs Documents against Payment (D/P)

- a. Collections should not contain bills of exchange payable at a future date with instructions that commercial documents are to be delivered against payment.
- b. If a collection contains a bill of exchange payable at a future date, the collection instruction should state whether the commercial documents are to be released to the drawee against acceptance (D/A) or against payment (D/P).

In the absence of such statement, commercial documents will be released only against payment and the collecting bank will not be responsible for any consequences arising out of any delay in the delivery of documents.

If a collection contains a bill of exchange payable at a future date and the collection instruction, indicates that commercial documents are to be released against payment, documents will be released only against such payment and the collecting bank will not be responsible for any consequences arising out of any delay in the delivery of documents.

Article 8

Creation of Documents

Where the remitting bank instructs that either the collecting bank or the drawee is to create documents (bill of exchange, promissory notes, trust receipts, letters of undertaking or other documents) that were not included in the collection the form and wording of such documents shall be provided by the remitting bank, otherwise the collecting bank shall not be liable or responsible for the form and wording of any such document provided by the collecting bank and/or the drawee.

D. LIABILITIES AND RESPONSIBILITIES

Article 9

Good Faith and Reasonable Care

Banks will act in good faith and exercise reasonable care.

Article 10

Documents v Goods/Services/Performances

- a. Goods should not be despatched directly to the address of a bank or consigned to or to the order of a bank without prior agreement on the part of that bank.
Nevertheless, in the event that goods are despatched directly to the address of a bank or consigned to or to the order of a bank for release to a drawee against payment or acceptance or upon other terms and conditions without prior agreement on the part of that bank, such bank shall have no obligation to take delivery of the goods, which remain at the risk and responsibility of the party despatching the goods.
- b. Banks have no obligation to take any action in respect of the goods to which a documentary collection relates, including storage and insurance of the goods even when specific instruction are given to do so. Banks will only take such action if, when, and to the extent that they agree to do so in each case. Notwithstanding the provisions of Sub-Article 1(c), this rule applies even in the absence of any specific advice to this effect by the collecting bank.
- c. Nevertheless, in the case that banks take action for the protection of the goods, whether instructed or not, they assume no liability or responsibility with regard to the fate and/or condition of the goods and/or for any acts and/or omissions on the part of any third parties entrusted with the custody and/or protection of the goods. However, the collecting bank must advise without delay the bank from which the collection instruction was received of any such action taken.
- d. Any charges and/or expenses incurred by banks in connection with any action taken to protect the goods will be for the account of the party from whom they received the collection.
 - i. Notwithstanding the provisions of Sub-Article 10(a), where the goods are consigned to or to the order of the collecting bank and the drawee has honoured the collection by payment, acceptance other terms and conditions, and the collecting bank arranges for the release of the goods, the remitting bank shall be deemed to have authorised the collecting bank to do so.
 - ii. Where a collecting bank on the instructions of the remitting bank or in terms of Sub-Article 10(e)i, arranges for the release of the goods, the remitting bank shall indemnify such collecting bank for all damages and expenses incurred.

Article 11

Disclaimer for Acts of an Instructed Party

- a. Banks utilising the services of another bank or other banks for the purpose of giving effect to the instructions of the principal, do so for the account and at the risk of such principal.
- b. Banks assume no liability or responsibility should the instructions they transmit not be carried out, even if they have themselves taken the initiative in the choice of such other bank(s).
- c. A party instructing another party to perform services shall be bound by and liable to indemnify the instructed party against all obligations and responsibilities imposed by foreign laws and usages.

Article 12

Disclaimer on Documents Received

- a. Banks must determine that the documents received appear to be as listed in the collection instruction and must advise by telecommunication or, if that is not possible, by other expeditious means, without delay, the party from whom the collection instruction was received of any documents missing, or found to be other than listed.

Banks have no further obligation in this respect.

- b. If the documents do not appear to be listed, the remitting bank shall be precluded from disputing the type and number of documents received by the collecting bank.
- c. Subject to Sub-Article 5(c) and Sub-Articles 12(a) and 12(b) above, banks will present documents as received without further examination.

Article 13

Disclaimer on Effectiveness of Documents

Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document(s) or for the general and/or particular conditions stipulated in the document(s) or superimposed thereon, nor do they assume any liability or responsibility for the description, quantity, weight, quality, conditions, packing, delivery, value or existence of the goods represented by any document(s), or for the good faith or acts and/or omissions, solvency, performance or standing of the consignors, the carriers, the forwarders, the consignees or the insurers of the goods, or any other person whomsoever.

Article 14

Disclaimer on Delays, Loss in Transit and Translation

- a. Banks assume no liability or responsibility for the consequences arising out of delay and/or loss in transit of any message(s), letter(s), or document(s) or for delay, mutilation or other error(s) arising in transmission of any telecommunication or for error(s) in translation and/or interpretation of technical terms.
- b. Banks will not be liable or responsible for any delays resulting from the need to obtain clarification of any instructions received.

Article 15

Force Majeure

Banks assume no liability or responsibility for consequences arising out of the interruption of their business by Acts of god, riots, civil commotions, insurrections, wars, or any other causes beyond their control or by strikes or lockouts.

E. PAYMENT

Article 16

Payment without Delay

- a. Amounts collected (less charges and/or disbursements and/or expenses where applicable) must be made available without delay to the party from whom the collection instruction was received in accordance with the terms and conditions of the collection instruction.
- b. Notwithstanding the provisions of Sub-Article 1(c) and unless otherwise agreed, the collecting bank will effect payment of the amount collected in favour of the remitting bank only.

Article 17

Payment in Local Currency

In the case of documents payable in the currency of the country of payment (local currency), the presenting bank must, unless otherwise instructed in the collection instruction, release the documents to the drawee against payment in local currency only if such currency is immediately available for disposal in the manner specified in the collection instruction.

Article 18

Payment in Foreign Currency

In the case of documents payable in a currency other than that of the country of payment (foreign currency), the presenting bank must, unless otherwise instructed in the collection instruction, release the documents to the drawee against payment in the designated foreign currency only in such foreign currency can immediately remitted in accordance with the instructions given in the collection instruction.

Article 19

Partial Payments

- a. In respect of clean collection, partial payments may be accepted if and to the extent to which and on the conditions on which partial payments are authorised by the law in force in the place of payment. The financial document(s) will be released to the drawee only when full payment thereof has been received.
- b. In respect of documentary collections, partial payments will only be accepted if specifically authorised in the collection instruction. However, unless otherwise instructed, the presenting bank will release the documents to the drawee only after full payment has been received, and the presenting bank will not be responsible for any consequences arising out of any delay in the delivery of the documents.
- c. In all cases partial payments will be accepted only subject to compliance with the provisions of either Article 17 or Article 18 as appropriate.

Partial payment, if accepted, will be dealt with in accordance with the provisions of Article 16.

F. INTEREST, CHARGES AND EXPENSES

Article 20

Interest

- a. If the collection instruction specified that interest is to be collected and the drawee refuses to pay such interest, the presenting bank may deliver the document(s) against payment or acceptance or on other terms and conditions as the case may be, without collecting such interest unless Sub-Article 20(c) applies.
- b. Where such interest is to be collected, the collection instruction must specify the rate of interest, interest period and basis of calculation.
- c. Where the collection instruction expressly states that interest may not be waived and the drawee refuses to pay such interest the presenting bank will not deliver documents and will not be responsible for any consequences arising out of any delay in the delivery of document(s). When payment of interest has been refused, the presenting bank must inform by telecommunication or, if that is not possible by other expeditious means without delay the bank from which the collection instruction was received.

Article 21

Charges and Expenses

- a. If the collection instruction specifies that collection charges and/or expenses are to be for account of the drawee and the drawee refuses to pay them, the presenting bank may deliver the document(s) against payment of acceptance or on other terms and conditions as the case may be without collecting charges and/or expenses, unless Sub-Article 21(b) applies.

Whenever collection charges and/or expenses are so waived they will be for the account of the party from whom the collection was received and may be deducted from the proceeds.

- b. Where the collection instruction expressly states that charges and/or expenses may not be waived and the drawee refuses to pay such charges and/or expenses, the presenting bank will not deliver documents and will not be responsible for any consequences arising out of any delay in the delivery of the document(s). When payment of collection charges and/or expenses has been refused the presenting bank must inform by telecommunication or, if that is not possible, by other expeditious means without delay the bank from which the collection instruction was received.

- c. In all cases where in the express terms of a collection instruction or under these rules, disbursements and/or expenses and/or collection charges are to be borne by the principal, the collecting bank(s) shall be entitled to recover promptly outlays in respect of disbursements, expenses and charges from the bank from which the collection instruction was received, and the remitting bank shall be entitled to recover promptly from the principal any amount so paid out by it together with its own disbursements, expenses and charges, regardless of the fate of the collection.
- d. Banks reserve the right to demand payment of charges/and expenses in advance from the party from whom the collection instruction was received, to cover costs in attempting to carry out any instructions and pending receipt of such payment also reserve the right not to carry out such instructions.

G. OTHER PROVISIONS

Article 22

Acceptance

The presenting bank is responsible for seeing that the form of the acceptance of a bill of exchange appears to be complete and correct, but is not responsible for the genuineness of any signature or for the authority of any signatory to sign the acceptance.

Article 23

Promissory Notes and Other Instruments

The presenting bank is not responsible for the genuineness of any signature or for the authority of any signatory to sign a promissory note, receipt or other instruments.

Article 24

Protest

The collection instruction should give specific instructions regarding protest (or other legal process in lieu thereof) in the event of non-payment or non-acceptance.

In the absence of such specific instructions, the banks concerned with the collection have no obligation to have the document(s) protested or (subjected to other legal process in lieu thereof) for non payment or non-acceptance.

Any charges and/or expenses incurred by banks in connection with such protest or other legal process will be for the account of the party from whom the collection instruction was received.

Article 25

Case-of-need

If the principal nominates a representative to act as case-of-need in the event of non-payment and/or non-acceptance the collection instruction should clearly and fully indicate the powers of such case-of-need. In the absence of such indication banks will not accept any instructions from the case-of-need.

Article 26

Advices

Collecting banks are to advise fate in accordance with the following rules:

- a. **Form of Advice:** All advices or information from the collecting bank to the bank from which the collection instruction was received, must bear appropriate details including, in all cases, the latter bank's reference as stated in the collection instruction.
- b. **Method of Advice:** It shall be the responsibility of the remitting bank to instruct the collecting bank regarding the method by which the advices detailed in c(i), c(ii) and c(iii) are to be given. In the absence of such instructions, the collecting bank will send the relative advices by the method of its choice at the expense of the bank from which the collection instruction was received.
- c. **Advice of payment:** The collecting bank must sent without delay advice of payment to the bank from which the collection instruction was received, detailing the amount or amounts

collected, charges and/or disbursements and/or expenses deducted, where appropriate, and method of disposal of the funds.

- d. **Advice of Acceptance:** The collecting bank must send without delay advice of acceptance to the bank from which the collection instruction was received.
- e. **Advice of Non-Payment and/or Non-Acceptance:** The presenting bank should endeavour to ascertain the reasons for non-payment and/or non-acceptance and advise accordingly, without delay, the bank from which it received the collection instruction.

The presenting bank must send without delay advice of non-payment and/or advice of non-acceptance to the bank from which it received the collection instruction.

On receipt of such advice the remitting bank must give appropriate instructions as to the further handling of the documents. If such instructions are not received by the presenting bank within 60 days after its advice of non-payment and/or non-acceptance, the documents may be returned to the bank from which the collection instruction was received without any further responsibility on the part of the presenting bank.

Appendix 3

Export Documents

THE MANAGER
REPUBLIC BANK
FOREX DEPARTMENT,
2-2-18, S.R ROAD BRANCH
SECUNDERABAD 500 003, A.P

29/3/2000

RB-3403-EB

DEAR SIR,

WE HEREWITH SUBMIT THE APPLICATION FOR OPENING LC FOR USD 19000/- IN FAVOUR OF M/S STARGOLD LIMITED, U.K TOWARDS IMPORT OF CAPITAL GOODS.

ENCLOSED IS COPY OF PROFORMA INVOICE NO. 23548 DATED:21/3/2000 FOR YOUR READY REFERENCE.

WE REQUEST YOU TO OPEN FULL TELEX L.C, AND SEND US A COPY BY COURIER.

THANKING YOU,

YOURS FAITHFULLY,
FOR RADIANT SYSTEMS PRIVATE LIMITED,

GEORGE ROBERT
DIRECTOR.

Letter of Credit

APPLICATION TO OPEN IRREVOCABLE DOCUMENTARY CREDIT

L/C Ref No.

Applicant:

Beneficiary:

IMPORTER-EXPORTER CODE NO. _____

Advising Bank Amount not exceeding: _____

In figures: currency _____
Amount _____

In words: _____

Expiry Date

For Shipment

For negotiation

At the counters of negotiation bank

To

The Manager
Republic Bank
S.R. Road Branch

Please open by Full telex / Airmail / Fax an irrevocable confirmed documentary credit
Cable at urgent / ordinary rate

available to the aggregate sum not exceeding _____ by negotiation of beneficiary's
sight/_____days usance drafts drawn on us covering
_____and accompanied by (Description of goods)

1. Signed commercial invoices for a value not exceeding the draft amount quoting import licence No _____ and certifying goods are as per order/Indent _____. The gross FOB/CIF/C&F value of the goods before deduction of agent's commission, if any, must not exceed the credit amount.
 2. Certificate of _____ origin issued by a Chamber of Commerce.
 3. Full set, signed. "Clean", "On Board", Ocean Bills of Lading of a Conference Line Vessel made out to order and blank endorsed marked "Freight prepaid/Freight payable at destination" and notify _____
- And _____

L/C No. and date evidencing current shipment of merchandise stated above.

and

Short form bill of lading and third party bill of lading are not acceptable.

- 3a. Airway Bills/Air consignment notes addressed to _____
account openers indicating letter of credit number and market freight/prepaid/payable at
destination. Airway Bills/Air consignment notes must indicate flight number and date.
4. Lloyds Certificate that carrying steamer is seaworthy and not more than 15 years old.
5. Marine Insurance Policies/Certificate dated not later than the date of Bill of Lading and blank
endorsed for 10% over invoice value covering institute Cargo Clause (A) Institute War
Clause (Cargo) and Institute Strikes Clause (Cargo) Warehouse to Warehouse Clauses with
claims payable in India irrespective of percentage. Transshipment risks must be covered if
goods are subject to transshipment.
6. Test Certificate/Inspection Certificate/Preshipment Certificate of a reputed agency current
dated or issued by _____ specifying _____
7. Packing list with the same details as in No. 6 above.

Shipment/Despatch should be affected from _____ to _____.

Bill of lading/Airway Bill must be dated not later than _____ nor
prior to the date of this credit. (We confirm that this date is within the date stipulated in the Import
Licence).

Transshipment is ~~permitted~~/prohibited. Markings:RSPL

Patancheru, Dist. Medak A.P.

Part-Shipment is ~~permitted~~/prohibited.

ADDITIONAL CONDITIONS

1. All bank charges outside India are for beneficiary/opener's account.
2. The transport document:-
 - a. Must contain all the conditions of carriage on the original document.
 - b. Must not indicate the place of final destination as being different from the port of discharge.
 - c. Must not contain the indication "intended" or similar qualification in relation to the vessel or other means of transport or port of loading or port of discharge.
 - d. Must be issued by carrier or his agent and not by any freight forwarder.
 - e. Must not contain a provision that goods may be carried on deck.
3. "LASH" transport documents are not acceptable.
4. Transport documents bearing reference by stamp or otherwise to costs additional to the freight charges are not acceptable.
5. Short form or blank-back transport documents are not acceptable.
6. A transport document bearing a date of issuance prior to that of the credit is not acceptable.

In consideration of your opening the above credit, I/We hereby agree and undertake as follows:

1. I/We, hereby agree and undertake to accept and pay all bills of exchange drawn or purported to be drawn pursuant to the terms of the credit and take up and pay for all the documents negotiated thereunder in accordance with the terms thereof, as also for any disbursement made or liability incurred by you for my/our account under the credit, together with interest, costs, charges, and expenses due to you in respect thereof as hereinafter mentioned.
2. (i) I/We further agree to pay to you interest on the amount(s) payable in respect of my/our liability under the Credit, at the rate of _____ percent per annum over the Prime Lending Rate subject to a minimum of _____ percent per annum or at such other rate as may be prescribed by Bank from time to time for advances to non-priority sectors.
(ii) The aforesaid rate of interest shall however be applicable only during the period from the date of negotiation of the bill/documents under the credit up to and inclusive of the date immediately preceding the date of payment by me/us or the date of crystallization of my/our liability on the foreign currency bill pursuant to Clause 5(i) below, whichever is earlier, after which interest shall be payable at the rate stipulated in the said Clause 5(i).
3. I/We further agree to pay to you on demand (i) the charges that may be levied as per the Foreign Exchange Dealer's Association of India Rules in force from time to time for any early/late delivery of the relevant foreign exchange/currency under the Forward Exchange Contract, if any, booked by me/us and (ii) the commission or handling charges at the rate of 0.15% on the amount of the bill(s) drawn under the credit.
4. I/We also agree to pay you on demand, all costs (legal costs on full indemnity basis) customs duty, penalty, demurrage, storage charges, clearing and forwarding charges and all other charges and expenses which you may be put to or suffer or incur in connection with the goods and or the documents of title to goods covered by the credit including for re-shipment thereof for any reason whatsoever, or in the exercise or enforcement of any right or power hereby conferred or otherwise howsoever, and further agree and undertake to hold you safe and harmless and keep you indemnified against any claim, action or proceeding made or brought against you, your correspondents or agents against any liability or loss incurred or suffered by you, your correspondents or agents as also by reason of your having established the credit pursuant to my/our application or otherwise howsoever in the premises.
5. (i) If I/We fail to make due payment to you of a sight bill on its presentation or a usance bill on the date of its maturity, which is drawn or purported to be drawn under the Credit and expressed to be payable in a foreign currency, then you shall be at liberty without prejudice to your rights hereunder, to crystallize my/our liability on the foreign currency amount into Indian Rupees on the 10th day after the date of receipt of documents by you under the credit in the case of a sight bill remaining unpaid till then, or on the date of maturity in the case of a usance bill, whereupon I/We shall be liable to pay to you the Indian Rupee equivalent of such foreign currency amount as calculated at the rate of _____ percent per annum with quarterly rests, or at such other rate

- and/or with such other rests as may be notified by you from time to time, until payment or realization, and all costs, charges and expenses payable by me/us hereunder.
- (ii) The rate of exchange applicable to such conversion of the foreign currency amount into Indian Rupees shall be
 - (a) Your applicable bill selling rate prevailing on the date falling on the 10th day after the date of receipt of documents by you under the credit in case of a sight bill or on the date of maturity in the case of a usance bill provided however that if the relevant rate of exchange is not quoted or available for any reason on such 10th day in the case of a sight bill or on the date of maturity in the case of a usance bill, then the rate prevailing on the immediately next working day when such rate shall be quoted or be available, shall be the applicable rate of exchange, or
 - (b) The forward exchange contract rate in case a forward exchange contract has been booked by me/us with you.
 - (iii) The date of receipt of documents by you under the credit as registered in your record shall be conclusive and binding on me/us.
 - (iv) I/We confirm that crystallization of my/our liability on the foreign currency bill by you and the charging/payment of interest at a higher rate as aforesaid shall not be deemed to create any right in me/us to keep any bill unpaid when due.
6. I/We further agree that you shall have a pledge upon all goods and documents of title to goods and other documents covered under the credit which may have been already delivered or shall be hereafter delivered or shall be hereafter delivered into your possession or into the possession of your agents by me/us or by any person, firm or company or my/our behalf as a result of your opening the credit or in connection with the transaction thereunder. The said goods and the documents shall be deemed to be so delivered in pursuance of my/our this agreement to pledge them to you as security for all payments which may be made by you or your correspondents or agents under the credit for my/our account as also for any liability whatsoever incurred or which may be hereafter incurred by you or your correspondents or agents as a result of the opening of this credit, together with interest, costs charges and expenses as herein above mentioned.
 7. In the event of my/our committing a default in making due payment of any bill drawn or purported to be drawn under the credit or in making reimbursement on demand of any payment made by you for my/our account in respect of any liability that may be suffered or incurred by you or your correspondents or agents under or in connection with the credit then you shall be entitled without prejudice to any of your rights and without credit (the said "goods") whether before or after their arrival, either by public auction or tender or by private contract and subject to such conditions as you may deem fit to impose or otherwise dispose of or deal with the said goods or any part thereof and or with the relative documents of title to goods in any manner whatsoever, without being bound to exercise any of these powers or liable for any loss in the exercise or non-exercise thereof. The net proceeds realized from sale of the said goods or transfer of any document of title, remaining after deducting therefrom the costs and expenses of and incidental to such sale or transfer, shall be applied in or towards payment or satisfaction of the amount(s) due to you in respect of any payment or disbursement made by you under the credit for my/our account, and interest thereon and all costs, charges and expenses as hereinabove mentioned. I/We agree to accept bank's account of sale or realization as conclusive evidence both in and out of court as to the amount(s) realized and expenses incurred, and to pay forthwith any shortfall or deficiency remaining after such application. I/We further agree that you shall not be liable to me/us for any loss which may occur pending sale or disposal of the goods and/or documents of title to goods, whether by reason of theft, damage, deterioration or decay of the goods or depreciation in the value thereof or otherwise whatsoever be the cause.
 8. I/We agree to keep the said goods further insured from the time of expiry of insurance cover under the initial policy or policies of insurance, against all risks which are normally covered for goods of the nature purchased under the credit as also against such other risk(s) as may be required by you, and in the event of my/our failing to do so, you shall be at liberty to insure the said goods at my/our cost and expense without prejudice to your rights hereunder. Until all your dues in respect of the credit are paid in full, I/We agree to pay to you forthwith all moneys if received by me/us under any policy or policies of insurance and until payment to you of such insurance moneys, I/We undertake to hold the same in trust for you.

International Finance and Trade

9. I/We further agree and undertake to sign, execute and deliver to you from time to time on demand made by you, such further or other deeds, documents and writings, and do all such acts, matters and things as may be required by you for better perfecting your title to the said goods and the documents covered under the credit and are to render the same readily saleable or transferable by you to any purchaser(s) at all times.
10. Shipping documents and goods thereunder is entirely at my/our risk. You and your correspondents shall not be responsible for any error or delay in such transmission or loss or delay in delivery of the documents or the goods nor shall you or your correspondents or agents be liable in any respect beyond ensuring that bill(s) drawn under the credit and the relative documents covered thereunder purport to comply with the terms and conditions of the credit.
11. I/We have made adequate arrangements for retiring the bills under the credit and do not contemplate to seek any financial assistance from you for the purpose.
12. I/We agree to the negotiations of the drafts drawn under the credit being confined to your branches or agencies or to any bank acceptable to you.
13. I/We confirm that the goods described above are covered under my/our below mentioned import license.
14. I/We enclose for your perusal:
 - (i) Order together with the order confirmation of overseas supplier
Or
 - (ii) Pro forma invoice of overseas supplier duly countersigned by us
Or
 - (iii) Indent/Offer from overseas supplier or his authorized agent together with the Exchange control copy of the relative import licence.
15. This application shall be deemed to have been accepted and the Credit deemed to have been established when written advice thereof has been sent to the beneficiary.
16. I/We agree and confirm that this credit may be amended and/or modified by you in your absolute discretion, including for an increased limit, on our giving you written instructions for the same and in such an event, such amendment/modification will be deemed to form part of this credit application and will be governed by the terms hereof and I/We agree, covenant, record and confirm that I/We shall be bound by the same as if such amendment/modification including the increased limit had originally constituted the term of this credit.
17. This Agreement shall be binding upon me/us, my/our heirs, executors and administrators/successors and shall ensure to be of and be enforceable by you, your successors, transferees and assigns.
Except as otherwise expressly stated to this credit is to be opened subject to the uniform customs and practice for documentary credits (1993 revision) as contained in the international chamber of commerce publication no.500 as amended from time to time.
18. I/We confirm that the goods/items to be imported are not in the negative list of current import policy of Government of India.

Licence No.	Date
For Rs. Valid upto	
Date Signature	
HO Limit Rs _____	Number _____
Outstanding L/C Rs _____	
L/C Amount Rs _____	Date of issue
Margin held Rs _____	Date of expiry _____
_____	Goods _____
Value Rs _____	
Limiting factor _____	Value/Quantity/Both
Signature of Manager Officer	Signature of

NO: 00270
REPUBLIC BANK, S.R. ROAD, AUTO SEND
APR 04 2000 13:25:16

FROM: REPUBLIC BANK, S.R ROAD, SECUNDERABAD, A.P., INDIA

TO: LLOYDS BANK, LONDON, U.K

TEST 29-870 FOR USD 19000 DATED 4TH APRIL, 2000.

WE ESTABLISH OUR IRREVOCABLE/CONFIRMED DOCUMENTARY LETTER OF CREDIT AS FOLLOWS:

L/C NO. 505/RP/010/2000 DATED 4TH APRIL, 2000.

APPLICANT

M/S RADIANT SYSTEMS PRIVATE LIMITED
25, RADIANT HOUSE
COLABA, MUMBAI-400 005
INDIA.

BENEFICIARY

M/S STARGOLD LIMITED
RIDGEWAY INDUSTRIAL ESTATE
IVER,
BUCKINGHAMSHIRE, UNITED KINGDOM

VALUE: NOT EXCEEDING USD 19000 (US DOLLARS NINETEEN THOUSAND ONLY)

TERMS: FOB

COVERING SHIPMENT OF

1 NO. OF LD 1080 SINGLE PLANE 200 MM, 1 NO. OF CI900-1C AND 1.NO. OF CABLE LD TO CI900 AS PER PROFORMA INVOICE NO.23548 DATED 21ST MARCH, 2000 OF BENEFICIARY.

SHIPMENT

LATEST BY 25TH JUNE, 2000 FROM ANY U.K AIRPORT TO HYDERABAD AIRPORT.

NEGOTIATION

LATEST BY 30TH JUNE, 2000 AT THE COUNTERS OF ADVISING BANK AGAINST THE FOLLOWING DOCUMENTS IN TRIPLICATE UNLESS OTHERWISE SPECIFIED.

1. DRAFTS DRAWN BY THE BENEFICIARY ON US IN DUPLICATE FOR 100 PERCENT INVOICE VALUE AT SIGHT AND MARKED DRAWN UNDER DOCUMENTARY CREDIT NO. 505/RP/010/2000 OF REPUBLIC BANK, FOREX DEPARTMENT., 2-2-18, S.R ROAD BRANCH, SECUNDERABAD, A.P., INDIA.
2. SIX COPIES OF SIGNED COMMERCIAL INVOICES FOR A VALUE NOT EXCEEDING THE DRAFT AMOUNT QUOTING IMPORT UNDER OGL OF EXPORT AND IMPORT POLICY 1997-2002 AND CERTIFYING THAT THE GOODS ARE AS PER PROFORMA INVOICE NO.23548 DATED 21ST MARCH, 2000 OF BENEFICIARY.
3. THE GROSS FOB VALUE OF GOODS BEFORE DEDUCTION OF AGENTS COMMISSION, IF ANY, MUST NOT EXCEED THE CREDIT AMOUNT.

