Block

1

FUNDAMENTALS OF INTERNATIONAL FINANCE

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COURSE INTRODUCTION

Of late, the liberalization of economies was predominantly witnessed than ever before during the last decades of the twentieth century. This change led to the expansion of inter-country businesses. With an increase in cross-border operations, companies were to trade with other countries and in different currencies. This prominent international trade resulted in tremendous expansion of foreign exchange markets in the world. The role of currency markets in international trade, exchange rate determination, and forecasting bears good amount of significance before entering an international trade. This course provides the inputs essential for decision making using the above information. A fair amount of understanding is essential to identify different types of exposures a firm is exposed to due to international trade. This course provides a good overview of managing different exposures. Besides, it helps to know the various financial instruments available that can be utilized for investing or borrowing from international financial markets. The applications of centralized and decentralized cash management techniques are discussed to manage short-term finances in MNCs. A good amount of content is dedicated to international trade covering – trade blocks, WTO, GATT, Documentary Credits, EXIM Policy, and Export and Import Finance Regulations.

After reading this course, students would be able to comprehend the following topics.

Introduction to International Finance that outlines the increasing interdependence of economies due to cross border trade. Further, it highlights the integration of financial markets, costs, and benefits. The evolution of various prominent international trade theories is also discussed. The exchange control regulations related to imports and exports in India and the modes of financing are also discussed.

Balance of Payments which systematically records the economic transactions of a country with the rest of the world. The knowledge of the principles of BoP accounting, factors affecting BoP, and BoP compilation would help the reader understand the economic situation of any economy.

Exchange Rate System that determines the framework of exchange rate movements such as fixed, floating or hybrid. Different types of exchange rate systems that have evolved and that currently are prevailing in various countries give a manager a fair picture before undertaking any currency hedging.

The structure and mechanics of currency dealing, types of exchange rate quotations, computation of forward and spot rates in forex markets, etc.

Need for exchange rate determination using Purchasing Power Parity, Interest Parity and Fischer Effect. An elaborate understanding of this will impact a firm's borrowing and investing decisions. Further, exchange rate forecasting models are also covered.

Due to cross border transactions, firms are exposed to transaction, translation and operating exposures. Students will get an understanding of the various internal as well as external techniques to minimize these exposures are discussed in this course.

Foreign Direct Investment which has taken the center stage in today's trade and business environment. Students will have a clear picture of the growth of foreign direct investment that is witnessed across the globe due to growing needs of companies.

The Adjusted Present Value (APV) approach which enables to assess the project internationally, is discussed in detail.

International financial markets facilitate companies to borrow and invest using financial instruments. This book gives an extensive coverage of various international instruments available and their features. Besides, short-term financial management strategies of MNCs – centralization and decentralization, and their advantages and disadvantages are discussed. The course also covers international accounting and taxation.

In order to facilitate and increase regional trade, a number of trade blocks were formed. This book will enable the students to understand the formation of trade blocks, cartels, bilateral and multilateral trades, and their objectives. The significance of EXIM Policy, role of documentary credits, and the export import policy regulations are also covered.

The course contains five blocks.

The *first block* contain four units in which student is introduced to theories of international trade, developments in international trade and trade barriers. Discussion also goes on international trade finance in India, the role of EXIM Bank and the participation of commercial banks in international trade; also there is discussion on balance of payments from the macro perspective of the country.

The *second block* on foreign exchange transactionshas four units in which discussion on Indian monetary system, the foreign exchange market, various types of quotes relating to forex transactions, exchange control regulations, exchange rate determination and also exchange rate forecasting.

The *third block* on Exchange rate mechanism has two units discussing the detailed nuances of exchange rate risk and management of exchange risk relating to transaction and economic exposures. There is also discussion on management of operating risk, country risk and international project appraisal including appraisal of foreign direct investment.

The *fourth block* on international financial management also has units explaining the international financial markets and instruments like equity instruments, and bonds used across the globe and India Millennium Deposit and India Development Bond, international equity investments, short term financial management and international accounting and taxation.

The last and *fifth block* on international trade has four units wherein student is exposed to various trade blocks in international trade, foreign trade policy and details of documentary credit. A good account of export finance and exchange control regulations governing exports and finally on import finance and exchange control regulations relating to import finance.

This edition has added a large number of contemporary examples and deletion of old examples and exhibits.

BLOCK 1: FUNDAMENTALS OF INTERNATIONAL FINANCE

This is the introductory block to International Finance. It highlights the significance of international trade in the wake of globalization. With the increase in cross border trade, companies from different economies trade in various products and services with a variety of currencies. This block outlines the significance of international trade, various international trade theories propounded, relevance of trade barriers, financing imports and exports, and balance of payments.

Unit 1 *'Introduction to International Finance'* covers the meaning and implications of globalization. This unit briefly discusses the reasons for integration of financial markets, the benefits, the costs involved, and its effects.

Unit 2 *'Theories of International Trade'* outlines some of the fundamental issues that need to be addressed in the context of international trade. It also gives an outline of the evolution of various international trade theories. Further, this unit discusses the need for trade barriers, the