International Finance and Trade

4. AIRWAY BILLS/AIR CONSIGNMENT NOTES ADDRESSED TO REPUBLIC BANK, FOREX DEPT 2-2-18, S.R., ROAD BRANCH, SECUNDERABAD-500003, A.P INDIA, FOR ACCOUNT OPENERS INDICATING LETTER OF CREDIT NUMBER AND MARKED FREIGHT PAYABLE AT DESTINATION.
5. AIRWAY BILLS/AIR CONSIGNMENTS NOTES MUST INDICATE FLIGHT NUMBER AND DATE.
6. PACKING LIST.
7. INSURANCE WILL BE ARRANGED BY THE OPENERS. BENEFICIARY SHOULD FAX THE DETAILS OF AIRWAY BILL IMMEDIATELY AFTER SHIPMENT TO THE OPENERS FAX NO. 22-217843 TO ENABLE THEM TO ARRANGE INSURANCE COVER.
8. TEST/INSPECTION CERTIFICATE ISSUED BY MANUFACTURER.
9. CERTIFICATE OF U.K ORIGIN ISSUED BY A CHAMBER OF COMMERCE.

ADDITIONAL CONDITIONS

1. ALL BANK CHARGES OUTSIDE INDIA ARE FOR BENEFICIARY'S ACCOUNT.
2. TRANSHIPMENT PROHIBITED.
3. PARTSHIPMENT PROHIBITED.
4. ALL CASES/PACKINGS SHOULD BEAR THE FOLLOWING MARKINGS. RSPL, PATANCHERU, DIST.MEDAK, A.P.
5. DIRECTIONS TO NEGOTIATING BANK
 1. FORWARD DOCUMENTS IN TWO CONSECUTIVE REGISTERED AIRMAIL/COURIER.
 2. NEGOTIATE DOCUMENTS WITHIN 5 DAYS OF SHIPMENT, BUT WITHIN THE VALIDITY OF THE DOCUMENTARY CREDIT.
3. IF THE DOCUMENTS ARE IN STRICT CONFORMITY WITH THE TERMS AND CONDITIONS OF THE LETTER OF CREDIT CLAIM REIMBURSEMENT FROM OUR IBD, MUMBAI A/C NO. 7800054325 WITH BANK OF NEW YORK, NEW YORK, USA.

DIRECTIONS TO ADVISING BANK

1. PLEASE ADD YOUR CONFIRMATION AND ADVISE THE BENEFICIARY THROUGH
NATIONAL WESTMINSTER BANK PLC,
P.O BOX NO. 34, 15 BISHOPGATE,
LONDON, EC2P 2AP
SORT CODE 50-00-00
A/C NO. 30078256
2. THIS TELEX IS THE OPERATIVE CREDIT INSTRUMENT AND NO MAIL CONFIRMATION FOLLOWS. THIS LETTER OF CREDIT IS SUBJECT TO UCPDC 500 (1993).

REGARDS
MANAGER.
888301 LOYDLN G
4256595
MMMM
DURATION 010.3 MIN

Lloyds TSB International Services Center
Two Brindleyplace
P.O Box 63
Birmingham B1 2AB

Telephone: Telex Telegraphic Address
0121 643 9840 888301 & 883474

Overloyd Birmingham

Mail To:
Republic Bank
FOREX DEPT,
2-2-18, S.R ROAD
SECUNDERABAD 500 003
A.P
INDIA

Our Reference: Documentary Letter of Credit:
XQSTM253831P001 505/RP/010/2000

Date:
23rd June, 2000

PLEASE FOLLOW INSTRUCTIONS MARKED (X) BELOW.
THESE DOCUMENTS ARE SENT TO YOU "IN TRUST" UNDER THE PROTECTION OF
YOU ABOVE MENTIONED DOCUMENTARY CREDIT AND ON THE STRICT
UNDERSTANDING THAT THEY ARE TO BE RELEASED ONLY AGAINST:

(X) Payment.

	Draft	Inv.	Fax/Conf	Test/Cert	Pkg./List	Cert./Orig	Move/Doc.	Cert	
ORIGINALS	[1x1]	[1x5]	[1x2]	[2x2]	[1x2]	[1x2]	[1x2]	[1x1]	[]
ENCLOSED									
DUPLICATES	[1x1]	[1x1]	[1x1]	[2x1]	[1x1]	[1x1]	[1x1]	[]	[]
TO FOLLOW									

Bill of Exchange

Amount USD 19,000.00

Drawn on Yourselves

Tenor SIGHT

(X) Discrepancies if any are to be advised to us by Teletransmission
(X) On your taking up documents
(X) Credit our account held with BANK OF NEW YORK, NEW YORK
under telex advice to us quoting our reference.
the sum of USD 19,000.00

Subject to Uniform Customs and Practice for Documentary Credits 1993 revision International
Chamber of Commerce Publication No. 500

AUTHORISED SIGNATORY

International Finance and Trade

No. 38704 (Drawn under Documentary Credit No. 505/RP/010/2000 of Republic Bank, Forex
Department, Secunderabad, A.P India)

20th June 2000 For USD 19000.00

At Sight **Second** Pay this Bill of Exchange THE FIRST BEING -----
----- ----- -----

UNPAID to the Order of STAR GOLD LIMITED NINETEEN THOUSAND,
----- -----

US DOLLARS ONLY

Value Received FOR 100 PERCENT INVOICE VALUE-----..

To Republic Bank For Star Gold Limited
S.R Road -----
Secunderabad, A.P
India Director

INVOICE 38704

M/S STAR GOLD
RIDGEWAY INDUSTRIAL ESTATE
IVER
BUCKINGHAMSHIRE
U.K

Sales Order No. 23548	Date Invoiced 08/06/00
Packing Slip No. 23548*1	Date Shipped 08/06/00
Customer Purchase Order No: BLL-3307-EB	
Sales Representative: M.A. GEORGE	Code: F04
Shipped Via: AIR FREIGHT	
Payment Terms: LETTER OF CREDIT	

Invoice To	RADIANT SYSTEMS PVT LTD RADIANT HOUSE 25, COLASI MUMBAI – 400 005 INDIA	Ship To	REPUBLIC BANK, 2-2-18, S. R. ROAD SECUNDERABAD RADIANT SYSTEMS PVT LTD MUMBAI
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Line	Product/Description	Commodity Code	Qty Ordered	Qty Shipped	Unit Price	Total Price
001	GA 1530-9593-2/A LD 1080M SINGLE AXIS 200 MM ** Serial Number(s) 57601	90268091	1		14,500.00	5,500.00
002	MAN/E 1530-6563 MAN LD1005/10/25/40/80	90269090	1			
003	AK1530-6101-1/C ACCY KITLD 1005-1040X&XY	90269090	1			
004	PAC 1530-9559, PACKING BOX LD1005-1040X&XY	90269090	1			
005	GA1532-0846-1/C - CI900-1D ** Serial Number(s) 57604	90268091	1		3,700.00	3,700.00
006	MAN/E1532-0866 CI900-1C/6C OP GUIDE	90269090	1			
007	MAN/E1532-0872 CI900-1C/6C INST H/BK	90269090	1			
008	AK1532-0845-1/A ACCY KIT FOR CI900 MK2	90269090	1			
009	PAC1532-0525 PACKING INDICATOR BOX	90269090	1			
010	CA5100-0231.30MO/A CABLE LD TOCI00 MK2	90269090	1		325.00	325.00
Cha	FREIGHT – CHARGES					475.00
	1 NO. OF LD 1080 SINGLE PLANCE 200MM, 1 NO. OF CI900-1C AND 1.NO OF CABLE LD TO CI900 AS PER PROFORMA INVOICE NO.23548 DATED 21ST MARCH 2000 OF BENEFICIARY LETTER OF CREDIT NO.505/RP/010/2000 DATED 4TH APRIL 2000. CARTON 1 OF 2 G. 18 KGS. N. 12 KGS. M. 109 X 44 X 27 CMS CARTON 2 OF 2 G. 10 KGS. N. 7 KGS. M. 69 X 58 X 29 CMS SHIPPING MARKS: RSPL, PATANCHERU, DIST MEDAK, A.P.					

Bank Details
National Westminster Bank Pic
Bishopsgate Corporate Business Center
15 Bishopsgate, London EC2P 2AP

Bank Account
GBP : 45201463
EURO : 06833535
USD : 40056007
Sort Code: 50-00-00
Swift Code: NWBKG2L

The prevailing Terms and Conditions
Relating to this order/sale are
Printed overleaf or attached

SUB TOTAL 19,000.00
Discount 0.00
SUBTOT.DISC 19,000.00
VAT 0.00
US DOLLAR 19,000.00

VAT	ANALYSIS	PCT	GOODS	AMOUNT
2	ZERO RATED-	0.00%	375.00	0.00
3	STANDARD	0.00%	17125.00	0.00

For and on behalf of Stargold Limited

Import under OGL of Export and Import Policy 1997-2000. Above goods are of UK Origin and Our Manufacture. We certify that the goods are as per Proforma Invoice No. 23548, dated 21st March, 2000 of beneficiary.

1. Consignor Stargold Limited Ridgeway Industrial Estate Iver, Buckinghamshire, U.K	NO.FH 603639	COPY
2. Consignee Republic Bank, Forex Department 2-2-18, S. R Road Branch, Secunderabad, 500 003, A.P. INDIA Account: Radiant Systems Pvt Limited Mumbai – 400 005 India	EUROPEAN COMMUNITY CERTIFICATE OF ORIGIN	
	3. Country of Origin EUROPEAN COMMUNITY/UNITED KINGDOM	
4. Transport details (Optional) Aircraft	5. Remarks	
6. Item number, marks, numbers number and kind of packages: description of goods 1. 1 of 2 One Carton 1 NO. OF LD 1080 SINGLE PLANE 200 MM, 1 NO. OF CI900-IC AND 2. 2 of 2 One Carton 1. No of CABLE LD TO CI900 AS PER PROFORMA INVOICE NO. 23548 DATED: 21ST MARCH, 2000 OF BENEFICIARY. ADDRESSED TO CONSIGNEE LETTER OF CREDIT NO. 505/RP/010/2000 DATED 4TH APRIL, 2000		7. Quantity G. 18 KGS N. 12 KGS G. 10 KGS N. 7KGS
8. THE UNDERSIGNED AUTHORITY CERTIFIES THAT THE GOODS DESCRIBED ABOVE ORIGINATE IN THE COUNTRY SHOWN IN BOX 3 THAMES VALLEY CHAMBER OF COMMERCE AND INDUSTRY M. ATKINSON Thames Valley Chamber of Commerce and Industry		

International Finance Trade

Shipper's Name & Address Star Gold Ltd Ridgeway Industries Estate BUCKINGHAMSHIRE, UNITED KINGDOM. GB			Shipper's Account Number 7500779429			Not Negotiable Air Waybill (Air Consignment note) Issued by MSAS Global Logistics (UK) Ltd. London Cargo Center, Great South West Road, Hatton Cross, Feltham Middlesex TW14 OPL Tel 0181 750 7000 Facsimile 0181 890 8444										
Consignee's Name and Address Republic Bank Forex, Dept 2-2-18, S.R. Road Branch India For Account Openers			Consignee's Account Number 0000003352			Copies 1,2 and 3 of this Air Waybill are originals and have the same validity. It is agreed that the goods described herein are accepted in apparent good order and condition (except as noted) for carriage SUBJECT TO THE CONDITIONS OF CONTRACT ON THE REVERSE HEREOF ALL GOODS MAY BE CARRIED BY ANY OTHER MEANS INCLUDING ROAD OR ANY OTHER CARRIER UNLESS SPECIFIC CONTRARY INSTRUCTIONS ARE GIVEN HEREON BY THE SHIPPER. AND SHIPPER AGREES THAT THE SHIPMENT MAY BE CARRIED VIA INTERMEDIATE STOPPING PLACES WHICH THE CARRIER DEEMS APPROPRIATE. THE SHIPPER'S ATTENTION IS DRAWN TO THE NOTICE CONCERNING CARRIERS LIMITATION OF LIABILITY. Shipper may increase such limitation of liability by declaring a higher value for carriage and paying a supplemental charge if required.										
Issuing Carrier's Agent Name and City MAWB No. 176-9982 9306						Accounting Information P. O. NBR: BLL – 3307 –EB IRREVOCABLE DOCUMENTARY CREDIT NUMBER: L/C NO. 505/RP/010/200 DATED 4 TH APRIL, 2000 FREIGHT PAYABLE AT DESTINATION										
Agencies ATA Code			Account Number													
Airport of Departure (Addr. Of first Carrier and Requested Routing) LONDON HEATHROW																
to DXB	By first Carrier EK	Routing and Destination	to BOM	by EK	to HYD	By	Currency GBP	Chgs Code	WT Val	Other	Declared Value for Carriage NVD				Declared value for Customs NCV	
											PPD X	Coll X	PPD X	Coll X		
Airport of Destination			Flight/Date	For carrier Use only		Flight/Date	Amount of Insurance		INSURANCE: If carrier offers insurance and such insurance is requested in accordance with conditions on reverse hereof, indicate amount to be insured in figures in box marked amount of insurance.							
HYDERABAD (INDIA)			EK 006/10		EK 502/11				XXX							

Handling Information DOCS ATTACHED : COMM INV. 38704												
NOTIFY APPLICANT: RADIANT SYSTEMS PVT LTD, RADIANT HOUSE, 25, COLABA, MUMBAI – 400 005, INDIA.												
No. of pieces RCP	Gross Weight	Kg lb		Rate Class		Chargeable Weight		Rate Charge		Total		Nature and Quantity of Goods (Inc. Dimensions or Volume)
				Commodity Item No.								
2	28.0	K	R	9999		41.0		.850		34.85		1 NO. OF LD 1080 SINGLE PLANE 200 MM, 1 NO. OF CI900 – 1C AND 1 NO. OF CABLE LD TO CI900 AS PER PROFORMA INVOICE NO.23548 DATED 21 ST MARCH, 2000 OF BENEFICIARY. VOL.:245MTQ DIMS: 1 @ 109X44X27 CMT 1 @ 69X58X29 CMT
2	28.0									34.85		
Prepaid		Weight Charge			Collect		Other Charges			FSE 2.46		
						34.85						
				Valuation Charge								
				Tax								
				Total Other Due Agent								
				Total other Charges Due Carrier				Shipper certifies that the particulars on the face hereof are correct and that insofar as any part of the consignment contains dangerous goods, such part is properly described by name and is in protect condition for carriage by air according to the applicable Dangerous Goods Regulations.				
55.00				2.46				MSAS GLOBAL LOGISTICS (UK) LTD FOR STAR GOLD PVT. LTD				
								Signature of Shipper or his Agent				
								Carrier Certifies that the goods described hereon were received for carriage subject to the Conditions of Contract on the reverse hereof of the goods then being in apparent good order and condition except as may be noted hereon.				
Total prepaid				Total collect				09 Jun 00 LON MSAS GLOBAL LOGISTICS (UK) LTD				
55.00				37.31				Executed on (Date) at (Place) Signature of Issuing Carrier or its Agent				
Currency Conversion Rates				Cc changes in Dest. Currency								
For Carriers Use only at Destination				Charges of Destination		Total Collect Charges						

International Finance and Trade

PRESENTATION MEMO

BY COURIER/REGD POST

REPUBLIC BANK
S.R. ROAD,
SECUNDERABAD

TEL

TELEX

MAIL TO
RADIANT SYSTEMS PVT LTD
MUMBAISTAR GOLD LIMITED
UK

DEAR SIR/S

A/C

REF : IMPORT DOCUMENTS

OUR REF : IS/FIBC NO: 41/2000 LC No: 10/2000 Dt:

We have received the following bill drawn on you, which we hereby present for payment/acceptance. Please return the attached exchange control FORM-A1 signed by you.

Kindly Note if the Bill is not,

1. Paid at our office the day after presentation.
2. Accepted duly stamped and returned to us within 48 hours from first presentation. It will be considered as dishonored.

THE DOCUMENTS RECEIVED ARE AS FOLLOWS:

- 1) Bill of Exchange
- 2) Invoice
- 3) B/L or AWB
- 4) Cert. Of Origin
- 5) Cert. Of Insurance
- 6) Packing List
- 7) Lloyd's/Shipping Company's Cert..
- 8) Beneficiary's Lr.
- 9) Other documents

SPECIAL INSTRUCTIONS

The Documents have been received with the following discrepancies :

A/C debited on
30/06/2K

BILL AMOUNT	RATE	RUPEE EQUIV.
Currency Amt. USD 19000		
Plus:		
Interest from :		
to :		
@		
Overdue Int FM :		
to :		
@		
Correspondents Charges		
Postage/Courier		
Commission @ 0.15%		
Stamps		
Telex		
TOTAL Rs.		

Please let us know whether these discrepancies are acceptable to you to enable us to inform to our correspondents.

Note: The rate of exchange has been calculated at a provisional rate. However the rate of exchange will be fixed on the date of payment or 10th day from the date of this advice (whichever is earlier) in case of sight and on the due date in the case of Usance Bills.

MESSAGE CONFIRMATION

DATE : 19-06-2000, MON 13:54
 NAME : STARGOLD
 TEL : +44 (0) 1494 892200

PHONE	:	9009122215782
PAGES	:	1/1
START TIME	:	19-06 13:53
ELAPSED TIME	:	00' 32"
MODE	:	ECM
RESULTS	:	OK

⇒ First page of recent document transmitted

Star Gold

Ridgeway Industrial Estate
 Iver,
 Buckinghamshire,
 U.K

Date: 19-6-00

To:
 Company: Radiant Systems Private Limited
 Fax: 0091 22 215782

From: Rob Stuart
 Phone: +44 (0) 1494 892200
 Fax: +44 (0) 1494 892302

Pages: 1

Subject: L/C No. 505/RP/010/2000,

Dtd: 4.4.2000

WE CONFIRM SHIPMENT OF GOODS FOR INSURANCE PURPOSE AS FOLLOWS:-

FLT EK006/10.6.00 – EK 502/11.6.00
 ETA MUMBAI 11-6-00
 MAWB NO. 176-9982 9306
 HAWB NO. LON 03-742699
 DESCRIPTION: 1 NO OF LD1080 SINGLE PLANE
 200 MM, 1 NO OF CI900-1C AND 1 NO OF CABLE
 LD TO CI900 AS PER PROFORMA INVOICE NO. 23548
 DATED 21ST MARCH 2000 OF BENEFICIARY.

BEST REGARDS

STARGOLD

International Finance and Trade

4256595 ABRP IN
NO: 00307
REPUBLIC BANK, S.R ROAD, AUTO SEND
APR 25 2000 11:58:08

FROM: REPUBLIC BANK, S.R ROAD BRANCH, SECUNDERABAD, A.P., INDIA.
TELEX 4256595

TO: BANK OF NEW YORK, NEW YORK.

TEST 1328 FOR USD 19000 DATED 25th APRIL, 2000

RE: AUTHORISATION TO REIMBURSE.

OUR DOCUMENTARY CREDIT NUMBER	:	505/010/2000 DATED 4th APRIL, 2000
ACCOUNT IDENTIFICATION	:	OUR INTERNATIONAL BANKING
DIVN.,		MUMBAI A/C NO. 7800054325
CREDIT AMOUNT	:	USD 19000
DATE AND PLACE OF EXPIRY	:	30th JUNE, 2000 U.K.
AVAILABLE WITH/BY	:	ANY BANK BY NEGOTIATION
DRAFTS AT	:	AT SIGHT
DRAWEE	:	M/S RADIANT SYSTEMS PRIVATE
LIMITED		25, RADIANT HOUSE
		COLABA,
		MUMBAI – 400005, INDIA.
REIMBURSEMENT BANK'S CHARGES	:	FOR BENEFICIARY'S ACCOUNT.

WE AUTHORISE YOU TO HONOUR THE CLAIM UNDER OUR ABOVE LC.
THIS REIMBURSEMENT IS SUBJECT TO ICC URR 525.

REGARDS
MANAGER.

232241 ITNY UR

42

EDX HYD 53239 30.06 13:47 GA
00+
GX BY 30.06 13:49
+
4256595 ABRP IN
GA
25232241+V
NO: 00269
REPUBLIC BANK, S.R ROAD BRANCH, AUTO SEND

IWEZV

REP GARBLE
FROM: REPUBLIC BANK, S.R.ROAD BRANCH, SECUNDERABAD, A.P., INDIA
TELEX: 4256595

TO: BANK OF NEW YORK, NEW YORK, USA.

TEST 1437 FOR USD 19000 DATED 30th JUNE, 2000.

CHARGE OUR INTERNATIONAL-BANKING DIVISION, MUMBAI A/C.NO. 7800054325
WITH YOU AND PAY USD 19,000 (US DOLLARS NINETEEN THOUSAND ONLY) TO
BANK OF NEW YORK, NEW YORK TO THE CREDIT OF ACCOUNT OF LLOYDS TSB,
INTERNATIONAL FINANCES SERVICES, BIRMINGHAM QUOTING THEIR REF. NO.
XQSTM25831P001 AND OUR REF.FIBC.NO.041/2000.

REGARDS
MANAGER

+
232241 ITNY UR

4256595 ABRP IN
MMMM
DURATION 001.9 MIN

International Finance and Trade

EDX HYD 53275 30.06 13:50 GA

00+

GX BY 30:06 13:52

+

4256595 ABRP IN

GA

51888301+

888301 LOYDLN G

NO: 00270

REPUBLIC BANK, S.R ROAD, AUTO SEND

JUN 30 2000 14:14:32

FROM: REPUBLIC BANK, S.R ROAD, SECUNDERABAD, A.P., INDIA

TELEX 425 6595

TO: LLOYDS TSB, INTERNATIONAL SERVICE CENTRE, PO.BOX 63, BIRMINGHAM, U.K.

RE: OUR FLC NO. 505/RP/010/2000

REF: YOUR COLLECTION REF NO. XQSTM253831P001 DATED 23.6.2000 FOR USD
19,000

TODAY WE HAVE COVERED YOU WITH BANK OF NEW YORK, NEW YORK FOR USD
19000 BEING PROCEEDS OF YOUR ABOVE COLLECTION.

WITH VALUE DATED 30th JUNE, 2000.

PL CONFIRM RECEIPT OF FUNDS.

REGARDS

MANAGER.

+

888301 LOYDLN G

4256595 ABRP IN

MMMM

DURATION 001.9 MIN.

Chapter IV

Export Finance and Exchange Control Regulations Governing Exports

After reading this chapter, you will be conversant with:

- Incentives Available to Exporters
- Export Control Regulations Relating to Exports

As discussed earlier, exports play a key role in the Indian economy. In order to give a boost to this sector, various incentives are extended to exporters. Exports help in augmenting the country's foreign exchange reserves, besides generating employment. It also gives a boost to the economic activity in the country ultimately improving the standard of living. Given the fact that exports play a very crucial role in a developing economy like India any effort to promote exports cannot ignore the vital aspect of finance. The requirement of finance for an exporter may arise either at the pre-shipment stage or the post-shipment stage. Timely availability of credit at competitive rates enables an exporter to produce quality goods and ship it within the delivery schedules prescribed by the overseas buyer. It simply enhances the credibility of Indian exporters and in the process increase the share in the market.

INCENTIVES AVAILABLE TO EXPORTERS

The Reserve Bank of India has introduced various measures in its effort to encourage exports.

- Exporters are eligible to avail finance at concessional rates of interest.
- Banks being the main source of finance are encouraged to extend credit liberally to exporters, including granting lines of credit for 2-3 years at a stretch.
- It is mandatory for banks to extend a minimum of 12% of net bank credit to the export sector.
- To compensate banks for extending finance at lower rates of interest, export refinance facility is provided by the Reserve Bank of India.
- To encourage banks to grant credit to exporters liberally, credit guarantee is arranged from ECGC, for loans extended to exporters at both pre- and post-shipment stage.
- Exporters are also granted loans against duty draw back entitlements.
- Exporters can retain a certain proportion of export proceeds in foreign currency in the EEFC account at the rate of 70% in case of 100% E.O.U and 50% in case of any other person resident in India.
- Export earnings are not fully taxed.

We shall now focus on export finance in detail.

Export finance can be categorized into pre-shipment finance and post-shipment finance depending at what stage of export activity, finance is extended.

Pre-shipment Finance

Pre-shipment finance is basically a short-term finance (inventory finance) extended to exporters in anticipation of export of goods. This finance enables exporters to procure raw materials, process, manufacture, warehouses, ship the goods meant for export.

Pre-shipment finance can be classified as:

- a. Packing credit.
- b. Advance against incentives receivable from Government covered by ECGC Guarantee.
- c. Advance against cheques/drafts received as advance payment.

PACKING CREDIT

It is a loan or advance granted to the exporter for purchase of raw materials/processing/packing based on Letter of Credit (LC) opened in his favor by the importer. The LC/Confirmed order will be retained by the bank and will be endorsed accordingly indicating that packing credit has been availed of by the exporter.

ELIGIBILITY

An exporter who wants to avail of pre-shipment finance should obtain an importer-exporter code number from the DGFT. In addition, the exporter should not be under the caution list/special approval list of RBI/ECGC.

Usually, packing credit is extended to exporters who have the export order/letter of credit in their name. It can also be extended where the contract is concluded by exchange of messages between the two parties, with the opening of LC to be followed later on. In such instances banks may grant packing credit based on the communication, provided the following information is made available:

- a. Name of the overseas buyer
- b. Particulars of goods to be exported
- c. Quantity and unit prices or value of order
- d. Dates of shipment
- e. Terms of sales and payments.

Packing credit is also extended to supporting manufacturers/suppliers of goods who do not have LCs in their own name but orders have been placed on them for supply of goods by an LC holder.

TYPE OF FINANCE

Packing credit is normally a funded advance. It takes the form of an unsecured/clean loan in the initial stages of disbursement of funds (i.e. when raw materials are yet to be procured). It is called extended packing credit. When the exporter gets a title to the goods it becomes a secured advance.

At times pre-shipment finance will be extended in a non-fund form, like issuing LCs favoring the suppliers of raw materials, opening guarantees for credit purchases, etc.

QUANTUM OF FINANCE

Quantum of loan will not normally exceed FOB value of goods or domestic market value of goods whichever is lower. However, there are certain exceptions to this. Packing credit may be granted up to the domestic cost of goods even if it is higher than the FOB value, provided the goods are covered by export incentives of the Government of India and availability of Export Production Finance Guarantee offered by ECGC. The excess of advance over FOB value should be adjusted from the cash incentives/duty draw back received.

MARGIN REQUIREMENTS

Pre-shipment finance being a need based finance, banks have the freedom to determine the margin that is to be brought in by the exporters.

Margins serve three important purposes:

- a. To ensure that the exporter has a stake in the business.
- b. To take care of erosion in the value of goods charged to the banker.
- c. To ensure that bank finance is not extended to cover exporters profit margin.

The percentage of margin will depend on the nature of the order, commodity, capability of the exporter, etc. Disbursement of funds under packing credit takes place in phases depending on the length of the operating cycle.

PERIOD OF FINANCE

Period of advance for a packing credit advance is depend upon the circumstances of the individual case, such as the time required for procuring, manufacturing or processing (where necessary) and shipping the relative goods. It is primarily for the banks to decide the period for which a packing credit advance may be given having regard to the various relevant factors so that the period is sufficient to enable the exporter to ship the goods Further if pre-shipment advances are not adjusted by submission of export documents within 360 days from the date of advance, the

advances will cease to qualify for concessive rate of interest to the exporter ab initio. In other words concessional rates of interest will be applicable only if export of goods takes place within the time stipulated. This period has been fixed as 360 days from the date of availing the finance. In case export of goods do not take place within the stipulated period, banks are eligible to charge interest from the very first day of advance at a rate prescribed for 'Export credit not otherwise specified'.

RATES OF INTEREST

The interest rates given below are prescribed by the RBI and are effective till 31.10.2003:

Table 1

Pre-shipment Credit (From the date of advance)	Current Rate
(a) i. Up to 180 Days	Not exceeding BPLR minus 2.5 percentage points
ii. Beyond 180 days and up to 360 days	Free
(b) Against incentives receivable from government covered by ECGC guarantee (up to 90 days)	Not exceeding PLR minus 2.5 percentage points

Note:

Free: The banks are free to determine rates of interest subject to BPLR and spread guidelines.

LIQUIDATION OF PACKING CREDIT

All packing credit advances should be liquidated from funds received by the exporter from either one or a combination of any of the following sources:

- a. Proceeds of bill drawn for the exported commodities on its purchase, discounts, etc.
- b. Balances in Exchange Earners' Foreign Currency A/c (EEFC A/c) and from rupee resources of the exporter to the extent exports have actually taken place can also be used to repay/prepay the advance.

If a packing credit advance is not liquidated by export proceeds, that particular advance will not be entitled for concessional rate of interest.

SUBSTITUTION OF CONTRACTS

Where an exporter has availed packing credit, but the export order cannot be executed because of cancellation of the order or for any other reason beyond the exporter's control, then banks are given the discretion to adjust the packing credit availed of, from the proceeds of any other export order subject to the authorized dealer being satisfied about the commercial necessity of such a switch-over.

PRE-SHIPMENT CREDIT IN FOREIGN CURRENCY (PCFC)

Exporters often complain about the high cost of capital vis-à-vis their competitors from other countries. In order to make their prices competitive and thereby give a boost to exports, the Government of India made available yet another mode of financing — financing exporters in foreign currency at internationally competitive interest rates.

- i. The scheme is an additional window for providing pre-shipment credit to Indian exporters at internationally competitive rates of interest. It will be applicable to only cash exports.
- ii. The exporter will have the following options to avail of export finance:
 - a. To avail of pre-shipment credit in rupees and then the post-shipment credit either in rupees or discounting/rediscounging of export bills under EBR Scheme.
 - b. To avail of pre-shipment credit in foreign currency and discount/rediscoung of the export bills in foreign currency under EBR scheme.
 - c. To avail of pre-shipment credit in rupees and then convert drawals into PCFC at the discretion of the bank.

LIQUIDATION OF CREDIT

PCFC can be liquidated out of proceeds of export documents on their submission for discounting/rediscounting under the EBR Scheme or by grant of foreign currency loans (D P bills) subject to the mutual agreement between the exporters and the bankers. It can also be repaid/prepaid out of balances in Exchange Earners' Foreign Currency A/c (EEFC A/c), and also from rupee resources of the exporter to the extent exports have actually taken place. In case of cancellation of the export order for which the PCFC was availed of by the exporter from the bank, or if the exporter is unable to execute the export order for any reason, it will be in order for the exporter to repay the loan together with accrued interest thereon, by purchasing foreign exchange (principal + interest) from domestic market through the bank. In such cases, interest will be payable on the rupee equivalent of principal amount at the rate applicable to 'Export Credit Not Otherwise Specified' (ECNOS) at pre-shipment stage plus a penal rate of interest to be decided by the bank from the date of advance after adjustment of interest of PCFC already recovered. Banks may extend PCFC to such exporters subsequently, after ensuring that the earlier cancellation of PCFC was due to genuine reasons.

Table 2: Rates of Interest Applicable under PCFC

Post-Shipment Credit	Current Rate
(a) On demand bills for transit period (as specified by FEDAI)	Not exceeding 0.75 over LIBOR/EURO LIBOR/ EURIBOR
(b) Usance Bills (Credit for total period comprising usance period of export bills, transit period as specified by FEDAI and grace period wherever applicable) Up to 6 months from the date of shipment	Not exceeding 0.75% over LIBOR/EURO LIBOR/ EURIBOR
(c) Export bills (demand or usage realize after due date but up to date of crystallization)	Rate for (ii) (b) above plus 2.0 percentage points

ADVANCES AGAINST INCENTIVES RECEIVABLE FROM GOVERNMENT OF INDIA

These advances are generally granted at post-shipment stage. However, in exceptional cases, where the value of material to be procured for export is more than the FOB value of the contract and considering the availability of receivables from Government of India, advances are granted for a maximum period of 90 days for more than the FOB value. These advances are liquidated by negotiation of export bills and out of proceeds of receivables from Government of India.

ADVANCE AGAINST DUTY DRAWBACK

Pre-shipment finance can also be extended against duty drawback entitlements provisionally certified by the customs. The loans so extended will be adjusted when the final assessment is made by customs and duties are refunded by them. Duty drawback loans are normally granted by banks at the post-shipment stage for a period not exceeding 90 days at lower interest rate as specified.

ROLE OF CUSTOMS AND C&F AGENTS

Freight forwarders act on behalf of exporters and importers in arranging services such as loading and unloading of goods, obtaining payment on behalf of customers, booking of space, and customs clearance for air cargo, sea cargo, land transportation, rail freight, custom agency services, multimodalism, door-to-door pick-up and delivery services, etc. Their earnings consist of commissions paid for their services.

Before proceeding to discuss about post-shipment finance, we shall, in brief, discuss the customs formalities to be followed by exporters for clearance of goods to be exported.

CUSTOMS FORMALITIES FOR CLEARANCE OF GOODS TO BE EXPORTED FROM INDIA

Certain formalities have to be fulfilled for clearance of exports by the customs authorities. The exporter is required to submit necessary documents for this purpose. The main document required by the customs authorities for permitting clearance is the shipping bill. While the exporter should submit the shipping bill in case of export by sea or air, he is required to submit a bill of export in case the export is by road. Shipping bills are of four kinds:

- White shipping bill prepared in triplicate is to be submitted for export of duty free goods.
- Green shipping bill prepared in quadruplicate should be submitted, for export of goods under which duty drawback is to be claimed.
- Yellow shipping bill in triplicate is to be submitted for export of dutiable goods.
- Blue shipping bill prepared in seven copies will be required, for exports under the DEPB scheme.

Other documents required for processing of shipping bill includes:

- GR forms in duplicate for shipment to all countries.
- 4 copies of the packing list giving details like contents, quantity, gross and net weights of each package.
- 4 copies of invoice giving all relevant details like number of packages, quantity, unit rate, total f.o.b or c.i.f value, correct and full description of the goods, etc.
- Contract/LC or Purchase order of the buyer.
- AR4 (original and duplicate) and invoice.
- Inspection/Examination certificate.

The customs appraiser first checks if the quantity and value declared on the shipping bill tallies with that indicated in the LC or purchase order. In addition he will check if other formalities like exchange control regulations, pre-shipment inspection has been complied with or not. After verification, all documents, with the exception of the original GR form, the original shipping bill and a copy of the commercial invoice are handed over to the forwarding agent to be submitted to the dock appraiser. The original GR form is then forwarded by the customs department to the Reserve Bank of India. It is the dock appraiser who endorses the "Let Export" endorsement on the duplicate copy of the shipping bill. After endorsement, the documents are returned to the forwarding agent who submits the same to the preventive officer of the customs department who endorses the "Let Ship" endorsement on the duplicate copy of the shipping bill. The duplicate copy of the shipping bill is then handed over by the forwarding agent to the agent of the shipping company following which the captain of the ship in which the goods are loaded hands over a "Mate Receipt" to the Shed superintendent of the port. After payment of port charges, the forwarding agent is given the mate receipt. The mate receipt is then handed over to the preventive officer who records the certificate of shipment on all the copies of the shipping bill, original and duplicate copies of the AR4. Following this, the mate receipt is handed over by the forwarding agent to the shipping company to procure the bill of lading.

After the goods have been shipped, the exporter should send a shipping advice to the importer enclosing relevant documents which include non-negotiable copy of bill of lading, invoice, packing specification, etc.

Post-shipment Finance

Post-shipment finance is defined as “any loan or advance granted or any other credit provided by an institution to an exporter from India from the date of extending the credit after shipment of the goods to the date of realization of the export proceeds”. It is basically meant for financing export sale receivables of the exporter. Post-shipment finance can be availed on submission of commercial documents evidencing export to the authorized dealer. The exporter is required to submit the documents to the bank within 21 days from the date of shipment of goods. The documents to be submitted include all shipping documents and an extra copy of invoice, relating to any export declaration form endorsed by Customs/Postal authorities.

Post-shipment finance can be classified as under:

- Negotiation/Payment/Acceptance of export documents under letter of credit.
- Purchase/discount of export documents under confirmed orders/export contracts, etc.
- Advances against export bills sent on collection basis.
- Advances against exports on consignment basis.
- Advances against undrawn balance on exports.
- Advances against receivables from the Government of India.
- Advances against retention money relating to exports.
- Advances against approved deemed exports.

ELIGIBILITY FOR POST-SHIPMENT FINANCE

Post-shipment finance is extended to the actual exporter or to an exporter in whose names the export documents are transferred. In case of deemed exports, finance is extended to the deemed exporters. In case of cash exports, exporters should submit GR/PP/VP/SOFTEX forms, as applicable along with the shipping documents for negotiation.

QUANTUM

Post-shipment finance can be extended up to 100% of the invoice value of the goods. However, banks are free to stipulate margin requirements as per their lending norms.

PERIOD OF FINANCE AND INTEREST RATES APPLICABLE

Post-shipment finance may be availed of either in Indian rupees or by using the rediscounting of export bills abroad scheme.

Even though post-shipment finance is working capital finance, it may be offered on short-term basis or on a long-term basis depending upon the payment terms offered by the exporter to the overseas buyer.

The rate of interest depends on the nature of the bills, i.e. whether it is a demand bill or usance bill. A demand bill or a sight bill is one which is payable immediately on presentation. In case of a usance bill, the terms of payment are specified on the bill. Under this arrangement the importer is allowed a grace period for payment of the bill. Export finance availed against sight bills will be charged lower rates of interest for a maximum period of the normal transit period (NTP) stipulated for the concerned bill as per FEDAI rules. FEDAI has fixed different transit periods for export bills drawn on different countries. The export bill (Demand) should normally be realized within that period. The transit period so fixed by FEDAI is known as ‘Normal Transit Period’ and mainly depends on geographical location of a particular country. Concessional rates of interest will be charged by banks up to the actual date of realization of export proceeds or NTP stipulated for the bill, whichever is earlier. Where the sight bill is not paid on or

before the normal transit period, it will be considered as an overdue bill. The rate of interest charged for the overdue period i.e. from the due date to 180 days from the date of shipment will be “Export credit not otherwise specified”. For the period beyond 180 days from the date of shipment, higher rate of interest as given in the interest rate directive will be charged.

In case of usance bills, concessional rate of interest is applicable up to the notional due date. However, the maximum period for which lower rates are charged cannot exceed 90 days. While determining the notional due date of a usance bill, three components have to be taken into consideration.

1. Normal transit period as fixed by FEDAI
2. Usance period of the bill
3. Grace period if applicable in the country on which the bill is drawn.

Where an export bill has a usance period of more than 90 days, such a bill will not be eligible for concessional rates of interest. In this situation, banks are free to determine the rate of interest on such credit.

Where an export sight bill denominated in foreign currency purchased/discounted negotiated is not paid within 30 days after normal transit period and 30 days after notional due date in the case of usance bills, the foreign currency amount has to be reversed from export bills. The unrealized foreign currency amount will be crystallized by the bank at the prevailing TT selling rate by effecting a notional sale. The rupee equivalent amount so converted should be shown in the advances portfolio of the bank under the head “Advances against overdue export bills realizable” account. When the bills are actually realized, purchase should be reported in respective R-returns under the head “Purchases relating to reversed export bills”.

REDISCOUNTING OF EXPORT BILLS ABROAD

The scheme was introduced by the Reserve Bank of India on 6th October, 1993. It serves as an additional window for early realization of export proceeds. Under this scheme, authorized dealers in India and exporters can have an access to the overseas market for rediscounting of export bills. Authorized dealers can have the eligible export bills in their portfolio for rediscounting abroad. Exporters also have been permitted for discounting their export bills directly subject to the following conditions:

- a. Direct discounting of export bills by exporters with overseas bank and/or any other agency will be done only through the branch of an authorized dealer designated for the purpose.
- b. Discounting of export bills will be routed through designated bank/authorized dealer from whom the packing credit facility has been availed of. In case, these are routed through any other bank/authorized dealer, the latter will first arrange to adjust the amount outstanding under the packing credit with the concerned bank out of the proceeds of the rediscounted bills.

SOURCE OF FUNDS

Authorized dealers can utilize the foreign exchange resources available with them in Exchange Earners Foreign Currency Accounts (EEFC), Resident Foreign Currency Accounts (RFC), Foreign Currency (Non-Resident) Accounts (Banks) Scheme and Escrow Accounts to discount usance bills and retain them in their portfolio without resorting to rediscounting. In the case of demand bills these may have to be routed through the existing post-shipment credit facility.

For rediscounting of bills, authorized dealers may, wherever necessary, access the local market, which will enable the country to save foreign exchange to the extent of the cost of rediscounting.

It is comparatively easier to have a facility against bills portfolio (covering all eligible bills) than to have a rediscounting facility abroad on bill by bill basis, as various rediscounting agencies may require detailed information relating to the underlying transactions, such as names of exporters and importers, commodities exported, letter of credit details, etc.

Authorized dealers can therefore arrange a “Bankers Acceptance Facility” (BAF). Each Authorized dealer can have his own BAF limits fixed with an overseas bank or a rediscounting agency or an arrangement with any other agency such as a factoring agency.

Under the scheme, rediscounting is available in any convertible currency.

ELIGIBILITY CRITERIA

Export bills up to a usance period of 180 days from the date of shipment including normal transit period and grace period will be covered under this scheme.

SPREAD

Where the rate of interest on rediscounting does not exceed 0.75 percent over the six months LIBOR/EURO in case of rediscounting of bills with recourse basis. It is recognised that it will be difficult to get ‘without recourse’ facility from abroad under LIBOR or any other facility. The bills may be rediscounted ‘with recourse’. However, if an AD is in a position to arrange ‘without recourse’ facility on competitive terms, it is permitted to avail itself of such a facility.

Refinance

Banks will not be eligible for refinance against bills discounted/rediscounted under this scheme and hence the bills discounted/rediscounted in foreign currency should be shown separately from the export credit figures reported for purposes of drawing export credit refinance.

GOLD CARD SCHEME FOR EXPORTERS

In the Exim Policy 2003-04 the Government (Ministry of Commerce and Industry), in consultation with RBI Gold Card Scheme was drawn up. The Scheme envisages certain additional benefits based on the record of performance of the exporters. The Gold Card holder would enjoy simpler and more efficient credit delivery mechanism in recognition of his good track record. The salient features of the Scheme are:

- a. All creditworthy exporters, including those in small and medium sectors with good track record would be eligible for issue of Gold Card by individual banks as per the criteria to be laid down by latter.
- b. Gold Card under the Scheme may be issued to all eligible exporters including those in the small and medium sectors who satisfy the laid down conditions.
- c. Gold Card holder exporters, depending on their track record and creditworthiness, will be granted better terms of credit including rates of interest than those extended to other exporters by the banks.
- d. Applications for credit will be processed at norms simpler and under a process faster than for other exporters.
- e. Banks would clearly specify the benefits they would be offering to Gold Card holders.
- f. The charges schedule and fee-structure in respect of services provided by banks to exporters under the Scheme will be relatively lower than those provided to other exporters.
- g. The sanction and renewal of the limits under the Scheme will be based on a simplified procedure to be decided by the banks. Taking into account the anticipated export turnover and track record of the exporter the banks may determine need-based finance with a liberal approach.

- h. 'In-principle' limits will be sanctioned for a period of 3 years with a provision for automatic renewal subject to fulfillment of the terms and conditions of sanction.
- i. A standby limit of not less than 20 percent of the assessed limit may be additionally made available to facilitate urgent credit needs for executing sudden orders. In the case of exporters of seasonal commodities, the peak and off-peak levels may be appropriately specified.
- j. In case of unanticipated export orders, norms for inventory may be relaxed, taking into account the size and nature of the export order.
- k. Requests from cardholders would be processed quickly by banks within 25 days /15 days and 7 days for fresh applications/renewal of limits and ad hoc limits, respectively.
- l. Gold card holders would be given preference in the matter of granting of packing credit in foreign currency;
- m. Banks would consider waiver of collaterals and exemption from ECGC guarantee schemes on the basis of card holder's creditworthiness and track record.
- n. The facility of further value addition to their cards through supplementary services like ATM, Internet banking, International debit/credit cards may be decided by the issuing banks.
- o. Gold Card holders will be given preference for grant of packing credit in foreign currency (PCFC) and on the basis of their track record of timely realization of export bills, will be considered for issuance of foreign currency credit cards for meeting urgent payment obligations, etc. The credit to Indian exporters should be at rates of interest not exceeding LIBOR + 0.75 per cent. In case sufficient dollars are not available with the bank to lend to the exporters at a particular time, service charge at flat rate of 0.1 per cent may be charged by the bank on the inter-bank foreign currency borrowings for the purpose.

EXPORT CONTROL REGULATIONS RELATING TO EXPORTS

In the previous chapter we have seen that exporters/importers are required to adhere to certain trade regulations. Apart from this, they are also required to comply with exchange control regulations. Exchange control regulations in India are issued and administered by the Reserve Bank of India. Some of the aspects covered by these regulations include the method of realization of proceeds of exports, purchase and sale of foreign exchange, maintenance of balance at foreign centers, etc. The Reserve Bank of India, ensures strict compliance of these regulations in order to conserve foreign exchange reserves. We shall now discuss in detail, the exchange control regulations governing exports.

Export Declaration Forms

As per FEMA, every person/firm engaged in the business of exports (with the exception of exports to Nepal and Bhutan) is required to make a declaration giving the full value of the exported goods on an export declaration form.

Export declaration forms are of different types depending on the mode of export.

Mode	Form
Exports made otherwise than by post	GR form
Export by post	PP form
Export of computer software	SOFTEX form.
Declared to Customs Offices notified by the Central Government which have introduced Electronic Data Interchange (EDI) system for processing shipping bills notified by the Central Government.	SDF form

GR forms (Annexure) and PP forms have to be submitted in duplicate while SOFTEX forms are to be submitted in triplicate. GR and PP forms bear a printed number which is required to be quoted in all remittance applications and correspondence with the Reserve Bank of India. In case of GR form, even the 10 digit number allotted by the Customs Department should be quoted.

Box 1: GR Forms
<p>As per the foreign exchange rules every exporter exporting goods has to make declaration of exports on the prescribed declaration forms. The forms prescribed for this purpose are as under:</p> <ul style="list-style-type: none"> – GR forms (to be made in duplicate) – in case of exports to all countries made otherwise than by post. – Form SDF – to be used for declaring exports in the case of specified customs offices and specified categories of shipping bills under the EDI system. – PP form – in case of exports to all countries by post parcel except when made on ‘value payable’ or ‘cash on delivery’ basis. <p>Both the copies of the GR form are required to be submitted by the exporter to the customs authorities along with the shipping bill. After allotting the customs number and certifying the value declared by the exporter on both the copies, the duplicate copy will be returned to the exporter. The original will be retained by the customs department for onward forwarding to the Reserve Bank of India. The exporter should once again resubmit the duplicate copy to the customs along with the cargo to be shipped. After examination of the goods and certifying the same, the duplicate copy will be properly endorsed and returned to the exporter to enable him to submit the same to his authorized dealer along with other relevant shipping documents in order to realize payment of exports.</p>

Importer Exporter Code

Every person/firm/company engaged in the business of exports has to obtain an Importer-Exporter Code Number from the DGFT. Export declaration forms submitted should bear this number. Export forms which do not bear the Importer-Exporter Code Number will not be entertained by Customs/Post Office/Department of Electronics.

Methods of Repatriation of Export Proceeds

- i. Export proceeds representing the full value of exported goods should be received through the medium of an authorized dealer in the manner specified in the Foreign Exchange Management (Manner of Receipt & Payment) Regulations, 2000. Where the exporter has received payment directly in the form of bank draft, pay order, banker’s cheque, personal cheque, etc. the authorized dealer will handle export documents only if the exporter’s track record is good. The authorized dealer should also be convinced that the instrument represents payment for exports.
- ii. Proceeds of goods sold to overseas buyers on their visits to India may be received by the exporter either by reimbursement against charge slips signed by the International Credit Card (ICC) holders (overseas buyers) or as instantaneous credit to the exporter’s bank account in India. Authorized dealers will handle export documents even in such cases. Form GR/SDF (duplicate) will be released by the authorized dealers on receipt of funds in their Nostro account¹ or on production of a certificate by the exporter from the Credit Card Servicing bank in India to the effect that it has received the equivalent amount in foreign exchange, if the authorized dealer concerned is not the credit card servicing bank. The payment may also be made to the Authorized Dealers for the exports made outside India through the importer’s credit card wherein the reimbursement from the card issuing bank/organization is received in foreign exchange.

¹ Nostro Account – A bank account maintained with a bank located in another country, in the currency of that country

- iii. Funds held in the Foreign Currency (Non-resident) account and Non-resident (External) Rupee Account may also be utilized for payment of export proceeds.
- iv. Export proceeds may also be paid by foreign currency notes/foreign currency traveler cheques by the buyer on his visit to the country.
- v. For the transactions between a resident of India and a resident of Nepal, the payment maybe settled in Rupees. In the case where the goods are exported to Nepal and the importer resident in Nepal has permission from Nepal Rashtra Bank for making payment in free foreign exchange, such payments are routed through the ACU mechanism.
- vi. The export proceeds may be made to Gem & Jewellery units in SEZs and EOUs in the form of precious metals such as Gold / Silver / Platinum equivalent to value of jewellery exported such that the same and the approximate value of precious metal is provided as indicated in the relevant GR / SDF / PP Forms of sales contracts.

Time Limit for Realization of Export Proceeds

Export proceeds have to be realized on the due date of payment or within six months from the date of shipment whichever is earlier. In case of exports to Indian-owned warehouses abroad established with the permission of the Reserve Bank of India, a maximum period of 15 months is allowed for realization of export proceeds.

The exporter is required to submit the duplicate copy of the GR Form along with relative shipping documents and an extra copy of the invoice to the authorized dealer within 21 days from the date of shipment. After the documents have been negotiated or sent for collection, the authorized dealer is required to report this transaction to the Reserve Bank of India in statement ENC (Annexure) under cover of appropriate R-Supplementary Return. The duplicate copy of the GR form and the extra copy of the invoice will be retained by the authorized dealer until the export proceeds have been realized. The duplicate copies will not be returned to the exporters except in cases where rectification of errors have to be made. The exporter is required to re-submit the duplicate copies after the necessary rectification. On realization of the export proceeds, the form and the invoice will have to be submitted to the RBI duly certified, under cover of appropriate R-Supplementary Return.

Exports under Trade Agreements/Rupee Credits

In a situation where special arrangements or rupee credits are extended by the Government of India to foreign governments, export of goods will be regulated in accordance with the conditions set forth by the Trade Control authority in India and the instructions issued periodically by Reserve Bank. These conditions are covered in the relative public notices and are related to various aspects such as type of goods eligible for export, procedure for obtaining approval for individual export contracts, manner of receiving payment and other matters. Important instructions are communicated to ADs by means of AD circulars.

In addition to the above, the EXIM Bank also extends line of credit to commercial banks/financial institutions in foreign countries for financing exports from India to those countries. Terms and conditions relating to this form of financing are advised by the Reserve Bank and is made known to the authorized dealers by way of AD circulars and authorized dealers are advised to refer to these circulars while dealing with documents relating to such credits.

Protection against Transit Risks under f.o.b, c&f etc. Contracts

Where the export transaction is either on f.o.b or c&f basis, and where an irrevocable letter of credit is not opened, exporters should take care to ensure that even before the goods are shipped, the shipment is adequately insured to cover all risks of loss or damage during the entire course of transit, the insurance cover incorporates seller's interest clause in the policy, and that in case of loss/damage to the shipment, claims are paid to the exporter in India before the ownership of goods passes to the buyer.

Bid Bonds and Other Guarantees against Commodity Exports

Authorized dealers are permitted to offer guarantee in favor of overseas buyers provided they are satisfied with the bonafides of the export transaction. However, before giving guarantee they should also satisfy themselves with the bonafides of the applicant, and his ability to perform the contract. Also, the value of the guarantee as a percentage of the value of the contract should be reasonable, should be in accordance with normal practice in international trade and the terms should comply with the exchange control regulations. Authorized dealers are also permitted to issue counter guarantees in favor of their branches/correspondents abroad in cover of guarantees required to be issued by the latter on behalf of Indian exporters in cases where guarantees of only resident banks are acceptable to overseas buyer in accordance with local/laws/regulations. If and when the bond/guarantee is invoked, authorized dealers may make payments due there under to non-resident beneficiaries but a report should be sent to the Reserve Bank where the amount of remittance exceeds US dollars 5000 or its equivalent.

Foreign Currency Accounts

Exporters having a good track record may be permitted to open foreign currency accounts with banks abroad for crediting the export proceeds. This facility will be subject to certain terms and conditions. Monitoring of the operation in the account abroad will be done by a designated branch of the authorized dealer.

Exporters intending to avail this facility have to make an application on Form EFC (Annexure) which has to be submitted through the designated branch to the Exchange Control Department under whose jurisdiction the exporter is functioning.

Counter Trade Arrangements

Proposals for opening an **escrow account**² for adjustment of value of goods imported into India against value of goods exported from India may be permitted by the Reserve Bank of India. Such an arrangement should be a voluntary arrangement between the Indian party and the overseas party. Also, the escrow account should be opened in India in US dollar. Under this arrangement all imports and exports should be at international prices in compliance with the Foreign Trade Policy and Foreign Exchange Management Act, 1999 and the Rules and Regulations made thereunder. Payments relating to imports and exports will be made on the balances standing to the credit of the account and in case of temporary surplus funds, such funds will be held in a short-term deposit up to a total period of three months in a year for which interest will be payable to the exporter at the applicable rate. No overdraft or loans will be permitted against the funds in the escrow account.

Application for permission for opening an escrow account may be made by the overseas exporter/organization through the authorized dealer with whom the account is proposed to be opened, to the office of the Reserve Bank under whose jurisdiction the authorized dealer is functioning.

² Escrow account is a foreign currency account opened under a 'countertrade arrangement'. A countertrade arrangement is voluntarily entered into between an Indian party and an overseas party, whereby the value of goods imported into India is adjusted against the value of exports from India.

Export of Good on Lease, Hire, etc.

No person shall, except with the prior permission of the Reserve Bank, take or send out by land, sea or air any goods from India to any place outside India on lease or hire or under any arrangement or in any other manner other than sale or disposal of such goods.

Participation in Trade Fairs Abroad

Indian exporters intending to participate in Trade Fairs conducted abroad, have to make an application to the authorized dealer giving necessary particulars. Foreign exchange will be released by the AD after scrutinizing the application, provided the exporter agrees to give a proper account of the expenditure incurred for the above purpose. Exporters may also open temporary foreign currency accounts abroad for depositing the foreign exchange obtained on sale of goods at the trade fairs. The foreign currency account will be closed, once the fair ends and any balance in that account will be repatriated back to India through normal banking channels within a period of one month from the date of closure of the exhibition/trade fair. Details of the transactions entered and the sale of goods (duly certified by the exporter's banker) will have to be made to the RBI.

Now a days the firms and organizations participating in Trade fair and exhibitions abroad are allowed to export goods abroad for exhibition abroad without prior approval of RBI. Even the sales of unsold exhibit items are allowed outside the exhibition/trade fair in the same country or in another third country at the discounted rates. The exporters are also permitted to 'gift' unsold goods upto the value of US \$ 5000 per exporter, per exhibition/trade fair. In addition documentary proof as to re-import of goods unsold will have to be furnished within 30 days from the entry into India.

Project Exports and Service Exports

Export of engineering goods on deferred payment terms and execution of turnkey projects and civil construction contracts abroad are collectively referred to as 'Project exports'. Prior approval of the Authorised Dealer/Exim Bank/Working Group is required where Indian exporters offer deferred payment terms to overseas buyers and those participating in global tenders for undertaking turnkey/civil construction contracts abroad. Regulations relating to 'Project Exports' and 'Service Exports' are laid down in the revised Memorandum on Project Exports (PEM)

Export on Elongated Credit Terms

A proposal containing the full particulars has to be submitted by the exporters intending to export goods on elongated credit terms their banks to the concerned Regional Office of Reserve Bank for consideration. For the exports done on consignment basis, the approval of ADs is provided upto 360 days from the date of shipment for realization of export proceeds. The exporters can also abandon the books remaining unsold at the expiry of the period of sale contract.

Shut out Shipments and Short Shipments

Short shipment in case of shipment covered by a GR form that is filed with the Customs should be intimated to the Customs in the prescribed form and according to the prescribed manner. Where there is a delay in obtaining certified short shipment notice from the customs, the exporter should give an undertaking to the authorized dealer that he has filed the notice with the customs and will submit it on receipt of the same. The short shipment notice along with the duplicate copy of the GR form will be sent to the RBI.

In a situation where the shipment is totally shut out and reshipment of goods is delayed, then the exporter is required to give notice in duplicate to the customs in the form and manner prescribed. Unused duplicate copy of the GR form and the shipping bill should be attached to the form in which notice is given. After verification, the copy of the notice will be certified as correct and will be forwarded to the RBI along with the unused duplicate copy of the GR form. The original GR received from the customs will be canceled and in case reshipment of goods takes place, a fresh set of GR forms should be completed.

Shipments Lost in Transit

Where shipments in respect of which payments are not yet received are lost in transit, the AD will have to ensure that the insurance claim is made as soon as possible as the loss is known. The duplicate copy of the export declaration form (GR/SDF/PP) will have to be submitted to the RBI giving details like,

- Amount for which shipment was insured
- Name and address of the insurance company
- Place where claim is payable.

In case the claim is payable abroad, the AD should first arrange to collect the amount through the medium of his overseas branch/correspondent. The duplicate copy of export declaration form will be submitted to the RBI only after the amount is collected with their authentication of receipt of claim on the reverse of the duplicate copy.

Note: Sometimes claims on shipments lost in transit are also partially settled directly by shipping companies/airlines under carrier's liability. Authorized Dealers should ensure that amounts of such claims if settled abroad are also repatriated to India by exporters.

Exports by Air-Delivery of Goods only on Payment/Acceptance

In case of air consignments, exporters are advised to consign the goods in favor of the overseas branch/correspondent of the authorized dealer through whom shipping documents will be forwarded for collection. ADs will instruct their overseas branch/correspondent to arrange for issue of delivery order in favor of the buyer only on payment/acceptance of the bill drawn by the shipper.

Consolidation of Air Cargo

Where air cargo is shipped under consolidation, the Airline Company's Master Airway Bill is issued to the Consolidating Cargo Agent who will in turn issue his own House Airway Bills (HAWBs) to individual shippers.

The HAWBs will be negotiated by ADs only if relative LC specifically provides for negotiation of these documents in lieu of Airway Bills issued by the airline company. Authorized Dealers may also accept Forwarder's Cargo Receipts (FCR) issued by steamship companies or their agents (instead of 'IATA' approved agents), in lieu of bills of lading, for negotiation/collection of shipping documents, in respect of export transactions backed by letters of credit, only if the relative letter of credit specifically provides for negotiation of this document, in lieu of bill of lading. Further, it may also be provided in the relative sale contract with the overseas buyer that FCR may be accepted in lieu of bill of lading as a shipping document.

Trade Discount

Any trade discount given by the exporter will have to be declared on the GR form at the time of shipment and accepted by customs. Only then will the documentary bill in respect of exports by sea or air which fall short of the value declared on GR forms on account of trade discount be accepted by authorized dealers.

Advance Payment Against Exports

Exporters are permitted to receive advance payments from the overseas buyers provided, the shipments are monitored by the AD through whom advance payment is received. The appropriations made against every shipment must be endorsed on the original copy of the inward remittance certificate issued for advance remittance.

Note: Purchase of foreign exchange from the market for refunding advance payment credited to EEFC account may be allowed only after utilizing the entire balances held in the exporter's EEFC accounts maintained at different branches/banks.

Part Drawings

In certain lines of export trade, it is customary for exporters not to draw bills for the full invoice value, but to leave a certain part undrawn. In such cases, ADs will accept part drawings provided:

- a. The undrawn balance is in conformity with the normal level of balance in that particular line of trade, subject to a maximum of 10 percent of the export value and
- b. The exporter gives a declaration that the balance proceeds will be surrendered to the AD within the prescribed period for realization. The undertaking will have to be given on the duplicate copy of the GR/SDF/PP forms.

Where the exporter has not been able to repatriate the balance proceeds in spite of his best efforts, ADs on being convinced of the bona fides of the case may submit the duplicate copies of GR/PP forms to RBI duly certified for the amount actually realized, provided the exporter has realized at least the value for which the bill was initially drawn or 90% of the value declared on GR/PP form whichever is more and a period of one year has elapsed from the date of the shipment.

Consignment Exports

When goods have been exported on consignment basis at the risk of the exporter for sale and eventual remittance of sale proceeds to him by the agent/consignee abroad, authorized dealer, while forwarding shipping documents to his overseas branch/correspondent, will instruct the latter to deliver them only against trust receipt/undertaking to deliver sale proceeds by a specified date which should be within the period prescribed for realization of export proceeds. This procedure will be followed even if according to the practice in certain trades, a bill for part of the estimated value is drawn in advance against the exports.

Deduction of Expenses from Sale Proceeds

Expenses normally incurred like landing charges, warehouse rent, handling charges, etc. may be deducted by the agents and the net proceeds may be remitted to the exporter.

Insurance on Consignment Exports

In case of export on consignment basis, freight and marine insurance should be arranged in India.

Establishment of Overseas Warehouses

Certain Indian organizations have been permitted to establish warehouses abroad, to help Indian exporters to arrange off-the-shelf sales for achieving greater penetration of overseas export markets subject to the following conditions:

- a. Applicant's export outstanding does not exceed 5 percent of exports made during the previous year.
- b. Applicant has a minimum export turnover of USD 1,00,000 during the last year.
- c. Period of realization should be as applicable i.e., 180 days for non-status holder exporters and 12 months for status holder exporters.
- d. All transactions should be routed through the designated branch of the Authorized dealer.

The above permissions may be granted to the exporters initially for a period of one year and the renewal thereof may be considered subject to the applicant satisfying the requirement at (a) above.

Deduction from Account Sales

Proper verification of the account sales should be undertaken by the authorized dealer before it is sent to the Reserve Bank of India. Exporters having overseas warehouses are required to produce the supporting bills/receipts in original towards deductions in account sales except in case of petty items like postage/cable charges, stamp duty, etc.

Dispatch of Shipping Documents

Shipping documents received from the exporter should be dispatched to the overseas branch/correspondents of the ADs as quickly as possible. In case of exports to neighboring countries, it should be ensured that documents reach the buyer before the steamer discharges the cargo at the port of destination. To make this possible, exporter should prepare the shipping documents as early as possible and submit the same to the ADs at the earliest.

Dispatch of Shipping Documents Direct to the Consignees

Shipping documents may be dispatched directly to the consignee or his agent by the authorized dealer, provided advance payment or an irrevocable LC for the full export value has been received. Moreover, the sale contract should specify that documents should be directly dispatched to the consignee or his agent resident in the country of final destination of goods. For the exporters having not made the advance payments, the ADs can still accept their request for dispatch of documents direct to the consignee/agent provided the exporter is a regular customer and AD is satisfied with his standing and track record and the arrangements made for realization of export proceeds.

Handing over Negotiable Copy of Bill of Lading to Master of Vessel/Trade Representative

Authorized dealers are permitted by the Reserve Bank to deliver one negotiable copy of the bill of lading to the master of the vessel or trade representative in respect of exports to certain landlocked countries provided an irrevocable LC has been opened and documents are in conformance to the terms of LC which provides for such delivery.

Reduction in Value

In case the exporter wants to reduce the amount after the bills are negotiated/sent for collection, he is first required to make an application to such bank giving full details of the shipment, an attested copy of the invoice and documentary evidence in support of the reduction sought for. However, approval will be granted provided:

- a. Reduction in amount does not exceed 10% of invoice value.
- b. The export does not relate to gold or silver or articles made out of cut and polished diamonds. It does not relate to commodities subject to floor price stipulations and the exporter is not on the caution list of RBI.
- c. The proportionate export incentive availed of is surrendered.

Exporters who are in the field of exports for more than three years may be allowed to reduce the amount without any ceiling provided their track record is satisfactory i.e. export outstandings should not exceed 5% of the average annual export realization during the preceding three calendar years.

For determining the percentage of outstanding export bills to average export realizations during the preceding three calendar years, an exporter is permitted to ignore outstanding export bills in respect of exports made to countries facing externalization problems, provided the payments have been made by the buyers in the local currency.

Box 2: XOS Statements (Annexure)

Authorized dealers are required to monitor carefully the realization of export bills and where export bills remain outstanding beyond the due date for payment, authorized dealers are required to take up the matter promptly with the exporter. In case the exporter does not make payment on the due date, the RBI should be informed about the same by a letter citing the reasons for the delay in realization of the export proceeds.

Consolidated details of all export bills which remain unrealized beyond a period of 180 days from the date of shipment will have to be submitted by the authorized dealers in form XOS. Form XOS is a half-yearly statement and is submitted at the end of June and December every year. This statement is submitted in triplicate within fifteen days from the close of the relative half year. Authorized dealers will however continue to treat export bills which are unrealized and unpaid on the due date of payment as outstanding export bills.

Write-off of Unrealized Export Bills

In case the outstanding export dues are not realized in spite of the efforts of the exporter, he may request the concerned AD for write off of the unrealized portion. Appropriate supporting documentary evidence should be submitted in proof of the same.

The request may be agreed provided;

- a. The amount has been outstanding for one year or more.
- b. The aggregate amount of write off during a calendar year should not exceed 10% of the total export proceeds realized during the previous calendar year.
- c. The exporter submits satisfactory documentary evidence to prove that he has made all efforts to realize the dues.
- d. Write off will also be permitted in case:
 - i. Of insolvency of the overseas buyer and a certificate from the official liquidator has been obtained to that effect.
 - ii. It is not possible to trace the buyer over a long period of time and supporting documentary evidence is provided to that effect.
 - iii. The goods exported have either been auctioned or destroyed by the authorities in the importing country and a certificate to that effect has been issued.
 - iv. The unrealized amount represents the balance due in a case settled through the intervention of the Indian Embassy, Foreign Chamber of Commerce or similar organization.
 - v. The unrealized amount represents the undrawn balance of an export bill (not exceeding 10 percent of the invoice value) and has been unpaid and turned out to be unrealizable despite all efforts made by the exporter.
 - vi. Where the legal expenses likely to be incurred for recovering the said amount would be disproportionate and where the exporter in spite of the court order in his favor is not able to execute the same due to reasons beyond his control.
 - vii. Bills are drawn for the difference between the letter of credit value and actual export value or between the provisional and the actual freight charges but the amount has remained unrealized consequent on dishonor of the bills by the overseas buyer and documentary evidence is produced to show that there are no prospects of realization.
- e. The case is not the subject matter of any civil or criminal suit which is pending.

f. The exporter has not come to the adverse notice of the Enforcement Directorate or the Central Bureau of Investigation or such other law enforcement agency.

g. The export incentives availed of has been surrendered by the exporter.

Where there is no further amount to be realized against the GR/PP/SDF form covered by the write off, the authorized dealer will submit the duplicate copy of the same to the RBI along with R return with their certification, stamp and signature that

“Write off of _____ (Amount in words and figures) permitted in terms of paragraph C.18 of Directions to Authorized Dealer”.

Date

Stamp & Signature of
Authorized Dealer

Change of Buyer/Consignee

Where after the goods have been shipped, there is a change in the buyer to whom goods are transferred, prior approval of RBI is not required provided:

- The reduction in value does not exceed 10% of the invoice value.
- The export proceeds are realized within the stipulated time period of 6 months from the date of shipment.

Where reduction in value exceeds 10%, the exporter will have to comply with the regulations stipulated in the paragraph ‘Reduction in value’.

Extension of Time-limit

Where the exporter is unable to realize the export proceeds within six months but expects to do so provided extension is granted to him, then he should make an application (in duplicate) for this purpose to the RBI in Form ETX along with the necessary documentary evidence. Reserve Bank of India have permitted Authorized Dealers to extend the period of realization of export proceeds beyond 6 months from the date of export where the invoice value does not exceed US \$ 100,000 subject to certain conditions. The RBI should be convinced that the exporter is in no way directly or indirectly responsible for the delay and that by granting an extension he will be able to realize the export proceeds. The extension may be granted up to a period of 3 months at a time and while considering the extension beyond export outstandings of the exporter should one year from the date of export the total not be more than 10% of the average of export realizations during the preceding 3 financial years.

Payment of Claims by ECGC

The ADs can write off the relative export bills and delete the same from the XOS statement on the receipt of application from the exporter backed by documentary evidence from the ECGC confirming that the claim in respect of the outstanding bills has been settled by them. The limit of 10 per cent will not be applicable to such write-offs. Surrender of incentives, if any, in such cases will be as provided in the Foreign Trade Policy. The claims settled in rupees by ECGC will not be construed as export realization in foreign exchange.

Export of Computer Software

Export of computer software takes place either in the physical form or in the non-physical form. In the physical form software prepared on magnetic tapes and paper media are exported. The non-physical exports take the form of direct transmission abroad through dedicated earth stations/satellite links. Procedure relating to declaration of exports taking place in the physical form is the same as applicable to export of other goods. However, export of software in the non-physical form will have to be declared on SOFTEX form (Annexure). A set of SOFTEX forms comprises of three copies marked original, duplicate and triplicate which carry an

identical pre-printed serial number. The three copies duly completed should be submitted for the purpose of valuation together with relevant documents to the designated official of Ministry of Information Technology, Government of India at the Software Technology Parks of India (STPIs) or at the Free Trade Zones (FTZs) or Export Processing Zones (EPZs) or Special Economic Zones (SEZs) in India. SOFTEX forms submitted by exporters located outside the STPI will also be certified by the designated official/s at the nearest STPI.

After certification of all the three copies of the SOFTEX form, the original will be forwarded directly to the nearest office of the Exchange Control Department of the RBI on the day it is received or the next day. The duplicate copy of the form will be returned to the exporter. The designated official will retain the triplicate copy for their record.

Within 21 days of certification of the form, the exporter is required to submit the duplicate copy along with a copy of each of the supporting documents to the AD either for negotiation or for collection. The AD will retain the forms so submitted until the full export proceeds are realized. After the export proceeds are realized the forms will be submitted to the Reserve Bank duly certified under cover of an appropriate R return along with a copy/ies of invoice/s.

After the documents are negotiated/sent for collection, ADs should report the transaction to the Reserve Bank in a fortnightly statement in form ENC under the cover of appropriate R Return. Chronological order as recorded in the internal register (export bills register) should be maintained in case of entries in the ENC statement.

The export proceeds should be repatriated into India on due date of payment or within 180 days from the date of invoice whichever is earlier.

Terms of Payment-Invoicing

- i. In respect of long duration contracts involving series of transmissions, the exporters should bill their overseas clients periodically, i.e. at least once a month, or on reaching the 'milestone' as provided in the contract entered into with the overseas client and the last invoice/bill should be raised not later than fifteen days from the date of completion of the contract. Exporters are advised to submit a combined SOFTEX form for all the invoices raised on a particular overseas client, including advance remittances received in a month.
- ii. In respect of contracts involving only 'one shot operation' the invoice/bill should be raised within 15 days from the date of transmission.
- iii. The exporter should submit SOFTEX form in triplicate to the concerned official of the Government of India at STPI / EPZ /FTZ /SEZ for valuation/certification not later than 30 days from the date of invoice/the date of last invoice raised in a month as indicated above. The designated officials may also certify the SOFTEX Forms in respect of EOUs which are registered with them.
- iv. The invoices raised on overseas clients as indicated in (i) and (iii) above will be subject to valuation of export value declared on SOFTEX form by the designated official of the Government of India and consequent amendment made in the invoice value, if necessary.

Remittances Connected with Exporters

Exporters are permitted to retain a part of their export proceeds in a foreign currency account called the Exchange Earners Foreign Currency Account with an authorized dealer in India. This account may be maintained in current, savings or term deposit form. The balances in this account may be utilized for all bona fide payments (as listed in Annexure I to chapter 14 of the exchange control manual) of the exporter subject to production of documentary evidence.

Agency Commission

Agency commission on exports may be permitted provided certain conditions are fulfilled.

- a. The amount of commission should be declared on the export declaration form (GR/SDF/PP/SOFTEX) and accepted by the customs authorities. If the commission has not been declared in the prescribed form, the remittance is provided only if the concerned authorities are satisfied with the reasons adduced by the exporter for not declaring commission on Export Declaration Form, provided a valid agreement/written understanding between the exporter and/or beneficiary for payment of commission subsists.
- b. The commission paid by Indian exporters may be allowed by Authorized Dealers in respect of their exports covered under counter trade arrangement through Escrow Accounts designated in U.S.dollar provided The commission is not payable to Escrow Account holders themselves or The commission is not allowed by deduction from the invoice value.
- c. Payment of Commission is not allowed on account of exports made by Indian partners towards equity participation in an overseas joint venture/wholly owned subsidiary as well as exports under Rupee Credit Route except for tea & tobacco.
- d. The relative shipment has already been made.

Overprice

Overpricing of exports has been prohibited and cases having exceptional features may be referred to the RBI explaining why the exporter is unable to remunerate the agent by paying commission instead of overprice.

Export Claims

Remittances towards export claims will be made by Authorized Deal us provided the relative export proceeds should have been already realized and repatriated into India the exporter is not on the caution list of Reserve Bank.

In every such case, the exporter is required to surrender proportionate incentives, if any, received by him.

Dispatch of Goods not involving Foreign Exchange

In respect of exports by airfreight and post parcel which are covered by certificates issued by ADs confirming that the transaction does not involve any foreign exchange, the GR/PP forms procedure has been waived. Waiver will be permitted provided the following conditions are fulfilled:

Export is made by post parcel or airfreight.

AD is convinced that the transaction does not involve any foreign exchange flow. Value of shipment is not more than Rs.25,000.

SUMMARY

- Exports play a key role in the economy. It augments the country's exchange reserves. It also helps in maintaining a steady and stable growth rate besides improving employment opportunities. In view of this, Government of India provides different kinds of incentives to the exporters. One of the major incentives provided to exporters is granting of liberal credit by the banking system at concessional rates of interest. Banks are directed to make credit available both at pre- and post-shipment stages more liberally i.e. without asking for collateral securities, etc. Banks have been asked to grant lines of credit to exporters even for 3-4 year

- s depending on their track record, so that they can scout for business/export orders, without being bogged down with credit constraints.
- Packing credit at pre-shipment stage, discounting of bills at post-shipment stage, either in Indian rupees or foreign currency is the most common mode of credit supply. To encourage banks to liberally sanction loans to exporters, banks are provided loan guarantee facilities by an officially set up body called ECGC. Similarly, banks are also offered refinance facilities by the Reserve Bank of India, against the outstandings under export credit.
- There are certain exchange regulations that define the mode of conducting exports and all the organizations/persons dealing with exporters should comply with these regulations as they are mandatory. But for this, export credit, its assessment, sanction, monitoring for repayment, etc. are just like any other normal credit dispensation.

Appendix 1
EXCHANGE CONTROL DECLARATION (GR) FORM NO.
Original

Exporter		Invoice No. & Date		SB No. & Date			
		AR4/AR4A No. & Date					
		Consignee		Q/Cert No. & Date		Importer-Exporter Code No.	
Export Trade Control							
				Custom House Agent L/C.No.		If export under: Deferred Credit [] Joint Ventures [] Rupee Credit [] Others [] RBI's Approval/Cir.No. & Date	
Pre-Carriage by		Place of Receipt by Pre-Carrier		Type of shipment : Outright Sale [] Consignment Export [] Others [] (Specify)			
Vessel/Flight No.		Rotation No.					
		Port of Loading					
Port of Discharge		Country of Destination		Exchange Rate U/S 14 of CA Currency of invoice			
S.No		Marks & No.		No. & Kind of Pkgs			
				Statistical Code & Description of Goods			
				Quantity			
				Value FOB			
Net Weight							
Gross Weight							
Total FOB Value in words							
Analysis of Export Value		Currency Amount		Full export value OR where not ascertainable, the value which exporter expects to receive on the sale of goods. Currency _____ Amount _____			
FOB Value		_____					
Freight		_____					
Insurance		_____					
Commission		_____					
Discount		_____					
Other Deductions		_____					

EXCHANGE CONTROL DECLARATION (GR) FORM NO.

Is Export under L/C arrangements? Yes [] No [] If yes, name of advising bank in India		<u>FOR CUSTOMS</u> Customs Assessable value Rs. (Rupees	
Bank through which payment is to be received		Export Value Verified Customs Appraiser	
Whether Payment is to be received through the ACU YES/NO		Date of Shipment	Customs Appraiser
<p>Declaration under Foreign Exchange Regulation Act: I/We hereby declare that I/We am/are the *SELLER/CONSIGNOR of the goods in respect of which this declaration is made and that the particulars given above are true and that a) *the value as contracted with the buyer is the same as the full export value declared overleaf/ b) *the full export value of the goods is not ascertainable at the time of export and that the value declared is that which I/We, having regard to the prevailing market-conditions, expect to receive on the sale of goods in the overseas market.</p> <p>I/We undertake that I/We will deliver to the bank named herein the foreign exchange representing the full export value of the goods on or before @ in the manner prescribed in Rule 9 of the Foreign Exchange Regulation Rules, 1974. I/We further declare that I/We am/are resident in India and I/We have a place of business in India.</p> <p>I/We* am/are OR am/are not in Caution List of the Reserve Bank of India.</p> <p>Date..... Signature of Exporter)</p> <p>@ State appropriate date of delivery which must be the due date for payment or within six months from the date of shipment, whichever is earlier, but for exports to warehouses established outside India with the permission of the Reserve Bank of the date of delivery must be within fifteen months.</p> <p>* Strike out whichever is not applicable</p>			
<u>SPACE FOR USE BY RESERVE BANK OF INDIA</u>			

EXCHANGE CONTROL DECLARATION (GR) FORM NO.

Is Export under L/C arrangements? Yes [] No [] If yes, name of advising bank in India	<u>FOR CUSTOMS</u> Customs Assessable value Rs. (Rupees
Bank through which payment is to be received	Export Value Verified Customs Appraiser
Whether Payment is to be received through the ACU YES/NO	Date of Shipment Customs Appraiser
<p>Declaration under Foreign Exchange Regulation Act: I/We hereby declare that I/We am/are the *SELLER/CONSIGNOR of the goods in respect of which this declaration is made and that the particulars given above are true and that a)*the value as contracted with the buyer is the same as the full export value declared overleaf/ b) *the full export value of the goods is not ascertainable at the time of export and that the value declared is that which I/We, having regard to the prevailing market-conditions, expect to receive on the sale of goods in the overseas market.</p> <p>I/We undertake that I/We will deliver to the bank named herein the foreign exchange representing the full export value of the goods on or before @ in the manner prescribed in Rule 9 of the Foreign Exchange Regulation Rules, 1974.</p> <p>I/We further declare that I/We am/are resident in India and I/We have a place of business in India.</p> <p>I/We* am/are OR am/are not in Caution List of the Reserve Bank of India.</p> <p>Date..... Signature of Exporter)</p> <p>@ State appropriate date of delivery which must be the due date for payment or within six months from the date of shipment, whichever is earlier, but for exports to warehouses established outside India with the permission of the Reserve Bank of the date of delivery must be within fifteen months.</p> <p>* Strike out whichever is not applicable</p>	
<p align="center"><u>FOR AUTHORISED DEALER'S USE</u></p> <p align="right">Uniform Code Number.....</p> <p>*Indicate () in the box applicable Date of* (i) negotiation (ii) receipt for collection. Bill No.....</p> <p>Type of Bill* (i)DA[]/(ii)DP []/(iii)Others [].....(Specify)</p> <p>Type of shipment:*(i) Firm Sale Contract []/(ii)Consignment Basis []/ (iii)Others [](Specify)</p> <p>The GR Form was included in the Statement sent to the Reserve Bank with the R Return for the fortnight ending.....sent on.....</p> <p>We certify and confirm that we have received the total amount of..... (Current amount) as under being the proceeds of exports declared on this form.</p>	

Page No.

ENC(Paragraph 6 B.1)
(To be submitted in duplicate)**Statement of Export Bills negotiated/sent for collection during fortnightly period from to (to cover all exports under outright sales, consignment exports, exports under deferred payment arrangement or any other arrangement)**

Name of A.D.Branch _____

Uniform Code No. _____

We certify the following:

1. The proceeds of exports declared on the GR/PP/SOFTEX forms or in SDF appended to EC copy of EDI Shipping Bills listed below have been either received in advance (in full/part) or will be received within the prescribed period and in manner approved by Reserve Bank. In cases where part of export proceeds have been received in advance, we undertake to receive the balance of export proceeds within the prescribed period in an approved manner.
2. In respect of exports under deferred payment arrangements the concerned exporters have declared the RBI approval numbers and dates on the corresponding duplicate GR/PP forms/SDF with EC copy of EDI Shipping Bill.
3. The relative duplicate copies of GR/PP/SOFTEX forms/SDF with EC copy of EDI Shipping Bill are held with us and will be forwarded to Reserve Bank duly certified, on realisation of full export proceeds.
4. The negotiation and/or acceptance for collection of export bills pertaining to the forms listed herein is/are in accordance with the Exchange Control requirements.

STAMP

(Signature of Authorised Official)

Place: _____
Date: _____Name _____
Designation _____
Name and Address _____
of Authorised Dealer _____

Date of Transaction	Bill No. in Export Bills Register	Importer/Exporter Code number	GR/PP/SOFTEX Form No.	Shipping Bill No.		S/B Date <u>D</u> <u>M</u> <u>Y</u>	Customs Number*	Total Invoice Value		Remarks
				Port Code No. @	Shipping Bill No.			Currency	Amount	
1	2	3	4	5	6	7	8	9	10	11

@ In the case of EDI Shipping Bill

* For GR forms only

EFC

(Paragraph 6 A.12)

Application for opening foreign currency account with a bank in India or abroad by exporters

Instructions:

1. *The application should be completed in duplicate and submitted through the designated branch of a bank authorised to deal in foreign exchange in India with which the foreign currency account is to be maintained/which will monitor the account, to the Office of Reserve Bank under whose jurisdiction the exporter is located.*
2. *Before forwarding the application to Reserve Bank, authorised dealers should properly scrutinize it to ensure that it is complete in all respects.*

Documentation:

3. Exporter's declaration duly certified by his auditors, indicating export bills realised during the preceding 3 years and the export bills outstanding beyond the due date.
4. Auditor's certificate giving country-wise break-up of imports made during the preceding 3 years.
5. Certified copies of a letter from overseas bank indicating terms & conditions of the loan/overdraft/line of credit facilities offered.
6. Certified copies of Reserve Bank's approval in respect of foreign currency loans raised giving their maturity patterns.

International Finance and Trade

1.	Name and address of the Exporter				
2.	Importer-exporter's code number				
3.	Name and address of the bank/ branch with which foreign currency account is proposed to be maintained.				
4.	In case the account is to be maintained with a bank out-side India, name and address of the branch of a bank in India which will monitor the transactions put through the foreign currency accounts.				
5.	Details of exports made and proceeds realised during the period the preceding 3 years and outstanding at the end of the period.	Calendar Year	Total exports made (Rs.)	Amount realised (Rs.)	Outstanding at the end of the period (Rs.)
6.	Details of imports made Calendar Year Country Amount (Rs.) during the preceding 3 years, country-wise.	Calendar Year	Country	Amount (Rs.)	
7.	In case the account is proposed to be opened with a bank abroad, indicate the details of arrangements made for availing of loans/ overdrafts/lines of credit from the bank with which the account will be maintained.				
8.	Quarterwise projections of export receipts to be credited to the account and payments in foreign exchange (itemwise) to be made from the account under various heads, during the next year.				
9.	Whether the applicant's name has been/was placed on exporters' caution list at any time.				
10.	Details of foreign currency loan raised by the exporter and their maturity patterns.				
11.	Any other information that the applicant may like to provide in support of this application.				

Place:
Date :

Stamp

.....
(Signature of Applicant/Authorised Official)
Name:
Designation:

(Space for Authorised Dealer's comments)

Comments of the branch of the bank in India with which the account is proposed to be maintained or which will monitor the operations on account maintained with a bank abroad, as the case may be.

Place:
Date :

Stamp

.....
(Signature of Applicant/Authorised Official)
Name:
Designation:
Name and Address
of Authorised Dealer:

ECT

(Paragraph 6 A.17)

Application for permission for export of commodities on elongated credit terms beyond 180 days

Instruction:

The application complete in all respects should be submitted in duplicate through the applicant's bankers to the concerned regional office of Reserve Bank of India, under whose jurisdiction the applicant is situate.

1.	Particulars of exporter a) Name and address b) Importer-Exporter Code Number	
2.	Name and address of the Overseas buyer	
3.	Particulars of export Contract a) Commodity to be exported b) Terms of Contract (FOB, C&F, CIF, etc.) c) Quantity d) Total Contract Value	
4.	Period of credit required	
5.	Terms of payment: a) Whether the export is covered by irrevocable letter of credit; if so name and address of the opening bank. b) If the letter of credit has been confirmed by any bank, name of the confirming bank. c) In case the contract is not covered by letter of credit, details of guarantee if any, offered by overseas buyer.	

International Finance and Trade

6.	Rate of interest: i) The rate of interest, if charged separately ii) Element of interest included in the price if interest is not being charged separately									
7.	Exporter's past experience regarding repatriation of proceeds from the concerned buyer/country									
8.	Whether ECGC have agreed to provide necessary cover for the export order in question									
9.	Name and address of the bank in India from whom credit facilities are proposed to be obtained.									
10.	Whether any commission is payable in respect of the export order. If so, a) Name and address of the overseas agent. b) Rate at which the commission is payable									
11.	Profitability - A detailed statement indicating how the net profit has been arrived at should be enclosed									
12.	Exporter's export performance during the previous 3 years	<table border="1"> <thead> <tr> <th>Year</th> <th>Value of Exports made Rs.</th> <th>Total realisation Rs.</th> <th>Amount outstanding beyond 6 months Rs.</th> </tr> </thead> <tbody> <tr> <td></td> <td></td> <td></td> <td></td> </tr> </tbody> </table>	Year	Value of Exports made Rs.	Total realisation Rs.	Amount outstanding beyond 6 months Rs.				
Year	Value of Exports made Rs.	Total realisation Rs.	Amount outstanding beyond 6 months Rs.							
13.	Any other information relevant for consideration of the application									

Place:
Date :

Stamp

.....
(Signature of Applicant/Authorised Official)
Name:
Designation:
Registration No:

To be completed by the Exporter's bank

- Comments regarding the means and standing of the exporter
- Health Code allotted
- Credit limits enjoyed by exporter with the bank/other banks
- Any other comments

Place:
Date :

Stamp

.....
(Signature of Applicant/Authorised Official)
Name:
Designation:
Name and Address
of Authorised Dealer

XOS

[Paragraph 6 C.12(ii)]

A.D.Code Number.....

**Statement of particulars of export bills outstanding beyond the prescribed period/due date
of realisation as at 30th June/31st December 19**

Part I – Outstanding Export bills other than those on deferred payment terms

Sr. No.	Bill No. and date	Name and address of exporter	Importer Exporter Code No.	Date of export	Due date of reali- sation	GR/PP/ SOFTEX form no.	Port of Shipment	Shipping Bill No. & date	Name & of address the overseas buyer	Commodity
1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.

Invoice Value	Amount realised	Amount Outstanding	Rupee equivalent of outstanding amount (To be classified as)			Remarks
Currency and Amount	Currency and Amount	Currency and Amount	Cash exports	Exports on consignment basis	Undrawn balances	
12.	13.	14.	15.	16.	17.	18.

Total...

Part II – Exports on deferred payment terms where instalments (including interest) are outstanding beyond due date

Sr. No.	Name and address exporter	Exporter Code No. / IE Code No.	No. & date of RBI approval for deferred payment term	Date of export	GR Form No.	Port of Shipment & date	Shipping Bill No. overseas	Name and address of	Commodity	Invoice value Currency & Amount
1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.

Value of goods covered under deferred payment terms (including interest)		Total Amount of deferred instalments (including interest) already received		Total Amount of instalments outstanding (including interest) beyond due date		Rupee equivalent of outstanding (including interest)	Whether ECGC cover obtained (yes/no)	No. and date of bank certificate issued	Remarks
Currency	Amount	Currency	Amount	Currency	Amount				
12.		13.		14.		15.	16.	17.	18.

Total...

Part III – Summary

	'Cash' exports	Export on consignment basis	Undrawn balances	Total of Cols. (1+2+3)	Exports on deferred payments basis
	1	2	3	4	5
	Rs.	Rs.	Rs.	Rs.	Rs.

Outstandings as on

(end of previous
half-year)

Add: Addition during
the half-year
under report

Less: Deletion during
the half-year

Net position of
outstanding as on-

(end of half-year
under report)

We certify that all export bills i.e. export bills purchased, negotiated and sent for collection, outstanding beyond the prescribed period/due date of realisation as at the end of the half-year under report have been included in this statement.

Place: _____

(Signature of Authorised Official)

Date : _____ Stamp

Name : _____

Designation : _____

Instruction for Completing XOS Statement

- (i) Authorised dealers should submit a consolidated statement giving details of all export bills outstanding beyond the prescribed period of realisation as at the end of June and December each year, Net position of outstanding export bills included in Parts I and II of the statement should be given in Part III of the statement.
- (ii) In Part I, particulars of all out standing bills relating to 'cash' exports, exports on consignment basis including exports to Indian owned warehouses abroad, and undrawn balances outstanding should be included.
- (iii) In Part II, exporter-wise outstandings in respect of deferred payment exports should be reported indicating details of outstanding under each deferred payment contract approved by Reserve Bank.
- (iv) Exporter-wise totals/grand totals (converted into rupees wherever necessary) should be given.
- (v) Advance remittances and part realisations should be shown under the column 'Amount realised' and the balance shown as outstanding.
- (vi) Approval number and date of the Reserve Bank and the date upto which extension has been given should invariably be indicated in 'Remarks' column. Where approval for extension of time has not been obtained from the Control, steps taken in this regard should be indicated in 'Remarks' column.
- (vii) Incases where export proceeds against GR/PP/SOFTEX forms have not been realised either in full or in part because legal proceedings have been initiated against the buyers, a suitable remark should be made in the statement.
- (viii) Outstandings in respect of which proceeds are not recoverable but which are being reported only for technical reasons should be distinctly denoted quoting Reserve Bank's reference and date in terms of which the item is required to be reported as outstanding.
- (ix) In certain countries, remittances are not allowed to be made promptly even after the bills are paid by the importers in local currency, due to balance of payments difficulties. In such cases, the fact that payment has been made in local currency with date of payment should be indicated in 'Remarks' column.

FORM: SOFTEX

EXCHANGE CONTROL **(EXPORTER'S DECLARATION)**

ORIGINAL

Form Number: _____

1. Name and location of Technology Park			
2. Exporter's name and address			
3. Importer/Exporter Code No.			
4. Status of Exporter	Mother Unit	Subsidiary Unit	Other
5. Buyer's name and address			
6. Satellite Station			
7. Export Contract No. & Date			
8. Date of submission of contract to Competent authority (i.e. Department of Electronics, Government of India)			
9. Date of submission of contract to Reserve Bank			
10. How export value will be realised i.e. whether --- (a) Under L/C (b) Bank Guarantee (c) Any other arrangement e.g. advance payment, etc. (please specify)	(a) (b) (c)		
11. Name and address of bank opening L/C or furnishing guarantee			
12. Date/s of export (Details to be furnished separately as per Appendix)			
13. Description of software exported			
14. Total manhours used for development of the software			
15. Analysis of export value: (i) Full export value (ii) Add: Transmission charges, if any, payable by overseas buyers (iii) Deduct: Agency commission, if any, payable abroad at the rate of.....% (iv) Amount to be realised	Currency	Amount	
16. Name and address of designated bank in India through whom payment has been/is to be received.			

I/We, hereby declare that I/we am/are the seller of the computer software in respect of which this declaration is made and that the particulars given above are true and that the value to be received from the buyer represents the export value contracted and declared above.

I/We undertake that I/we will deliver to the bank named above the foreign exchange representing the value of the software exported as above on or before (i.e. the due date for payment or within six months from the date of transmission whichever is earlier), in the manner prescribed in Rule 9 of the Foreign Exchange Regulation Rules, 1974.

Place: _____ Stamp _____ (Signature of Exporter)
 Date: _____ Name: _____
 Designation: _____

(Space for use of the competent authority i.e. Department of Electronics)

Certified that the software described above was actually transmitted and the export value declared by the exporter has been found to be in order and accepted by us.

Place : _____ (Signature of Designated Official)
 Date : _____ Name : _____
 Designation : _____
 (Department of Electronics, Government of India)

APPENDIX
 (cf. Item 12 of form SOFTEX)
Details of Satellite Link Usage

Date of Transmission	Time of transmission		Duration of transmission: Outward/Inward	Cumulative duration of transmission: Outward/Inward	Whether Outward/Inward or both
	From	To			
1	2	3	4	5	6

CHECK-LIST

Instructions for filling up SOTTEX forms
for export of computer software via satellite

The following requirements should be carefully complied with by exporters while completing the form--

1. The SOTTEX form should be completed in triplicate and the entire set of three copies of invoice and bill of exchange should be submitted to the competent authority (Designated official of Department of Electronics, Government of India) for certifying the value of export.
2. The duplicate SOTTEX form returned by the Department of Electronics duly certified should be presented immediately to the designated branch of authorised dealer, together with attested copies of invoice, bill of exchange, etc. for realisation of the export proceeds.
3. Separate SOTTEX form should be submitted by the exporter for each completed export order or, if the job involves more than one transmission, the SOTTEX form should be completed on the basis of bills raised by the exporter on the importer. Exporters are expected to bill their overseas buyers atleast once a month in case of contracts which would be executed over a longer period. Alternatively, they should raise bills progressively on completion of a sizeable part, say 20% of the contract value, and continue submitting declaration on SOTTEX forms at these intervals.
4. Exporter's Code No. allotted by Reserve Bank of India should be indicated on all the copies of SOTTEX form.
5. Against the item 'Description of software exported' exporter should indicate the category to which the export relates, on the following basis:

Description of Software	Indicate as
(i) Data entry jobs and conversion software	S/W - A
(ii) Data processing software	S/W - B
(iii) Software based on scientific/engineering/ mathematical knowledge	S/W - C
(iv) Development of new algorithm for system software/communication software/ application software and other intricate knowledge of software and firm ware engineering.	S/W - D

6. Average manpower used in development of software should be furnished in manhours.
7. Name and address of designated bank in India through whom the proceeds of exports have been received or will be realised should be specified in the space provided for the purpose in the form.

Chapter V

Import Finance and Exchange Regulations Relating to Import Finance

After reading this chapter, you will be conversant with:

- Financing Imports
- Prerequisites for Opening an Import Letter of Credit
- Customs Procedure for Clearance of Imports into India
- Exchange Control Regulations Governing Imports

As seen in the previous chapter, imports into the country are regulated as per the provisions in Foreign Trade (Development and Regulation) Act, 1992, where under the Central Government announces from time to time policy guidelines governing imports. We have discussed about the regulations that are currently in force, at length under the Foreign Trade Policy 2004-2009 in Chapter II. We shall now discuss about financing imports and the exchange control regulations that govern imports into the country.

FINANCING IMPORTS

Bank lending activities under import financing are mainly concentrated on activities like:

- Import of consumable inputs and channelized items.
- Import of plant and machinery.
- Imports made under short-term credit facility extended by overseas seller.

Credit support to imports is usually extended in the form of:

- Opening of import letter of credit.
- Financing imports in the form of cash credit, loans mostly against import trust receipt, effecting payment in foreign exchange directly to overseas sellers.
- Issuing deferred payment guarantees favoring overseas seller on behalf of importer who is importing capital goods on long-term credit.

As a general rule, any credit facility extended to an importer is basically appraised like any other domestic credit proposal, to ascertain that the business has scope to generate cash flows that are sufficient to service the debt besides leaving a reasonable profit with the borrowers. In addition to these normal credit appraisal techniques, banks are expected to assess the loan requirement for compliance with trade and exchange regulations that are applicable to the respective import activity. It is in fact incumbent upon everyone concerned with imports to comply with these regulations. In view of this, we shall now discuss about opening of import LCs or financing an importer against import trust receipt, etc., and compliance with regulations in detail.

PREREQUISITES FOR OPENING AN IMPORT LETTER OF CREDIT

Whenever an importer approaches a bank for opening an import LC, banks usually subject the request for scrutiny under the premises of

- a. Trade Control Requirements
- b. Exchange Control Requirements
- c. Credit Norms of RBI
- d. U.C.P.D.C Provisions and FEDAI
- e. Bank's Internal Procedures.

Besides appraising its very creditworthiness.

According to the exchange control guidelines banks are required to open letters of credit for their own customers known to be participating in the trade. The opening of a letter of credit involves two stages wherein the importer is first required to make an application-cum-agreement in the required format to the bank for opening the LC. Along with the application the applicant is also required to submit certain important documents like,

- The exchange control copy of the import license/open general license declaration form, in case the items to be imported are covered under OGL.
- Letter of authority signed by the licenser in favor of the applicant, in case the applicant is not the holder of the license.

- Pro forma invoice/indent/sale contract etc. covering the goods to be imported.
- Board Resolution in the case of limited companies authorizing the company to establish the letter of credit.
- Board Resolution for availing of import loan wherever necessary.
- Evidence of the Import-Export Code Number allotted by the Director General of Foreign Trade (DGFT) to the importer.
- The sale contract between importer and exporter.

While submitting the application, the importer should take care to ensure that;

- The application form is duly stamped according to the law of the concerned state and dated.
- The application form is signed on all pages by the authorized signatory.
- The application is filled in completely and any corrections or alterations are duly authenticated.
- Particulars furnished conform to the proforma invoice/contract/indent backing the letter of credit.
- The tenor of the bill of exchange does not exceed that provided by the exchange control regulations in force.
- Currency in which payment is to be made is in conformance with the permitted methods of payment.
- Goods are consigned only in the name of the LC opening bank. Similarly, documents of title to goods are in the name of the LC issuing bank and never directly to the importer.
- The LC application clearly mentions the origin of the goods.
- The indent/contract continues to be valid.
- Terms and conditions mentioned are compatible with each other.
- The rate of interest if any for the the usance period does not exceed the prime rate of interest in the country of the currency in which goods are invoiced.

In order to assess the creditworthiness of an importer, banks obtain information relating to the following:

The importer should be in possession of an importer exporter code issued by the Director General of Foreign Trade.

As the exchange control copy of the import license should be submitted to the authorized dealer, the import license should:

- Be valid.
- Be issued on security paper and have a printed number and date.
- Have a security seal.
- Be in the name of the importer or properly transferred in his name with proper transfer letters authorizing him to effect import and open letter of credit, etc. by the licensee as per provisions of ITC policy.
- Commodity specified in the license should be the same as that indicated in the application. Similarly, quantity or amount limits specified in the license should be in agreement with that mentioned in the application. Also, irrespective of the sale terms for which the letter of credit is proposed to be opened, the import license should have adequate value to cover CIF value plus agency commission and interest, if any.
- Country of origin of goods authorized in the license and country of shipment as authorized should be in agreement with that which is stated in the letter of credit agreement.

- The license should be valid for shipment at least up to the last shipment date requested for in the letter of credit application.
- If license is issued under any bilateral or multilateral agreement, the conditions stated in the concerned agreements and the relative ITC notification are complied with.
- If license stipulates placement of order within a specified time limit, the sale contract submitted must confirm compliance of the condition.

Similarly, an import letter of credit will have to comply with certain exchange control aspects and hence, the importer should be aware that;

- LCs will be opened by bankers only in favor of their customers who are known to be participating in the trade.
- For those goods which are covered under the negative list of imports, LC will be opened only if the importer submits a license marked “For Exchange Control Purposes”.
- Where goods are imported from Nepal or Bhutan, payment will be made in rupees and such an LC would be treated as a domestic LC.
- If the beneficiary is from an ACU country, the LC should be denominated in ACU dollar which is equivalent value-wise to one US dollar.
- If import is made under a foreign loan or credit agreement and payment is authorized under letter of commitment method, letter of credit should not envisage any remittance from India. In the case of import licenses where reimbursement method applies authorized dealers will make appropriate stipulations to ensure that the prescribed documents are submitted to them without fail.
- In case of import of technology and drawings, the applicant will be required to pay Research and Development Cess, before allowing remittance. An undertaking to this effect is required to be given by the importer at the time of opening the LC.
- In case of imports on cash basis, remittance should be completed within six months from the date of shipment. However, in a situation where there is undrawn balance, payment for such amount can exceed six months, but no interest will be paid on such amount withheld.
- If a letter of credit is to be opened for transaction of merchanting or intermediary trade, a letter of credit for the other leg of the transaction on back to back terms will have to be opened or full advance payment should be made. Moreover, banks will open LCs only in favor of their clients who are genuine traders in goods and not mere financial intermediaries.

If the Letter of Credit application is found to be in order after scrutiny from all angles, the bank will open the LC in favor of the supplier of goods. The LC will be advised to the beneficiary by an advising bank based in the beneficiary's country. The mode of transmission of the LC is normally indicated by the applicant. However, in situations where such a request cannot be acceded to, the bank will inform the applicant and seek alternate instructions. The documents which are presented to the issuing bank are the same documents which are presented by the exporter. On receipt of documents from the exporter's bank, the importer's bank will examine the documents with the terms and conditions of the LC already issued and if found in order it will debit the importer's account for the amount in rupees equivalent to the bill amount plus its own charges and charges of the overseas bank and hand over the same to the importer.

The procedure for scrutiny of the said documents will be the same as that made by the exporter's banker. As payments under a letter of credit depend on the correctness and completeness of the documents submitted, both importers and exporters are required to follow certain safeguards while submitting the same.

CUSTOMS PROCEDURE FOR CLEARANCE OF IMPORTS INTO INDIA

A person in charge of the conveyance carrying imported goods should within 24 hours of the arrival of the conveyance is required to submit an import manifest to the customs department. The manifest includes details of all the goods that are on board the vessel, including those which are to be transshipped and those to be carried to subsequent ports of call. When the importer receives information about the arrival of goods, he or his agent is required to file a bill of entry in the prescribed form with the imports department of the customs house. The date of presentation of the bill of entry is important as the goods will be assessed to duty based on the rate prevailing on the date of presentation. After the bill of entry is noted in the imports department, the same should be presented at the appraising counters accompanied by the following documents:

- Import License, if necessary
- Exporter's Invoice
- Copy of Letter of Credit
- Original Bill of Lading and its Non-Negotiable Copy
- Two Copies of Packing List
- Weight Specifications
- Manufacturer's Test Certificate
- Certificate of Origin
- Delivery order issued by Shipping company or its Agent
- Freight and Insurance amount Certificate if the Import is on FOB terms
- A declaration from importer that he has not paid any commission to agents in India
- Customs Declaration
- Catalogue/Drawings, etc., for machinery imported.

After verification and completion of the bill of entry by the appraiser, the bill is countersigned by the Assistant Collector and sent to the License section with an order to the dock staff for examination of the goods before clearance.

The appraising procedure may be either the first check procedure or the second check procedure. Under the first check procedure, the appraiser after initial scrutiny of the documents submitted, returns the bill of entry with an order for examination of goods prior to assessment of duty.

Under the second check procedure, after payment of duty, the importer or his agent is required to obtain the duplicate copy of the bill of entry from the customs on which the order for examination of goods is given. (The original copy of the bill of entry is retained by the customs department.) If the description of goods is found to be the same as declared, then permission for clearance is given by the appraiser. It should be noted that under the second check procedure, the assessment of duty is made prior to examination of the goods.

Box 1: BEF Statements (Annexure)

Importers are required to submit the exchange control copy of the bill of entry for home consumption/postal wrappers to the authorized dealers as evidence that the goods against which payment has been made are actually brought into the country. Authorized dealers acknowledge evidence of import by issuing acknowledgement slips containing details like importer's full name, address, code number, import license number and date, bank's reference number (LC number, etc.), number and date of the exchange control copy of the bill of entry/postal wrapper, value and particulars of the imported goods.

In case the importer fails to furnish evidence of import within three months from the date of remittance, the AD will issue a reminder to the importer insisting him to produce the evidence. On failure to respond to this reminder by the importer, a second reminder by registered post acknowledgement due will be sent to the importer not later than one month from the date of the first reminder. If the importer fails to furnish evidence within a period of 21 days from the date of the second reminder, the AD will include details of the defaulting importer as well as the import transaction in the BEF statement (which is a half-yearly statement submitted as at the end of June and December every year) to be forwarded to the Reserve Bank of India. The Reserve Bank of India may initiate penal proceedings against the defaulting importer based on the details given in the BEF Statement.

Source: The Reserve Bank of India.

EXCHANGE CONTROL REGULATIONS GOVERNING IMPORTS

Import of goods into India is subject to exchange control regulations which are enumerated below.

FEMA places restriction on the purchase and sale of foreign currency. As per this Act, only authorized dealers or those generally or specially permitted by the RBI can purchase or sell foreign currency. Any foreign exchange that is required for import payment can be acquired only from an authorized dealer.

As per FEMA, foreign exchange that is acquired by any person should be utilized for that purpose alone. If the foreign exchange is not used (for any reason) for the intended purpose, such a person is required to surrender the foreign exchange without delay to an authorized dealer in foreign exchange. Utilization of such foreign exchange for a purpose other than what was intended will be treated as an offense under the Act.

FEMA also lays down that any person who acquires foreign exchange for importing goods into India but does not import the goods or does not import goods of value or kind or quality or quantity indicated while acquiring the foreign exchange, will be presumed to have been unable to use the foreign exchange for the purpose for which it was acquired or as the case may be, to have used the foreign exchange for a purpose other than the one for which it was acquired.

Payment of Imports under Foreign Loans/Credits arranged by Government of India from Foreign Governments Institutions

In a situation of adverse balance of payments, and where it is necessary to import certain goods, the Government/RBI may obtain a line of credit from the Central Bank of the overseas suppliers country. In such a case, payment may be made either by the letter of commitment method or the reimbursement method.

Under the letter of commitment method, payment is made directly by the loan agency (i.e., the Central Bank of the supplier) to the supplier of goods. The importer needs to make payment in Indian rupees only to the Government of India. The manner of converting the foreign currency payments into rupees under this method, recovery of payment from the importer and depositing the proceeds to the account of the Government of India are intimated through public notices.

Under the reimbursement method, payment is first made through normal banking channels (by the Government/RBI to the overseas supplier) and reimbursement is subsequently claimed by the Government/RBI from the credit agency (i.e., the Central Bank of the overseas supplier).

Advance Remittance

Authorized dealers* may allow advance remittance for import of goods without any ceiling subject to the following conditions:

- If the amount of advance remittance exceeds USD 100,000 or its equivalent, an unconditional, irrevocable standby Letter of Credit or a guarantee from an international bank of repute situated outside India or a guarantee of an authorized dealer in India, if such a guarantee is issued against the counter-guarantee of an international bank of repute situated outside India, is obtained.

- Physical import of goods into India is made within six months (three years in case of capital goods) from the date of remittance and the importer gives an undertaking to furnish documentary evidence of import within fifteen days from the close of the relevant period.
- In the event of non-import of goods, authorized dealer should ensure that the amount of advance remittance is repatriated to India or is utilized for any other purposes for which release of exchange is permissible under the Act, Rules or Regulations made there under.

Import Payment only on behalf of Residents in India

Foreign exchange for import payment can be sold by authorized dealer only to persons resident in India. For this purpose, persons, firms, companies or other organizations resident in Nepal and Bhutan should be treated as non-resident.

Delivery of Import Documents

Authorized dealers can deliver import documents received by them only to the drawees of the bills who may be the actual importers (including those holding import license where necessary) or holders of letter of authority.

Due care should be exercised while handling import documents on collection basis on behalf of importer customers with reference to their line of business, financial standing, frequency of import, etc., so as to establish the genuineness of the import. If the bills are of large value, additional care should be taken to see whether the importer is trading in the concerned items or the items are required for his actual use. In case the importer is not a customer, he should be asked to produce a detailed certificate-cum-report from his bank regarding the genuineness of the imports.¹

Time Limit for Settlement of Import Payments

Normally, remittances against imports should be completed within 6 months from the date of shipment. However, importers are permitted to withhold a small part of the cost of goods towards the guarantee of performance etc. Deferred payment arrangements including suppliers and buyers credit providing for payments beyond a period of six months from date of shipment upto a period of less than three years are treated as trade credits for which the procedural guidelines laid down in the Master Circular for trade credits may be followed.

Authorized dealers may also allow payment to be made, beyond 6 months from the date of shipment provided the delay is caused due to disputes, financial difficulties etc. Interest in respect of such delayed payments may be permitted at the rates prescribed in the Master Circular on trade credits. All cases of extended payment terms will require prior approval from the Reserve Bank of India.

Remittances against import of books may be allowed without restriction as to time limit, provided, interest payment, if any, is as per the rates prescribed in the Master Circular on trade credits.

Payment of Commission on Imports

Commission on imports may be of two types. One is commission of overseas supplier's agent in India which is payable in India in Indian Rupees. In such cases, normally overseas supplier prepares invoice for gross amount including the agent's commission which is shown as a deduction to arrive at the net amount remittable to him. He will also authorize payment of commission to the local agent and remittance of the net proceeds to him. Such payments of commission to local agents do not require RBI's approval but need to be endorsed on Exchange Control (EC) copies of import licenses, when held.

¹ Authorized dealers fall under the category of 'authorized persons'. As per Section 2(c) of FEMA, 'authorized person' means an authorized dealer, money changer, offshore banking unit or any other person who is authorized to deal in foreign exchange or foreign securities.

Authorized Dealers may on application supported by documentary evidence, also allow remittance of commission to overseas buying agents of Indian importers at rates not exceeding 2.5% of the F.O.B value of goods, either along with the cost of goods or separately. Such remittances should also be endorsed on Exchange Control (EC) copies of Import Licenses, if any.

Payment of Interest on Imports

Authorized dealers are authorized to make remittances on account of interest accrued on usance bills or overdue interest payable on sight bills for a period not exceeding six months from the date of shipment. The rate of interest should not exceed the rates prescribed in the Master Circular on trade credits.

Application Forms for Remittances Connected with Imports

Applications connected with import remittances, including advance remittances must be made in Form A1(Annexure). This form is prescribed by RBI for import payments. It is a simple application for remittance in foreign currency to be made by an Indian importer. It is obligatory for persons, firms and companies making payment towards import into India to apply in Form A1. There are three variants of Forms A1 printed in three different colors to be used for different types of remittances.

- a. Remittance in foreign currency – printed on white paper.
- b. Remittance by transfer of rupees to non-resident bank accounts – on light blue paper.
- c. Remittance through Asian Clearing Union – on light yellow paper.

Form A2 (Annexure) should be used in respect of the following payments:

- a. Import payments connected with merchanting trade transactions.
- b. Payment towards import of technical services/collaboration or any other type of services.
- c. Overseas bank charges connected with import transactions, when the remittance is made separately.
- d. Installments and interest on short-term foreign currency loans/credit with maturities up to one year and loans raised by export oriented units on self liquidation basis.
- e. Repayment of loan/credit and payment of other charges requiring RBI approval for remittance.

In case the remittance is within the powers of the authorized dealer, the authorized dealer will sell the required foreign exchange to the importer provided he is satisfied with the bona fides of the application.

However, if the remittance is outside the purview of the authorized dealer, an application in duplicate will be obtained from the importer. This application will be verified as to its correctness and will be certified and forwarded to the RBI for approval. The authorized dealer will not sell foreign exchange until a copy of the application (i.e. Form A1 or A2) has been returned by the RBI together with a permit authorizing remittance.

Endorsement on Import Licenses

Import Licenses (See Annexure) are required to be endorsed by authorized dealers under their stamp and signature giving details of letters of credit opened/forward contracts booked/remittances made in foreign currency as well as the amount of insurance, freight and commission paid by the importer locally in rupees.

Also, authorized dealers may endorse the value of back-to-back inland letters of credit opened by them on behalf of duty-free license holders as required in terms of the relevant provisions of the export import policy.

Manner of Rupee Payment

Payment of import bills by the importer should be received by authorized dealers either by a debit to the importers account with themselves or by means of a crossed cheque drawn by the importer on his other banks. In no case should payments against import bills be accepted in cash.

Letters of Authority

Even in a situation where the Exchange Control (EC) copy of the import license has been issued in the name of a party other than the applicant, authorized dealers may open letters of credit or make remittances provided such party produces a letter of authority (See Annexure) in his favor from the import license holder giving him authority to open letters of credit or make payments towards import. Letters of credit may also be opened by authorized dealers on behalf of the agents of the importers in cases where imports are allowed without license. However, before opening a letter of credit, they should confirm, by reference to the import policy, that the importers are permitted to utilize the services of agents. In all such cases, the letter of authority holder or the agent will be responsible for production of the customs bill of entry wherever required. An undertaking to this effect will have to be obtained by ADs from the Letter of authority holder or the agent.

Attestation of Invoices

Importers are required to submit a copy of the invoice attested by the authorized dealer as corroboratory evidence of the value of goods declared on the bill of entry at the time of clearance of goods. To enable importers to fulfill this obligation, authorized dealers may attest copies of invoices where the shipping bills/documents are received through their medium. There may be instances where the importer directly receives the relevant documents, and makes payment either before or after clearance of goods. In such cases also, the Authorized Dealers may attest the invoices provided the remittance is made/will be made through their branch.

Imports under Penalty

Authorized dealers may also permit remittance in a situation where goods are imported without authority but are cleared by the customs authorities upon payment of penalty. In such cases, remittance will be up to the C.I.F value of goods mentioned in the exchange control copy of the customs bill of entry evidencing import of goods into India.

Import into Bond²

No import license is required in case of imports into bond for purposes of re-export. Also, sale of foreign exchange against such imports is not allowed.

Firms and companies in India importing goods into bond for supply to foreign going vessels and sale to diplomatic missions/personnel are granted special facilities by the RBI subject to certain conditions.

Remittances against Replacement Imports

The following procedure is to be followed where goods are short-supplied, damaged, short-landed or lost in transit.

- a. Where no Letter of Credit (LC) has been opened, the Exchange Control (EC) copy of the import license may be treated as valid for the replacement goods, subject to shipment being within the validity period of the license.
- b. In case the authorized dealer has already opened a letter of credit and where the exchange control copy has already been utilized against the original goods, any endorsement made to the extent of the value of the lost goods may be canceled and fresh remittance for replacement imports are permitted

² **Import into Bond:** Goods imported into India may be cleared either for home consumptions or for warehousing. Goods which are warehoused may be cleared at a later date for home consumption or for exportation. When goods are warehoused, the importer is required to execute a bond equal to twice the amount of the duty assessed on the goods. By executing the bond, the importer undertakes to comply with the conditions laid down by the Customs Act.

without reference to the RBI. However, the insurance claim relating to the lost goods should have been settled in favor of the importer. The replacement goods should, however, be shipped within the validity period of the license.

- c. The importer will have to apply to the import trade control authorities for revalidation of license in case the shipment of replacement goods is to be made after the expiry of the license.

Surrender of Import Licenses to Exchange Control

When a letter of credit is opened, the exchange control copy of the import license should be retained by the authorized dealer and should be forwarded to the Reserve bank after full utilization along with R>Returns*³ (See Annexure) pertaining to the period during which the last remittances under the licenses were made.

Box 2: R>Returns

Authorized dealers are required to submit details regarding the various transactions in foreign exchange and in rupees undertaken by them to the Reserve Bank of India. Such details are to be submitted in R>Returns on a fortnightly basis. Since R>Returns are a useful source for compilation of the balance of payments data of the country, care should be taken to ensure that the details provided in the R>Returns are complete and accurate in every respect. Moreover, authorized dealers are also required to submit the same within the prescribed time schedule. R>Returns vary depending upon the currency in which the transaction has taken place. Hence, the authorized dealer has to submit different R>Returns depending upon the currency in which the transaction has taken place. For example, an R1 return (white) has to be submitted in case the transaction is in pound sterling. An R2 return (dark pink) has to be submitted in case the currency involved is the US dollar.

R>Returns should be submitted twice a month at the close of business as on 15th and the last day of the month. If the 15th or the last day is a holiday, the returns should be submitted as at the close of business of the preceding working day. The returns are to be sent to reach the Reserve bank within seven days from the close of the reporting period to which they relate.

Category A branches are those maintaining independent foreign currency accounts with overseas correspondents/branches in their own names. Category B branches are those that are not maintaining independent foreign currency account but are having powers of operating on the accounts maintained abroad by their head/principal offices or any other link offices. Category C branches are those which handle foreign exchange business through an office or branch in category A or B but do not have powers to operate on the accounts maintained abroad by their head/principal offices.

Every transaction that affects the position of foreign currency assets and liabilities has to be reported to the Reserve Bank of India. Transactions involving foreign exchange take place by debits and credits to the Nostro accounts (maintained by authorized dealers with foreign banks) and Vostro accounts (maintained by foreign banks with authorized dealers in India) respectively and all debits and credits effected are to be reported to the Reserve Bank of India. R>Returns are basically of two types: The R-Return (Nostro) and the R-Return (Vostro). R>Returns (Nostro) are required to be submitted by all category A and B branches of authorized dealers. The R>Returns (Nostro) of Category C branches will be routed through the category A and B branches. R>Returns (Vostro) are required to be submitted by offices/branches of AD maintaining accounts of non-resident banks. Category C branches and those offices/branches of authorized dealers not maintaining accounts of non-resident banks are not required to submit the R-Return (Vostro).

Source: RBI

³ **R>Returns:** These are statutory returns to be submitted by the authorized dealer for every fortnight in a calendar month to the RBI regional office within whose jurisdiction the concerned authorized dealer is located.

Import under Foreign Loans/Credits

Any proposal to raise foreign loans/credits for financing import of goods into India will first have to be submitted to the Government of India, Ministry of Finance (Department of Economic Affairs), ECB Division, New Delhi for the necessary clearance. Clearance will be given by the Government based on the merits of each case and in conformance with the prevailing Government policy.

When the borrower receives the letter stating the terms and conditions (applicable for borrowing), from the Government of India, he is required to make an application in Form ECB1 (Annexure) to the office of the Reserve Bank of India within whose jurisdiction its head/registered office is situated. When the Reserve Bank approval is received, the borrower can conclude the loan/credit agreement. Required number of copies of the agreement should be filed with the Government. After filing the copies with the Government, the borrower should seek permission from the Reserve Bank of India to effect drawal of the loan amount for utilization towards approved purposes.

Each foreign currency loan/credit will be allotted a registration number by the RBI. This number is to be quoted on all returns/statements which are submitted to the RBI. In case the borrower wants to open foreign currency bank accounts in India/abroad for retention of the loan funds pending disbursement, he may apply for permission from the RBI by furnishing relevant information like details of the loan, name and address of the overseas bank, type of account, rate of interest, etc. Issue of financial guarantees in favor of the foreign lenders by ADs require prior approval from the Reserve Bank of India.

Details about drawal and utilization of the loan amount will have to be furnished to RBI by means of quarterly statements in Form ECB2 in duplicate. These statements will have to be submitted till the time the loan is fully repaid. In case there is no drawal/repayment during a particular quarter, a "Nil" statement should be submitted. Borrowers will be penalized in case there is any delay in submitting the quarterly statements.

RBI will issue an acknowledgement on receipt of the quarterly statements. No remittances towards repayment of the loan/credit will be allowed by ADs until the statement in form ECB2 (Annexure) has been submitted to the Reserve Bank for the last quarter and an acknowledgement obtained from the Reserve Bank of India.

In case of repayment of the loan/credit, the borrower is required to make an application in Form ECB3 (Annexure) to the authorized dealer. This form will be forwarded by the authorized dealer to the Reserve Bank along with necessary supporting documents. Submission of the form and documents should be made well in advance so as to avoid penalty.

Sub Loans out of Lines of Credit/Loans obtained by Term Lending Institutions

Term Lending Institutions like IDBI, ICICI and IFCI have been given general permission by the RBI to,

- a. Sign agreements with their sub borrowers in India.
- b. To accept personal guarantees of directors/ promoters/partners, associates of sub borrowers/companies/firms by way of collateral/interim security provided such guarantees do not involve any direct or indirect outgo of foreign exchange.

Postal Imports

Payments against bills received for collection in respect of imports by post parcel will be made by authorized dealers only if the goods so imported are those which are normally dispatched by post parcel. Parcel receipts should be submitted as evidence of dispatch through post. Authorized dealers should also take an undertaking from the importers stating that the relevant parcel wrappers will be submitted within three months from the date of remittance.

In case the parcel is already received by the importer, the parcel wrapper should be produced in support of the remittance application. In case the AD is not satisfied about the bona fides of the application or where the goods imported are not normally those which are imported by post, then the AD should refer the same to the Reserve Bank of India for approval.

Payment towards import of books, samples through post parcel not exceeding US 250 dollars or its equivalent will be made by authorized dealers on submission of the original invoice by the importer. In such cases, authorized dealers will not insist on submission of the parcel receipt/postal wrapper. This is subject to the condition that the import is in accordance with the current EXIM policy and a declaration is furnished by the applicant that the goods have been imported through post parcel.

Imports through Courier

Import of goods through courier is allowed in accordance with the Courier Imports (Clearance) Regulations, 1995 as amended by the Courier Imports (Clearance) Amendment Regulations, 1997. In case the C.I.F value of goods imported through courier is less than Rupees One lakh, the relative bill of entry will have to be submitted by the registered courier service. In case the value exceeds Rupees One lakh, importers have to submit separate bill of entry as in the case of other imports. Hence, while making payments for imports through courier and where the value is more than one lakh, authorized dealers should ensure that the exchange control copy of the bill of entry for home consumption is submitted. Where the value is more than rupees one lakh, a copy of the bill of entry in the prescribed form issued by the customs in the name of the registered courier, duly certified by the authorized dealer of the courier should be obtained from the importer.

Merchanting Trade

The Exchange control regulations relating to merchanting trade lays down that goods involved in the transactions are permitted to be imported into India, such transaction should not involve foreign exchange outlay from India for a transit period exceeding three month and all rules, regulations and directions applicable to export out of India (except Export Declaration Form) are complied with in respect of the export leg and all rules, regulations and directions applicable to import (except Bill of Entry) are complied with in respect of the import leg of merchanting trade transactions. Authorized Dealers are also required to ensure timely receipt of payment for the export leg of such transactions. The short term credit is not available for merchanting trade or intermediary trade transactions either by way of suppliers' credit or buyers' credit. The authorized dealers have to make sure that the terms of payment for the import leg and the export leg of the transactions are in a manner that the liability for the import leg of the transaction ends by the payment received for the export leg of the transaction, without any delay and the entire merchant trade transaction is completed within a period of 6 months while undertaking bonafide merchanting trade transactions on their trader clients' behalf.

Advance Remittances to Overseas Suppliers

Advance remittance towards imports by merchant exporters may be permitted by authorized dealers provided confirmed orders have been received by the merchant exporters from the overseas buyers. In addition, the authorized dealer should be convinced about the capabilities of the merchant exporter in meeting his obligations under the order. Also, the transaction should result in adequate profit to the merchant exporter.

Where the amount of advance remittance exceeds US 15000 dollars, a guarantee from a reputed international bank located outside India should be obtained from the overseas seller.

Forward Exchange Contracts for Imports

In order to cover the exchange risk faced by importers, authorized dealers may book forward contracts for imports. However, booking of forward contracts is subject to certain regulations.

Forward contracts for imports can be booked only in respect of persons resident in India. Secondly, forward contracts can be booked only in case of genuine transactions and where there is exposure to exchange risk. Further, the maturity date should be identified and compliance with FEDAI rules is essential. This facility will be available only for valid import transactions and will be allowed for contracts in any permitted currency, i.e. a currency which is freely convertible.

The value of the forward contract should not be more than the value of goods contracted for by the importer or the value of the LC opened by the authorized dealer. In case the contract is on sales terms which are less than CIF terms, and freight/insurance, etc. is paid by the seller and recovered separately on actual basis, forward contract can cover such estimated charges also. In case local agency commission is paid, such commission should be deducted and the contract should be booked for net amount payable to overseas seller.

Usually, the customer is given the choice of deciding the period and extent of exposure. Delivery period of forward contract should be linked to the shipment/payment schedule under the contract even though contracts may be booked for shorter maturities. However, the last date of delivery should not exceed six months from the date of shipment/expected shipment date.

Proper verification of the sale contract should be undertaken by the AD at the time of booking forward contract. Where firm orders are placed by the importer, forward contract should be booked only after the overseas supplier has accepted the order. In case bills are already received for collection, the verification of contracts may be dispensed with. Proper endorsements should be made by the authorized dealer indicating that forward contract has been booked.

Forward contracts in case of merchanting trade transactions can be booked subject to the condition that contracts are booked simultaneously for both legs of the transactions i.e. import and export.

Cancellation of forward contracts by authorized dealers need not be reported to the Reserve Bank of India. However, in case the forward contract that is canceled is equivalent of US dollars 5,00,000 and above, full particulars of the same should be kept on record for verification by the RBI officials if necessary.

A1 forms are to be used to indicate that remittances have been made under a forward contract.

Follow-up for Submission of Evidence of Import Bill of Entry

As per exchange control regulations, the importer is required to submit the exchange control copy of the bill of entry⁴ or post wrapper to the authorized dealer within three months from the date of remittance. This serves as evidence that the goods have actually been imported into India. The internal inspectors of the bank are required to check the evidence and furnish half-yearly certificates to the RBI.

When the Exchange Control copy of the bill of entry is received from the importer, the AD should carefully scrutinize it and check if details like description of goods, quantity, value of goods, invoice number and date, details of import license correspond to the details submitted by the importer at the time of remittance. If the details correspond, such fact should be entered in the Bills register.

When the exchange control copy is received by the authorized dealer, an acknowledgement should be issued giving details like name, address of the importer, code number of the importer, number and date of import license,

4 **Bill of entry:** This document is required to be submitted by the importer to the customs. The clearance of imported goods is effected based on the details provided in this document. The format of the bill of entry is a standardized one and contains details like importer's code number, importer's name and address, description of the goods imported, quantity, country of origin of goods, customs duty payable, any additional duty payable, etc.

reference number of the bank's letter of credit, number and date of exchange control copy of the bill of entry and particulars and value of the imported goods.

On failure to submit the exchange control copy within the stipulated period (i.e. within three months from the date of remittance) a reminder should be sent to the importer demanding immediate submission of the documentary evidence. If the importer does not respond within one month of the date of the first reminder, a second reminder should be sent under Registered A/D.

In case, the importer does not respond to the second reminder within 21 days from the date of issue of the same, the matter should be reported to the RBI in a quarterly statement within 15 days from the end of each calendar quarter.

Legal Expenses for Imports

Any payment towards legal expenses relating to imports can be made by authorized dealers on behalf of their clients subject to submission of necessary documentary evidence. Authorized Dealers (ADs) should also satisfy themselves about the chances of success of the case by calling for legal opinion and an estimate of the total likely expenses to be incurred to satisfy themselves with the reasonableness of the charges. Where the payments exceed US dollars 1,00,000, full details of the payments should be given to the RBI on a quarterly basis.

SUMMARY

- Commercial banks have a vital role to play in not only financing imports but also ensuring that importers are complying with the trade and exchange regulations.
- The predominant activity under import financing is opening of import letters of credit on behalf of importers favoring overseas suppliers. At the time of opening an import LC, a bank ensures that the intended importer is known to the bank; he is in the line of business that needs the proposed goods for carrying out his business; he is permitted to import the said goods by way of either using an import license or its import is permitted under OGL, etc. They would also appraise the financial strength of the importer to ascertain the capacity to retire the documents received under LC as and when they become due.
- Banks also extend credit for enabling an importer to pay for the imported goods, either as or part of working capital limit sanctioned for carrying out production activities if the goods constitute part of raw materials or as a loan facility if the goods constitute a part of plant and machinery. In either of the cases, an import trust receipt is got executed by the importer, so that goods imported can be taken delivery and then create pledge or trade in the goods and the sale proceeds used to repay bank loan.
- Banks issue deferred payment guarantees in favor of overseas seller who is supplying capital goods on long-term credit, so that an importer can procure goods and make use of it to generate additional cash flows which can be used to redeem the installments.
- Every importer who has acquired foreign exchange must use it for the intended purpose and provide evidence to the effect that the intended goods are in fact brought into the country by submitting bill of entry issued by customs authorities while clearing the goods, to the authorized dealers through whom bills are retired and through them to the Reserve Bank of India. It is incumbent upon authorized dealers to follow up with importers and ensure that the importer submits bill of entry within the prescribed time-frame. To conclude, all the activities of importers and the authorized dealers must be within the ambit of Trade and Exchange regulations that govern import transactions.
- **Note:** The guidelines indicated are not exhaustive. These are extracted from the Exchange Control Manual. RBI issues amendment copies as and when any guidelines are changed. Market players – exporters, importers, authorized dealers, c&f agents, concerned government departments should keep abreast of the latest developments on a continuous basis.

Appendix 1

BEF

Statement showing details of remittances effected towards import in respect of which documentary evidence has not been received despite reminders

Name and address of AD branch.....

Name of controlling office of AD branch.....

Statement for the half year

Notes:

- i. The statement should be submitted, in duplicate, to the Regional Office of the Reserve Bank under whose jurisdiction of A.D. branch is functioning.
- ii. Details of transactions where the amount of remittance exceeds US\$ 5000 or its equivalent should only be included in the statement.
- iii. The statement should include details of all remittances from India or payments from abroad in connection with imports, including advance payments, delayed payments, etc. irrespective of the source of funding (i.e. EEFC accounts/foreign currency accounts maintained in India and abroad, payments out of external commercial borrowings, foreign investments in the shares of importers etc.).
- iv. The cases reported in Part I of statement for the previous half year should not be reported again in Part I of the statement for the current half year.
- v. In case no transaction is required to be reported, 'NIL' statement should be submitted.
- vi. Statement should be submitted within 15 days from the end of the half year.

PART I**Information regarding importers who have defaulted in submission of the documentary evidence of import**

Sr. No.	Importer/ Exporter Code No.	Name and address of the importer	No. and date of import licenses, if any	Brief description of goods	Date of remittance/ payment	Currency and amount	Rupee equivalent	Remarks
1	2	3	4	5	6	7	8	9
A.	Particulars of imports made by persons/parties other than Public Sector Undertakings/Government Departments							
1								
2								
3								
4								
etc.								
B.	Particulars of imports made by Public Sector Undertakings/Government Departments							
1								
2								
3								
4								
5								
etc.								

PART II

Information regarding subsequent receipt of documentary evidence of import from importers whose names were reported in Part I of earlier BEF statement/s

Sr. No.	Name and address of the importer	Period of the BEF statement and serial No. of the transaction reported earlier in Part I of BEF statement	Date of receipt	Amount of remittance		Remarks
				Currency & Amount	Rupee Equivalent	
1	2	3	4	5		6
A.	Parties other than Public Sector Undertakings/Government Departments					
1						
2						
3						
4						
etc.						
B.	Public Sector Undertakings/Government Departments					
1						
2						
3						
4						
5						
etc.						

Note: The transaction reported in Part II of BEF statement of earlier half year should not be repeated in Part II of the current half year

C E R T I F I C A T E

- i. We certify that the particulars furnished above are true and correct as per our records.
- ii. We further certify that the statement includes all cases which are required to be reported under the prescribed procedure.
- iii. We undertake to continue to pursue the cases with the importers reported in Part I of the statement.

Place :

Stamp

Date :

(Signature of the Authorised Official)

Name :

Designation :

(To be printed on Light Yellow paper)

Form A1
(For Import Payments only)

Application for Payment through Asian Clearing Union

A.D.Code No. _____

Form No. _____

(To be filled by authorised dealer)

Serial No. _____

(for use of Reserve Bank of India)

Amount _____

remitted	Currency	Amount
----------	----------	--------

Equivalent to Rupees _____

(To be completed by authorised

dealer)

I/We wish to remit through ASIAN CLEARING UNION_____

(Name of currency)

_____ through _____ for

(Amount in words)

(Name and address of the designated bank in India)

payment to _____ in payment of imports

(Name and address of the beneficiary of remittance)

into India, detailed below:

Details of goods imported or to be imported into India

Section A: Import Licence Particulars

[illegible]

@ Actual amount endorsed in rupees against each licence involved, should be stated under this column.

Note: If more than one licence is involved, particulars of all licences should be furnished. If the space is inadequate, a separate statement may be attached. The amount utilised against each licence should invariably be indicated.

Section B: Import Particulars

Invoice Details				Quantity of goods	Description of goods	Harmonised System of Classification	Country of origin of goods	Country from which goods are consigned	Mode of shipment (air, sea post, rail river, transport port, etc.)	Date of shipment (if not known approximate date)
No and date	Terms (c.i.f., f.o.b., c.&f. etc.)	Currency	Amount							

Section C: Other Particulars

1. Details of forward purchase contract, if any, booked against the import

(No. & date of Contract) (Currency and Amount of Contract) (Balance under the contract)

2. If remittance to be made is less than invoice value, reasons therefore (i.e. part remittance, instalment etc.)

I/We hereby declare that the statements made by me/us on this form are true and that I/We have not applied for an authorisation through any other bank.

I/We declare and also understand that the payments to be made by me/us, through ASIAN CLEARING UNION pursuant to this application shall be used by me/us only for the purpose stated above and that the conditions subject to which the permission is granted will be complied with.

.....

(Signature of Applicant/Authorised Official)

@ Name and Address of Applicant

Importer's Code Number

@ Nationality.....

Stamp

Date:.....

@ To be filled in capital letters

NOTE: For remittances covering intermediary trade, form A2 should be used.

Declaration to be furnished by Applicant

I/We declare that

- (a) the import licence/s against which the remittance is sought is/are valid and has/have not been cancelled by DGFT.
- (b) the goods to which this application relates have been* imported into India on my/our own account* will be*
- (c) the import is on behalf of @ _____* and
- (d) the invoice value of the goods which is declared on this form is the real value of the goods imported* into in India.
to be imported*

If the Import has been made I/We attach the relative Customs-stamped Exchange Control copy of Bill of Entry*
Post parcel wrapper (for imports by post)* / Courier Wrapper
(for imports through courier)*

or

If the import is to be made I/We undertake to produce within three months to the authorised dealer the relative Customs-stamped Exchange Control copy of Bill of Entry*
Post parcel wrapper (for imports by post)* / Courier wrapper
(for imports through Courier)*

* Strike out item not applicable

@ Where the import is on behalf of Central/State Government Department or a company owned by Central/State Government/Statutory Corporation, Local Body, etc. the name of the Government Department, Corporation etc. should be stated.

Date:.....

.....
(Signature of Applicant/Authorised Official)

Space for comments of the authorised dealer

(While forwarding the application to Reserve Bank for approval, reference to Exchange Control Manual paragraph/ A.D. Circular in terms of which the reference is made should invariably be cited. If any remittance application on account of the same import was referred to Reserve Bank earlier, reference to the last correspondence/approval should also be cited).

.....
(Signature of Authorised Official)

Name

Designation

Name and Address of

Authorised dealer

Stamp

Date:.....

Certificate to be Furnished by Authorised Dealer (Importer's Banker)

We hereby certify that:

- Put a tick (✓) in the relevant block**
- (a) This payment is
- (i) An advance remittance
- (ii) In retirement of bills under letter of credit opened through us
- (iii) Against documents received through our medium for collection
- (iv) On account of documents received direct by the applicant/s against undertaking furnished by the latter to submit Customs-stamped Exchange Control copy of Bill of Entry of Post Parcel/courier wrapper within three months
- (v) On account of documents received direct by the applicant/s against Customs-stamped Exchange Control copy of Bill of Entry/post parcel/courier wrapper (attached) submitted by the latter
- (vi) _____
(any other case, to be explained)
- (b) All the Exchange Control regulations applicable to the remittance have been complied with
- (c) The payment to the supplier of the goods has been* made
will be*
through _____
(Name & Address of the foreign bank)

We also certify/undertake that the relevant Customs-stamped Exchange Control copy of Bill of Entry or post parcel/courier wrapper

- * shall be verified by us within three months
[vide certificate (a)(ii) and (iii) above].
- * has been verified [vide certificate (a) (v) above].
- * shall be obtained from the applicant/s within three months
[vide certificate (a) (i) and (iv) above].

.....
(Signature of Authorised Official)
Name.....
Designation
Name and Address of.....
Authorised dealer

Stamp

Date:.....

* Strike out item not applicable

FORM A2

(for payments other than imports and remittances covering intermediary trade)

Application for Remittance Abroad

AD Code No. _____

Form No. _____

(To be filled in by the Authorised Dealer)

Serial No. _____

(For use of Reserve Bank of India)

Currency _____ Amount _____

Equivalent to Rs. _____

(To be completed by Authorised Dealer)

I/We wish to purchase/transfer _____

(Name of currency and amount in words)

through _____ for payment

(Name and address of Authorised Dealer)

to _____

(Name and address of the beneficiary)

by remitting the amount / by credit to the account of _____

(Full title of the account & country of non-resident bank and name of AD with whom account is maintained)

for the purpose indicated below:

(Remitter should put a tick (✓) against an appropriate purpose code. In case of doubt/difficulty, consult your banker.)

Code	Purpose
Capital Account Transactions	
S001	Investment in shares abroad by residents
S002	Investment in Debt Securities abroad by residents
S003	Investment in branches/subsidiaries abroad by residents
S004	Investment in real estate abroad by residents
S005	Repatriation of foreign investment in shares
S006	Repatriation of foreign investment in Debt Securities
S007	Repatriation of foreign investment in subsidiaries/branches
S008	Repatriation of foreign investment in real estate
S009*	Loans to non-residents
S010*	Repayment of LT/MT loans
S011*	Repatriation of NR deposits
S012	Repayment of ST (6 m. to 1 Yr.) Loans
S013	Repayment of loans/ODs by banks
S014	Notional sale for credit to NRI deposits
S015*	Other capital account payments
Other import payments not covered by form A1	
S103	Imports by diplomatic mission
S104	Imports under intermediary trade
Travel	
S301	Business travel
S302	Travel for Medical purpose
S303	Travel for education
S304	Basic Travel Quota (BTQ)
S305	Travel for pilgrimage
S310*	Other travel payments (Including credit card)
Transportation	
S401	Shipping transport - Remittance by fgn. cos.
S402	Air transport - Remittance by fgn. cos.
S403	Shipping transport - Remittance by Indian cos.
S404	Air transport - Remittance by Indian cos.
S405	Freight on imports
S406	Freight on exports
S407	Charter hire charges (Airline cos.)
S408	Charter hire charges (Shipping cos.)
S409	Booking of passage in foreign countries
S410*	Other transportation (e.g. demurrage, etc.)

Code	Purpose
Insurance	
S501	Life insurance premium
S502	General insurance premium
S503	Reinsurance premium
S504	Insurance commission
S510*	Other insurance payments
Other Services	
S601	Postal/Telecom services
S602	Projects abroad
S603	Band charges/commission
S604	Soft/Hardware consultancy, services
S605	Subscription to periodicals, Correspondence courses
S606	Computer and IT services
S607	Royalty, License fees
S608	Professional service, Technical fees
S609*	Refunds and rebates on trade
S610*	Other remittances
Government, Not included elsewhere	
S701	Maintenance of Indian Embassies
S702	Remittance by Foreign Embassies
Transfers	
S801	Foreigner's family maintenance
S802	Private gift/donation
S803	Grants/donations to charity by Govt
S804	Contribution by Govt. to international institutions
S810*	Other transfers
Income	
S901	Interest on NRI deposits
S902	Interest on loans
S903	Dividends, profits
S904	Interest on debentures/bonds
S905	Interest on ODs in Nostro A/c.
S906	Salary of Non-residents
S910*	Other income

International Finance and Trade

*Please give full details _____

I / We hereby declare that the statements made by me / us on this form are true and that I / we have not applied for an authorisation through any other bank.

I / We declare and understand that the foreign exchange to be acquired / payment to be made by me / us pursuant to this application shall be used / made by me / us only for the purpose for which it is acquired / to be made and that the conditions subject to which the exchange/permission is granted will be complied with.

I/We desire to travel to _____ via _____ for the purpose of _____

Passage has been booked through _____

(Name of airline/shipping co. or passage agent)

_____ The date of departure is _____ The exchange is required in the form of

	<u>Currency</u>	<u>Amount</u>
Notes & Coins	_____	_____
TCs	_____	_____
Draft	_____	_____
Letter of Credit	_____	_____
Total	_____	_____

Name of Applicant (s) _____ Nationality of Applicant (s) _____

Address of Applicant (s) _____

Date -----

Signature of Applicant(s)/Authorised Official _____

(Space for comments of the Authorised Dealers)

While forwarding the application to Reserve Bank of India for approval, reference to ECM paragraph / AD circular in terms of which the reference is made should invariably be cited.)

Approval for similar remittances was obtained from the Reserve Bank of India vide permit No.

_____ dated _____.

(Stamp and Signature of Authorised Official)

Name & Designation

Name & Address of Authorised Dealer

Date _____

Certificate to be furnished by Authorised Dealers (Applicant's Banker)

We hereby certify that

- A. the remittance has been made
In terms of authority delegated to authorised dealers vide paragraph _____ of
the Exchange Control Manual and / or AD Circular No. _____
dated _____
or
In terms of Reserve Bank Permit No. _____ dated _____
- B. all the Exchange Control regulations applicable to the remittance have been complied
with.
- C. documentary evidence in support of the payment has been verified.
- D. payment to the beneficiary has been/will be made through _____

—

(Name and address of the designated bank in ACU member country)

(Stamp and Signature of Authorised Official)

Name & Designation

Name & Address of Authorised Dealer

Date: _____

International Finance and Trade

IMPORT / EXPORT LICENCE
FOREIGN TRADE REGULATION

EXCHANGE CONTROL COPY

LICENCE NO. :

FILE NO. :

CATEGORY OF LICENCE :

LICENSING PERIOD :

EXPORT PERIOD :

CURRENCY AREA :

FOB VALUE RS. :

FOREIGN CURRENCY :

EXPORT OBLIGATION PERIOD :

IMPORTER-EXPORTER CODE NO. :

CLASS OF IMPORTER

PORT OF REGISTRATION :

EXPORT PRODUCT / END PRODUCT / EXPORT PRODUCT GROUP :

ISSUED BY :

(NOT TRANSFERABLE)

MESSERS :

TRANSFERABLE

NOT TRANSFERABLE

ARE HEREBY AUTHORISED TO IMPORT / EXPORT GOODS THE PARTICULARS OF WHICH ARE GIVEN BELOW:

Sl. No.	Name of Item	Item Code	Unit of Measurement		Quantity	C.I.F./FOB Value in Rs.	Foreign Currency
			Name	Code			

1. COUNTRY OF ORIGIN :

2. COUNTRY FROM WHICH CONSIGNED :

3. PLACE OF DESTINATION :

4. C.I. F VALUE (IN WORDS) RUPEES

(IN WORDS) FOREIGN CURRENCY

5. PERIOD OF SHIPMENT :

6. LIMITING FACTOR FOR PURPOSE OF CLEARANCE THROUGH CUSTOMS

7. ANY OTHER CONDITION, IF APPLICABLE

This licence is granted under the Foreign Trade (Development and Regulation) Act, 1992 (No. 22 of 1992) and is without prejudice to the application of any other prohibition or regulation affecting the Import / Export of the goods which may be in force at the time of their arrival / despatch.

Place :

Seal

Name :

Date :

Foreign Trade Development Officer

1. This licence shall be subject to the conditions in force relating to the goods covered by the licence and the class of importers as described in the relevant Export-Import Policy and Handbook of Procedures, or any amendment thereof made upto and including the date of issue of the licence, unless otherwise specified.
2. This licence shall be subject to the conditions contained in Clause 6 of the Foreign Trade (Regulation) Rules, 1993 as amended upto and including the date of issue of the licence.

TO BE FILLED AT THE TIME OF SHIPMENT

SHIPPING BILL NO. AND DATE	NAME OF VESSEL	QTY. FOR WHICH SHIPPING BILL HAS BEEN FILED	QUANTITY ACTUALLY SHIPPED	BALANCE	INITIALS OF	
					CLERK OR ASSTT.	PASSING OFFICER

TO BE FILLED IN BY THE BANKER

DATE OF TRANSACTION	PARTICULARS OF TRANSACTION	RUPEE EQUIVALENT OF L/C OPENED OR OF BILLS PAID NOT UNDER L/C AND BALANCE	RUPEE EQUIVALENT OF ACTUAL REMITTANCE AND BALANCE	BANK'S STAMP AND SIGNATURE

R-Return (NOSTRO)

 (CURRENCY NAME)

--	--	--

 (Currency Code)

Return of Transactions for the Fortnight Ended

 (Date DD-MM-YYYY in Numerals)

(to be submitted, in duplicate, fortnightly, as at the close of business on the 15th and the last day of each month)

Name of AD _____	AD Code No. _____
Address of AD _____	_____
Licence No. _____	Serial No. _____

 (Amount to be rounded off to the nearest unit of the currency)

I. Outflows
A. Sales to Public against Imports into India

- (i) Below the equivalent of Rs.5,00,000/-
 (Supported by Forms A1) _____
 (No. of Forms _____)
- (ii) Equivalent of Rs.5,00,000/- and above
 (Supported by Forms A1) _____
 (No. of Forms _____)

Total of IA(i) and IA(ii) _____

B. Sales to Public against Imports into other countries

 (i.e. Intermediary Trade)
 (Supported by Forms A2 - No. of forms _____) _____

C. Sales to Public for purposes other than Imports

- (i) Below the equivalent of Rs.5,00,000/-
 (Supported by Forms A2/ statement) _____
 (No. of Forms _____)
- (ii) Equivalent of Rs.5,00,000/- and above
 (Supported by Forms A2/ statement) _____
 (No. of Forms _____)

Total of IA(i) and IA(ii) _____

D. Sales to other Authorised Dealers in India

Total Outflows (Total of IA, IB, IC and ID) _____

(For 'A' Category Branches only)	
*	
*	E. <u>Sales to Reserve Bank of India</u> _____
*	
*	F. <u>Sales to overseas banks and branches</u> _____
*	(Supported by Statement)
*	
*	G. <u>Aggregate sales at Branches</u> (Reporting directly to _____
*	Reserve Bank) by adjustment through Head Office/Link Office _____
*	

Total of I A to I G _____

H. Notional sales relating to reversal of overdue export bills (Form A2 should Not be completed) The total of such sales should be shown separately here _____

II. Infows

A. Purchases from Public against exports

(i) Against GR/PP/SOFTEX Forms of Which

(a) Bills negotiated under L/C and bills purchased & discounted _____

(b) Bills for collection realised _____

(ii) Advance receipts which will be covered later by GR/PP/SOFTEX Forms _____

Total of II A(i)(a), II A(i)(b) & II A(ii) _____

Note: ENC Statement (in duplicate) alongwith duplicate GR/PP/SOFTEX forms and SCH 3 should be attached to R-Return.

B. Purchases from Public against third country exports (i.e. intermediary trade not covered by GR/PP/SOFTEX Forms) _____

C. Purchases from Public other than against exports

(i) Below equivalent of Rs.1,00,000/- _____

(ii) Equivalent of Rs.1,00,000/- and above _____

Total of II C(i) and II C(ii) _____

Note: In respect of item IIC(ii) a supplementary statement with bifurcating lines between two purchases) should be attached as in the prescribed proforma.

D. Purchases from Authorised Dealers in India _____

Total inflows(Total of IIA,IIB,IIC and IID) _____

(For 'A' Category Branches only)

*

* **E. Purchases form Reserve Bank of India** _____

*

* **F. Purchases form overseas banks and branches**
* **(Supported by Statement)** _____

*

* **G. Aggregate Purchase at Branches** (Reporting directly to
* Reserve Bank) by adjustment through Head Office/ Link Office _____

Total of II A to II G _____

H. Purchase relating to reversal Export bills

The total of such purchases should be
Shown separately here. _____

Items III C to III H and IV C to IV H on the following page are for 'A' category branches only. Balances against various accounts are to be shown as per respective mirror accounts maintained locally.

		Amount	
		Debit	Credit
III. <u>Opening Balance (Closing bal.of previous period)</u>			
A. Cash Balance			
B. Suspense Account Balance			
C. Deposits with/from other Authorised Dealers in India			
D. Deposits with Reserve Bank of India			
E. Fixed Deposits			
F. Treasury Bills/Treasury Deposits			
G. Securities and Shares			
H. Foreign Currency Loan (Outstanding)			
Total of IIIA to IIH			
IV. <u>Closing Balance</u>			
A. Cash Balance			
B. Suspense Account Balance			
C. Deposits with/from other Authorised Dealers in India			
D. Deposits with Reserve Bank of India			
E. Fixed Deposits			
F. Treasury Bills/Treasury Deposits			
G. Securities and Shares			
H. Foreign Currency Loan (Outstanding)			
Total of IVA to IVH			
Note: Authorised Dealers should ensure that Opening Balance + All Inflows – All Outflows tally with Closing Balance.			
V. <u>Aggregate Balances in</u>			
A. EEFC Accounts			
B. EFC Accounts			
C. RFC Accounts			
D. ESCROW F.C. Accounts			
E. FCNR(B) Accounts			
F. Other F.C. Accounts			

International Finance and Trade

We hereby certify that

- (a) the figures reported in the above Return are true and correct;
- (b) all the transactions effected by us and by our branches not submitting independent Returns during the reporting period to which this Return relates have been reported in this Return;
- (c) all the remittance forms alongwith SCH 1 and SCH 2, \ENC statement and all GR/PP/SOFTEX forms alongwith SCH 3 covering the transactions effected during the reporting period have been attached herewith.
- (d) no remittance forms and GR/PP/SOFTEX forms pertaining to any of the previous reporting periods of the current reporting period are outstanding with us;
- (e) a supplementary statement in respect of item II(ii) of the Return is enclosed;
- (f) all the Returns pertaining to the earlier periods have been submitted to the Reserve Bank and
- (g) the transactions of the offices/branches which are independently submitting Returns and adjusting through Head Office/Link Office account with us have been incorporated as branch sales/purchases in our Return.

Stamp

Seal

#

(Signature)

Name

Date: _____

Designation

[# This certificate must invariably be signed by the official holding charge of the branch for the time being or by person of status not lower than that of Scale IV Officer.]

R-Return (VOSTRO)

(Currency Name)

(Currency Code)

Return of operation of VOSTRO Accounts for the fortnight ended _____.

(Date DD-MM-YYYY in Numerals)

(To be submitted, in duplicate, as at the close of business on the 15th and the last day of each month)

Name and address
of the Authorised
DealerA.D.Code No.
Licence No.
Serial No. of the Return

Name, Place and Country of bank branch or Correspondent	Opening Balance	Credits					Debits					Closing Balance	Number of forms			
		Transactions with Public				Funding Transa- ctions (suppor- ted by forms A3	Total Credits (3)+ (4)+ (5)	Transactions with Public			Withdra- wal Tra- nsactions (suppor- ted by forms (A3)		Total Debits (7)+ (8)+ (9)	A1	A2	A3
		Imports (supported by forms A1		Others (supported by forms A2				Exports	Payments to Public							
		below Rs. 5.00 lakhs	Rs. 5.00 lakhs & Above	below Rs. 5.00 lakhs	Rs. 5.00 lakhs & above				Below Rs. 1.00 lakh.	Rs. 1.00 lakh & above (supported by supple- mentary statement)						
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)			
		(a)	(b)	(a)	(b)		(a)	(b)	(a)	(b)						
A) Banks																
B) Private Exchange Houses																
GRAND TOTAL																

We hereby certify that

- (a) the figures reported in the above Return are true and correct.
- (b) all the transactions effected by us and by our branches on the non-resident bank accounts maintained by us during the reporting period to which this Return relates have been reported in this Return.
- (c) all the remittance forms alongwith SCH1 and SCH@, ENC statements and GR/PP/SOFTEX forms alongwith SCH 3 covering the transactions effected during the reporting period have been attached herewith;
- (d) no remittance forms and GR PP/SOFTEX forms pertaining to any of the previous periods or the current period are outstanding with us; and
- (e) a supplementary statement in respect of Col.8(b) of the Return is enclosed;
- (f) all the Returns pertaining to the earlier periods have been submitted to the Reserve Bank.

Place:

STAMP

Signature _____
Name and Designated of Authorised Official _____
Name of the AD & branch _____

Date :

[# This certificate must invariably be signed by the official holding charge of the branch for the time being or by person of status not lower than Scale IV Officer]

ECB 1
[Paragraph 7 B.2]

Application for permission under Foreign Exchange Regulation Act, 1973 to raise foreign currency loan/credit or to import goods on deferred payment terms/Financial Lease (other than short-term loan/credit)

Instructions:

1. *The application should be completed in duplicate and submitted through an authorised dealer to the Office of Reserve Bank within whose jurisdiction the applicant company has its Registered Office.*
2. *Do not leave any column blank. Furnish complete particulars against each item. Where any particular item is not applicable write "N.A" against it. Firms/Companies obtaining sub-loans through IFCI/ICICI/IDBI should not complete this form but approach the concerned financial institution direct.*
3. *Before forwarding the application to Reserve Bank, the authorised dealer must properly scrutinise all the related original documents and ensure that the application is complete in all respects and strictly in order as per rules.*
4. *Application for permission to issue bank guarantee or letter of credit in favour of foreign banks should be submitted to Reserve Bank simultaneously with the proposal for foreign currency loan/credit together with a copy of the draft guarantee and other relevant documents.*
5. *If space is not sufficient for giving full information/particulars against any item, a separate sheet may be attached to the application and serially numbered as Annexure.*

Documentation:

5. **Please submit certified copies of the following documents, as applicable:**
 - (i) **Copy of contract/agreement for the proposed foreign currency loan/credit/financial lease.**
 - (ii) **Government's letter approving the terms of the loan/credit.**
Or
Reserve Bank letter approving Financial Lease.

- (iii) Letters from banks / institutions in India giving terms and conditions subject to which they have agreed to grant rupee loans for financing the part cost of the project.
- (iv) A certificate from the applicant company to the effect that the draft agreement has been carefully examined by them and their solicitors and that no additional foreign exchange liability either express or implied arises in proper performance of the agreement besides those approved by the Government of India/Reserve Bank.
- (v) Exchange Control copy of import licence or original letter of intent with a certified copy issued by Government of India indicating that they have approved, in principle, grant of the necessary import licence (where necessary).
- (vi) Schedule of draw down [of loan/credit (expected dates), currency, amount etc.]
- (vii) Schedule of loan/credit repayment (both principal and interest) indicating due date(s) and amount of each instalment or schedule of payment of lease rent in the case of Financial Lease indicating due date(s) and amount during the entire loan/lease period.

1. (a)	(i) No. & date of Government's approval for foreign currency loan/credit											
	(ii) Government Loan Key Number	<table border="1"> <tr> <td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td> </tr> </table>										
	(b) In case of Financial Lease for import of containers, aircraft, etc. RBI approval No. and date											
2.	(a) Name and address of the lender/foreign supplier/lessor (in the case of Financial Lease) (BLOCK LETTERS)											
	(b) Country of Lender/Lessor											
3.	(a) Name and address of applicant company/firm/lessee (BLOCK LETTERS)											
	(b) Address of its Registered Office (BLOCK LETTERS)											
	(c) Nature of business in India											
	(d) Name and telephone number of the Senior Executive of the applicant company/firm looking after the utilisation & repayment of this loan/credit, etc.											
	(e) Name and address of the applicant's bank through whom credit facilities are obtained and remittances of loan instalment/lease rent will be effected											

4. (A) Purpose of the loan -	
(i) Description and value of goods to be imported	
(ii) Description and value of goods to be acquired from domestic market	
(iii) Investments in real estate/fixed assets	
(a) Expansion of existing activity	(a)
(b) Export Oriented Units	(b)
(c) Modernisation	(c)
(d) Import of raw materials	(d)
(e) Import of capital goods	(e)
(f) Import of ships, aircraft, containers	(f)
(g) New projects (other than EOUs)	(g)
(h) Onward lending/sub-lending in case of FIs	(h)
(i) Rupee expenditure (local sourcing of capital goods)	(i)
(j) Others (Please specify)	(j)
(B) If the loan/credit has been negotiated for expansion/diversification/modernisation of any industrial activity, please state -	
(a) Cost of the project (Amount)	(a)
(i) Import of capital goods	(i)
(ii) Import of technical know-how	(ii)
(iii) Others	(iii)
(b) How financed? (Amount)	(b)
(i) Out of foreign currency loan	(i)
(ii) Remittances in free foreign exchange	(ii)
(iii) Others(Please specify details)	(iii)
(C) If the import is on financial lease basis - (specify all the lease charges payable item-by-item)	

<p>5. (i) Details of Import Licence;(where necessary)</p> <p>(a) Full number with prefixes and suffixes</p> <p>(b) Date of issue</p> <p>(c) Period of validity</p> <p>(d) CIF value</p> <p>(i) Currency</p> <p>(ii) Amount</p> <p>(e) If the import licence has been issued against a credit/loan obtained by the Government of India, state full particulars as given in the Import Licence</p> <p>(ii) Importer's Code Number</p> <p>(iii) Details of import</p> <p>(a) Description of goods to be imported</p> <p>(b) Country of origin of goods</p> <p>(c) Port and country of shipment</p> <p>(d) Value (specify whether f.o.b.,c.& f. or c.i.f)</p> <p>(e) Country to which the remittance is to be made</p> <p>(iv) Terms of Payment</p> <p>(a) Advance payment (%)</p> <p>(b) Payments against shipping documents(%)</p> <p>(c) Total amount to be paid in instalments</p> <p>(i) Principal repayment</p> <p>(ii) Interest payment</p>	<p>(a)</p> <p>(b)</p> <p>(c)</p> <p>(d)</p> <p>(i)</p> <p>(ii)</p> <p>(e)</p> <p>(ii)</p> <p>(iii)</p> <p>(a)</p> <p>(b)</p> <p>(c)</p> <p>(d) <u>Currency</u> <u>Amount</u></p> <p>(e)</p> <p>(iv)</p> <p>(a)</p> <p>(b)</p> <p>(c)</p> <p>(i)</p> <p>(ii)</p>								
<p>6. (i) Particulars of the proposed loan/credit</p> <p>(a) Currency and amount</p> <p>(b) Rate of interest</p> <p>(i) Fixed</p> <p>(ii) Floating</p> <p>(a) Base Rate</p> <p>(b) Margin</p> <p>(c) Penal interest for late payment</p> <p>(d) Commitment fees</p> <p>(e) Other charges</p>	<p>(a)</p> <p>(b)</p> <p>(i) _____%</p> <p>(ii) _____%</p> <p>(a) _____</p> <p>(b) _____% p.a.</p> <p>(c)</p> <p>(d)</p> <table border="1"> <thead> <tr> <th>Nature of the charges</th> <th>% p.a.</th> <th>Currency</th> <th>Amount</th> </tr> </thead> <tbody> <tr> <td> </td> <td> </td> <td> </td> <td> </td> </tr> </tbody> </table>	Nature of the charges	% p.a.	Currency	Amount				
Nature of the charges	% p.a.	Currency	Amount						

(ii) Schedule of draw down (of loan/credit/ financial lease)	(ii) Expected date(s) of drawal	Currency	Amount
	(a)		
	(b)		
	(c)		
(iii) Schedule of principal repayments and interest payments	(iii)		
(a) Periodicity of instalments	(a)		
(b) No. of instalments	(b)		
(c) Number of payments in a year	(c)		
(d) Date of commencement of first instalment(YYYY/MM/DD)	(d)		
(e) Date of payment of last instalment	(e)		
(f) Amount of each instalment i.e.	(f)		
Serial number of instalment	Currency and amount of Principal	Currency and amount of interest payment	
(1)	(2)	(3)	
Total			
(g) First date of interest payment (YYYY/MM/DD)			
(h) Number of payments in a year			

7.	Type of loan/credit offered i.e. Supplier's Credit (Deferred Payment Imports), Buyers' Credit, Line of Credit, etc.	
8.	Type of security offered for the loan/credit	
	(i) Government Guarantee	(i)
	(ii) Public Sector Bank Guarantee	(ii)
	(iii) Development Financial Institution	(iii)
	(iv) Multilateral/Bilateral Insurance	(iv)
	(v) Mortgage of Assets	(v)
	(vi) Unsecured (non-guaranteed)	(vi)
	(vii) Other Guarantee (Please specify)	(vii)
9.	Name and address of the authorised dealer who will be issuing the guarantee and through whom remittances will be effected	
10.	Any other information	

We hereby certify that the particulars given above are true and correct to the best of our knowledge and belief. No material information has been withheld and/or misrepresented.

Place:
Date : Stamp (Signature of authorised official)
Name:
Designation:

[For use of Authorised Dealer]

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- i) We certify that the particulars furnished in the application have been scrutinised by us and found to be correct.
- ii) We have verified the original records / documents and hereby certify that they have been found in order and all the essential information/particulars have been correctly reported/furnished in the application.
- iii) We also certify that the applicants are our regular customers and enjoy substantial credit facilities with us.

Place:

Date :

Stamp

.....
(Signature of authorised official)

Name
Designation
Name of bank/branch

**[Space for use of the Exchange Control Department,
Reserve Bank of India]**

- 1. Reserve Bank's approval No. and Date:
- 2. Name of office granting the approval:
- 3. Registration No.allotted to the credit:

Place:

Date :

.....
(General Manager/Deputy/Assistant General Manager)

ECB 2
[Paragraph 7B.6]

**Details of actual transactions of Foreign Currency
Loans/Financial Lease (other than short-term
foreign currency loans)**

Statement for the quarter ended.....

Instructions

1. *This statement should be submitted in duplicate, to Reserve Bank within 10 days from the close of the quarter to which it relates furnishing details of all types of foreign currency borrowings viz. foreign currency loans, suppliers' credits, bonds, convertible bonds, FRNs, cross-border financial lease, etc. If there are no transactions during a particular quarter, a "Nil" statement indicating only the outstanding balance of the loan/credit should be submitted.*
2. *One copy of this statement should be accompanied by an Annexure in the attached form, alongwith a complete set of documents towards utilisation of loan/credit. The information furnished in the Annexure should be certified by the Statutory Auditors/Chartered Accountant.*
3. *In case of suppliers' credits, the dates of imports are to be given in place of dates of drawals.*
4. *For utilisation of drawal following codes should be used -*
 - 1 - *Import of capital goods*
 - 2 - *Import of raw material*
 - 3 - *Remittance to India*
 - 4 - *Pre-payment of old loans/repayments*
 - 5 - *Amount held abroad in foreign currency account*
 - 6 - *Interest payment*
 - 7 - *Payment for technical services*
 - 8 - *Others (Specify)*
5. *For source of funds following codes should be used -*
 - A - *Remittance from India*
 - B - *From FCL funds held abroad*
 - C - *From foreign currency account held abroad*
 - D - *Conversion of equity capital*
 - E - *From export proceeds held abroad*
 - F - *By debit to EFC/EEFC account in India*
 - G - *Others (Specify)*

International Finance and Trade

6. *If repayment schedule indicating exact dates of payments has not been submitted at the time of agreement, the same should be given with this statement. Any revision in repayment schedule made subsequently should also be indicated.*
7. *All dates should be given as YYYY/MM/DD such as 1996/06/30 for June 30, 1996.*
8. *Indicate tranche number if the loan is multi-tranche, for items 5, 6 and 7.*

1. (a) Government Loan Key Number :

--	--	--	--	--	--	--	--	--	--

 (b) RBI Registration Number :

--	--	--	--	--	--	--	--	--	--
2. Name & address of Borrower/Lessee : _____

--	--	--	--

 [For RBI use] _____

3. Currency and Amount of Loan : _____

--	--	--

 [For RBI use]
4. Country of Lender : _____

--	--	--

 [For RBI use]
5. Drawdown Transaction during the quarter - Tranche No. : _____

No.	Date of drawal/Import (see instruction 3)	Currency	Amount	Amount of loan approved but not yet drawn

6. Utilisation during the quarter Tranche No. : _____

No.	Date	Purpose (only codes) (see instruction 4)	Country	Currency	Amount

7. Debt Servicing - Remittances during the quarter - Tranche No. : _____

No.	Purpose	Date of remittance		Currency	Amount	Source (only codes) [see instruction 5]
		Due date	Actual date of remittance			
1.	Principal					
2.	Interest					
3.	Others (specify)					

8. Amount of loan/credit outstanding at the end of the quarter -

Currency _____

--	--	--

 Amount _____
[For RBI use]

9. Country to which remittance sent _____

--	--	--

[For RBI use]

10. Repayment schedule

i) Number of instalments :

--	--	--

ii) Number of payments in a year :

--	--

iii) Currency and amount of Each instalment : _____

--	--	--

[For RBI use]

iv) Date of first payment (YYY/MM/DD) :

--	--	--	--	--	--	--	--

v) Date of final payment (YYYY/MM/DD) :

--	--	--	--	--	--	--	--

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(If instalments are of unequal amount or are not regular, furnish details of each instalment with date and amount in the following format by way of a separate sheet)

No.	Date (YYYY/MM/DD)	Currency	Principal	Interest

We hereby certify that the particulars furnished above are true and correct to the best of our knowledge and belief.

We confirm that prior approval of Reserve Bank of India/Authorised Dealer was obtained by us by submitting applications in form ECB 3 in respect of all the remittances made by us as described above.

Place

:

Stamp

(Signature of Authorised Official of
the borrower/lessee)

Date

:

Name : _____
Designation : _____

[Certificate by an Authorised Dealer]

We hereby certify that the information furnished above with regard to debt servicing, outstandings and repayment schedule is true and correct as per our record.

Place

:

Stamp

(Signature of Authorised Official)

Date

:

Name _____

Designation _____

Name & Address of _____
Authorised Dealer _____
Uniform Code No. _____

[Space for use of the Reserve Bank of India]

This statement has been scrutinised as per instructions contained in the Book of Instructions and circulars issued from time to time and found to be in order. Code numbers against items nos.2, 3, 4, 8, 9 and 10(iii) have been supplied in the relevant boxes. Further, the identification details of the loan/credit in question have been agreed with the corresponding entries in the statement furnished earlier to DESACS vide Form 83. Information supplied in this statement has been posted in the register in Form 85.

Assistant Manager
Date

Reserve Bank of India,
Exchange Control Department,

ANNEXURE TO ECB 2**Details of utilisation of foreign currency loan/credit**

[This supplementary statement should be submitted with ECB 2 with a complete set of documentary evidence in support of utilisation of loan/credit, till such time the loan/credit has been fully utilised and all the relative documents submitted to Reserve Bank]

Report for the period ended _____

1. Name of the borrower :
2. FCL Registration No. :
3. Government Loan Key No./
Sanction No. :

We state that we were permitted to raise a foreign currency loan/credit for _____
(amount)
from _____
for the purpose _____

We hereby certify that the amount of loan/credit has been utilised by us fully/partly for the approved purpose strictly in accordance with the terms and conditions of the loan approved by Government of India and Reserve Bank of India.

The details of utilisation are as under:

1. Loan utilised for the purpose of -

International Finance and Trade

A) If it is for Imports -

(a) Description of goods imported :

(b) Value of imports :

(c) Particulars of documentary evidence :
in support of above imports
(Enclose the following documents)

i) Original Invoice No. & date :

ii) EC copy of Bill of entry :
for Home Consumption
(No. & date)

iii) EC copy of import licence, :
if any - No. & date

iv) Others (specify)

B) If it is for a purpose other than for
imports, please state -

(a) Purpose :

(b) How actually the foreign currency :
has been disposed/utilised?

(c) Documentary evidence in support of (b) :
[Enclose relevant documents]

2. Any other information -

3. The unutilised amount of loan stands parked in our account No. _____
with _____

(Name and address of bank)

and its utilisation will be reported in the next ECB 2 statement(s). We note that if we decide
not to utilise this balance amount, we shall report the details to Reserve Bank and seek
further instructions.

4. We certify that the information furnished above is true and correct. No material information
which may affect the Reserve Bank decision to allow the remittances connected with this
loan/credit, has been withheld by us.

5.* We certify that we sanction and disburse foreign currency loans to our customers/borrowers strictly in accordance with the terms and conditions approved by Government of India and Reserve Bank of India and ensure that the funds are utilised by those borrowers for the purpose for which the loans are disbursed to them.

Date: _____

(Authorised signatory)

[Affix here stamp/seal of the
corporate office of the
authorised signatory]

Name: _____

Designation: _____

Full address: _____

* [For financial institutions who are permitted to raise
foreign currency loans for on-lending purposes]

[Statutory Auditor's/Chartered Accountant's Certificate]

We hereby certify that the foreign currency loan/credit permitted to be raised by RBI vide its letter No. _____ dated _____
and bearing Registration No. _____ has been raised by
_____ from _____

(Name of the borrower)

(Name of lender/lessor)

and duly accounted for in its books of account and related record. Further, the loan has been utilised by the said borrower for the declared purpose of _____

as approved by Government of India vide its letter No. _____ dated _____. We have verified all the relevant documents and record connected with the utilisation of loan/credit and found these to be in order in accordance with the terms and conditions of approval granted by Reserve Bank as also the provisions of Exchange Control Manual, 1993 Edition and to our satisfaction.

(Authorised Signatory)

Place:

Stamp

Name

Address

Date:

Registration No. _____

[FOR OFFICE USE]

ECB 3
[Paragraph 7 B.7]

**Application for repayment/payment of principal/interest and other charges under
Foreign Currency Loans/Credits
(Other than short-term foreign currency loan/credit)**

Instructions

- (i) *The borrowers should submit this application to Reserve Bank or to the authorised dealer (where general permission has been granted by Reserve Bank for making remittances connected with the foreign currency loan/credit), complete in all respects.*
- (ii) *Request for proposed remittance should be strictly in accordance with the terms and conditions of the loan as approved by Government of India and Reserve Bank of India and the loan agreement taken on record by Government of India.*
- (iii) *Please do not omit anything from this statement; delete under proper authentication whatever is not applicable.*
- (iv) *Request for payment of penal interest should invariably be accompanied by approval for it from the concerned office of Reserve Bank.*
- (v) *Please ensure that statement in form ECB 2 for the last calendar quarter has been submitted to the concerned office of Reserve Bank and an acknowledgement in respect thereof is enclosed to this application.*
- (vi) *This statement should be submitted to the authorised dealer even where the repayment/payment of principal/interest and any other charges connected with the loan/credit is to be made from any foreign currency account being maintained by the borrower in India or abroad.*

This has reference to the foreign currency loan/credit taken by us from, as per details given below: (Name of the lender/lessor)

- i) Government of India's approval no. and date and subsequent amendments, if any. :
 - ii) Loan key number allotted by Government. :
 - iii) RBI's approval no. and date and subsequent amendments, if any :
 - iv) Loan Registration Number allotted by RBI :
 - v) Amount of loan/credit approved :
 - vi) Amount of loan/credit actually availed of :
 - vii) Amount of loan/credit outstanding :
 - viii) Rate of interest as approved by Government/RBI :
 - ix) Commitment fee :
 - x) Other charges (specify) :
2. The loan/credit has been drawn in full/has not been drawn in full for the reasons(s)

..... The balance amount is proposed to be drawn during
 /is not to be drawn any more, because.....

2.1 The loan amount is/was parked with It has been fully
 (Name of bank and country)
 utilised/not fully utilised.

*2.2 The account has been closed and unspent balance of has been repatriated to
 India / surrendered to Authorised Dealer under advice to RBI vide our letter No.
 dated

OR

*2.2 The account opened with RBI permission vide its letter No.....
 dated.....is still being maintained by us with the present balance being.....
 for the reason(s)..... and, therefore, RBI's approval for
 remittance of principal and/or interest is hereby sought/has been obtained, vide its letter
 No.....dated.....

* Strike out whichever is not applicable

3. The loan was availed of for the purpose of the documentary
 Evidence in support of utilisation of the loan has been submitted to Reserve Bank of India,
 on along with statement in form ECB 2 for the quarter(s)
 (Name of the RBI office)
 ended vide letter No dated the asset acquired
 with the assistance of loan/credit in question continues to be held with us and on our books of
 accounts.

4. The principal amount of the loan/credit is repayable in half-yearly instalments,
 commencing from..... we have already repaid instalments and the next
 instalment No..... is now due for repayment.

We have already paid interest up to half-year ended now interest is
 payable for the half-year ended/ending.....

The following charges relating to the above foreign currency loan as approved by
 Government of India and Reserve Bank of India,, are now due for payment:
 (Name Office)

Sr.No.	Purpose (specify)	Amount
(i)		
(ii)		
(and so on)		

The above payments shall be made through
 (Name of authorised dealer)

(OR)

5.1 We have not been able to pay principal/interest for the period.....for the reason(s)
 accordingly, we
 have defaulted in the payment terms and attracted thereby penalty of penal interest in terms of
 clause/article No.....of the loan agreement dated..... between us and the lender,
 which has been taken on record by Government of India vide its letter No..... dated
penal interest is payable on for..... days at the rate
 ofand the payment to be made works out to we request RBI to grant approval for
 this payment.

* Strike out whichever is not applicable

(OR)

*5.1 We have since taken RBI's approval vide its letter No..... dated (copy enclosed) for making payment of penal interest.

5.2 We have earlier defaulted on occasions and a total sum of has already been paid by us by way of penalty due to.....

5.3 We are taking suitable steps to ensure that there should not be any default again in making repayment/payment on time as per the loan agreement in question. We are also keeping our Board of Directors fully informed of these defaults and have informed the Board that Reserve Bank of India views seriously the payment of penal interest by way of defaults.

6. We have submitted to Reserve Bank of India,, the statement in
(Name of Office)
Form ECB 2 for the last quarter ended.....and it has been acknowledged by that office vide its letter No..... dated....., a copy of which is enclosed.

7. We certify that the information furnished above is true and correct to the best of our knowledge. The foreign exchange acquired by way of foreign currency loan / credit in question has been utilised by us for the purpose for which it was acquired under approval from Government of India and Reserve Bank of India. The proposed repayment/payment ofis.

[Principal/Interest/ Other charges (specify)]

(i) Strictly in accordance with the terms and conditions of the loan agreement taken on record by the Government of India and subsequent amendments approved by Government of India and Reserve bank; and

(ii) It is outstanding and has not been paid earlier through any other authorised dealer or in any other manner whatsoever.

* Strike out whichever is not applicable

8. In view of the foregoing, we request the Reserve Bank of India/
(Name of the authorised dealer) to: permit us to make the following remittances:

Sr.No.	Purpose	Amount
(i)		
(ii)		

9. The payment of interest / penal interest is exempt from payment of tax in terms of Government's letter No..... dated.....(copy enclosed)/is not exempt from payment of tax and accordingly, NOC/TCC from the competent authority is enclosed.

10. Any other information.

Encl:

(Authorised signatory)

Name: _____

Designation: _____

Full address: _____

Stamp

Place :.....

Date :.....

[FOR OFFICE USE]

Glossary

Advising Bank	: The Advising Bank is the bank that advises the credit to the beneficiary after verification of its authenticity.
Airway Bill	: A receipt from the airline confirming receipt of goods from the shipper. It serves as a non-negotiable receipt for the shipper.
American Option	: An option that can be exercised any day up to its maturity.
Arbitrage	: The process of buying a product in one market and selling it in another, and thereby making a profit.
Ask Price	: The price for which a seller is ready to sell a product.
Authorized Dealers	: Those authorized by the RBI to deal in foreign currencies. As per Section 2(c) of FEMA, 'authorized person' means an authorized dealer, money changer, offshore banking unit or any other person who is authorized to deal in foreign exchange or foreign securities.
Back-to-Back Credit	: A credit that is opened against the security of another credit called the main credit.
Balance of Payments	: The account showing movements of goods, services and capital between a country and the rest of the world.
Bank for International Settlements (BIS)	: The bank for the industrial countries' central banks which helps them manage their reserves.
Beneficiary of LC	: The Beneficiary is the seller of goods who is to receive payment from the buyer. The LC is opened in his favor to enable him to receive payment on submission of the stipulated documents.
Bid Price	: The price a buyer is ready to pay for a product.
Bid-Ask Spread	: The difference between the bid and ask price.
Bill of Exchange	: A written unconditional order for payment from a drawer to a drawee, directing the drawee to pay a specified amount of money in a given currency to the drawer or a named payee at a fixed or determinable future date.
Bill of Lading	: A bill of lading is a document issued by the shipping company or its agent, acknowledging the receipt of goods for carriage which are deliverable to the consignee or his assignee in the same condition as they were received.
Blocked Currency	: A currency that is not convertible into other currencies due to regulations.
Bonded Warehouse	: A warehouse authorized by customs authorities for storage of goods where payment of duties on the goods is deferred until they are removed from the warehouse.
Canalized Goods	: Goods which are importable only by government trading monopolies.
Capital Account Balance	: A part of the balance-of-payments which reflects the net inflow of public and private capital.
Capital Flight	: A sudden and mass transfer of capital out of a country due to increased risk perceptions.
Caps	: A combination of call options on interest rate with different maturities.
Cash Exports	: Cash exports are those exports where the proceeds are realized within 6 months from the date of shipment or the due date for payment whichever is earlier.
Cash in Advance	: A payment method for goods in which the buyer pays cash to the seller before shipment of the goods.
Certificate of Origin	: A certified document detailing the origin of goods used in foreign commerce.
Charter Party	: Renting of an entire vessel or part of its freight space for a specified voyage or stipulated period of time.

Clean Bill of Lading	: A document specifying that the carrier receives the goods in apparent good order and condition.
Commitment Fee	: The fee payable on the undrawn balances of a loan.
Consignment	: The delivery of merchandise from an exporter to a distributor specifying that the distributor will sell the merchandise and then pay the exporter.
Convertible Currency	: A currency that is freely convertible to any other currency. On the basis of the transactions for which such conversion is allowed, the currency may be either convertible on the capital account or on the current account.
Correspondent Bank	: A bank that provides services to another bank in a different location.
Cost and Freight (C&F)	: "C&F to a named port" is used in connection with a price quotation under which the seller must pay all costs of goods and transportation to the named port except cost of insurance.
Cost, Insurance and Freight (C.I.F)	: Same as C&F except that seller also provides insurance up to the named destination.
Countertrade	: Involves adjustment of value of goods imported against value of goods exported, in terms of an arrangement voluntarily entered into between two parties.
Country Risk	: The risk perceived by a non-resident while dealing with a country in a commercial and/or investment transaction, which arises out of political and economic factors.
Covered Interest Arbitrage	: The act of making riskless profits by exploiting the lack of synchronization between the forward premium/discount on a foreign currency and the difference between the interest rates in the two countries.
Cross Rate	: The exchange rate between two currencies calculated by using their exchange rates with a third currency.
Current Account Balance	: A part of the balance-of-payments which reflects the net inflow on account of trade in goods, services and transfer payments.
Customs Tariff	: Charges imposed by the government and most other governments on imported and/or exported goods.
Deemed Exports	: Refers to those transactions in which the goods supplied do not leave the country and the payment for the goods is received by the supplier in India. EPCG refers to the Export Promotion Capital Goods (EPCG) Scheme, which gives the manufacturer facility for import of capital goods for export production at concessional rate of duty against certain level of export obligation over a period of time.
Depreciation	: A reduction in the value of a currency caused by market forces.
Devaluation	: A reduction in the value of a currency dictated by the authorities.
Euribor	: The German interbank offer rate for loans denominated in euro.
Euro	: The new common currency for eleven European nations which came into effect from January 1, 1999.
Euro-Dollar	: A currency outside its home country. For example, a dollar deposit outside the US is referred to as a euro-dollar deposit.
European Monetary Union	: A monetary system followed by 15 European nations, which culminated in a common currency called 'euro' for eleven of them.
European Option	: An option that can be exercised only on the date of maturity.
Exchange Rate System	: The system which facilitates international payments.
EXIM Bank	: The Export Import Bank of India, which encourages foreign trade by extending credit.
Export License	: A permit required to export commodities falling in the negative list.
Export Promotion Council	: EPCs are non profit organizations and help in promoting and developing the exports of the country. Each council is responsible for promotion of a particular group of products, projects and services.

Ex Works	: An international trade term meaning that the seller's sole responsibility is to make the goods available at seller's premises. The buyer bears the full cost and risk involved in bringing the goods from the seller's premises to the desired destination.
FEDAI	: The Foreign Exchange Dealers' Association of India, the self-regulatory body for the Authorized Dealers in foreign exchange.
Fiat Money	: Money whose face value is greater than its intrinsic value because of a government decree.
Fixed Exchange Rate System	: A monetary system under which the exchange rates between currencies is maintained at particular levels, which do not change frequently.
Floating Exchange Rate System	: A monetary system under which exchange rates change frequently in accordance with the market forces.
Floating Rate Notes	: Bonds with coupon rate that changes from period to period, with reference to some market rate like LIBOR.
Floors	: A combination of put options on interest rates with different maturities.
Foreign Currency Call Option	: A contract under which the buyer has the right (but not the obligation) to buy a foreign currency at a predetermined price at a future date.
Foreign Currency Forward Contract	: An over-the-counter contract under which a currency can be bought/sold at a future date at a predetermined price.
Foreign Currency Futures	: An exchange traded version of the forward contract, where the holder of a contract is subjected to the losses/gains arriving out of daily changes in the exchange rates.
Foreign Currency Put Option	: A contract under which the buyer has the right (but not the obligation) to sell a foreign currency at a predetermined price at a future date.
Foreign Direct Investment	: Investment in physical assets in a foreign country with the operating control being with the investor.
Forward Discount	: The difference between the spot price and the forward price of a currency expressed in percentage terms, with the forward price being lower than the spot price.
Forward Premium	: The difference between the spot price and the forward price of a currency expressed in percentage terms, with the forward price being higher than the spot price.
Forward Rate	: The rate quoted today for buying/selling a foreign currency at a future date.
Forward Rate Agreement	: An agreement under which the seller assures the buyer certain interest rate on a notional sum for a predetermined term, which is with reference to a pre-selected market rate, at the end of a specified period. The difference between the agreed rate and the actual market rate prevailing at the end of the specified period is paid by the seller to the buyer if the agreed rate is higher than the market rate, and vice versa.
Free Trade Zone	: An area designated by the government of a country to which goods may be imported for processing and subsequent export on duty-free basis.
Gold Points	: Limits on either side of the gold parity set by transaction and transportation costs, within which exchange rates could move under the Gold Standard.
Gold Standard	: A historical monetary system wherein the participating countries fixed the value of their currencies in terms of gold.
Harmonized System	: The Harmonized System (HS) is a classification system for goods in international trade that provides a domestic market uniform system of product classification for all major trading countries.
Import	: To bring foreign goods or services into a country.
Importer Exporter Code	: A code number issued by the Director General of Foreign Trade (DGFT) which is required to be indicated on export declaration forms submitted by the exporter.

Import License	: A license required and issued by the DGFT authorizing the entry of foreign goods into the country.
Incoterms	: An acronym for International Commercial Terms which are a series of 13 trade terms used in international sales contracts to clearly divide the risks and responsibilities of buyers and sellers with regard to the movement of goods between both parties.
Interest Rate Parity	: The condition under which the premium on a foreign currency is equal to the interest rate differential between the two countries.
International Bank for Reconstruction and Development (World Bank)	: A supranational body which extends loans at concessional rates to member countries for projects having high economic priority.
International Chamber of Commerce (ICC)	: Established in Paris in 1919, this is a non-governmental organization serving world business.
International Diversification	: The process of investing in securities of more than one country.
International Monetary Fund (IMF)	: Another supranational body, created to help countries in maintaining exchange rate stability which came into existence along with World Bank.
Invoice	: A document which is prima facie evidence of the contract of sale and purchase.
Irrevocable Letter of Credit	: An LC where cancelation or any amendment cannot be made without the prior acceptance of all the parties to the said LC.
J-Curve Effect	: The phenomenon of a country's trade balance worsening despite a depreciation of its currency, before it starts improving.
Lagging	: Delaying or postponing payables or receivables. Used as a technique for managing exchange exposure.
Law of One Price	: The law that states that the price of a commodity should be the same across nations.
Leading	: Bringing forward or advancing receivables or payables, for the purpose of managing exchange exposure.
Letter of Credit	: An arrangement by means of which a bank (Issuing Bank) acting at the request of a customer (Applicant), undertakes to pay to a third party (Beneficiary) a predetermined amount by a given date according to agreed stipulations and against presentation of stipulated documents.
LIBID	: The London Interbank Bid Rate. Exists for various currencies and for different maturities.
LIBOR	: The London Inter-Bank Offer Rate, the reference rate for most of the international financial transactions. It exists for various currencies and for different maturities.
Licensing Year	: It means the period beginning on the 1st April of a year and ending on the 31st March of the following year.
Loro Account	: A bank's account with a foreign correspondent bank, from a third party's point of view.
Multinational Corporation (MNC)	: A company that operates in a number of countries.
Netting	: Matching receivables with payables in the same currency to arrive at the net amount.
Nostro Account	: A bank's account with a correspondent bank located in a foreign country.
Official Reserves	: The Central Bank's holdings of foreign currencies, gold and SDRs.
Open Market Operations	: An instrument for controlling the level of money supply in the economy, whereby the Central Bank buys or sells government securities in the market.

Pre-shipment Finance	: Pre-shipment finance is a short-term finance (inventory finance) extended to exporters in anticipation of export of goods. This finance enables exporters to procure raw materials, process, manufacture, warehouses, ship the goods meant for export.
Price-specie-flow Mechanism	: The mechanism which automatically sets right any imbalance in the international payments under the Gold Standard.
Pro forma Invoice	: An invoice prepared by an exporter before the shipment of merchandise informing the buyer of the kinds of goods to be sent, their value and important specifications such as size, quantity and weight.
Project Exports	: Export of engineering goods on deferred payment terms and execution of turnkey projects and civil construction contracts abroad are collectively referred to as 'Project Exports'.
Protectionism	: The effort of a government to protect a domestic industry from a more competitive foreign industry by erecting trade barriers.
Purchasing Power Parity Theorem	: The theory that states that the purchasing power of all the currencies in the world should be the same. It has three versions – absolute, relative and expectations form.
Real Exchange Rate	: The nominal exchange rate between two currencies adjusted for the price movements in the two countries over a period of time.
Reporting Currency	: It is the currency in which an entity prepares its financial statements.
Revocable Letter of Credit	: A revocable letter of credit is one which can be revoked (either canceled or amended) by the issuing bank without giving notice to any of the parties concerned.
Revolving Credit	: A letter of credit whereby the credit available to the beneficiary gets reinstated to the original amount once a drawing is made, is called revolving credit.
Sight Draft	: A draft payable upon presentation to the drawee.
Society for Worldwide Interbank Financial Telecommunications (SWIFT)	: A worldwide computer network that supports international funds transfers between banks.
Spot Rate	: The rate quoted today for a currency to be delivered after two working days.
Standby Letter of Credit	: In a standby letter of credit, the credit is payable upon certification of a party's non-performance of the agreement, of course upon adducing evidence to the effect that payment has indeed been defaulted.
Sterilization	: Intervention by a Central Bank to prevent the BoP situation effect the domestic money supply.
Terms of Trade	: The ratio of the prices at which a country exports its products to the prices at which it imports products from other countries.
UCPDC	: Standardized code of practice issued by the International Chamber of Commerce in Paris covering Documentary Credits.
Uruguay Round	: The most recent round of trade talks (1989-1994) of the member countries of GATT.
Value Date	: The date when the settlement of a spot transaction or a forward contract takes place.
Vostro Account	: A nostro account from the correspondent bank's point of view.
Wharfinger	: The owner or incharge of a structure built near a harbor for facilitating the loading and unloading of goods into ships (a wharf). The goods remain in his custody before being loaded/ after being unloaded for which the exporter/importer is required to pay a rent. The wharfinger enjoys a lien on the goods till the rent is paid.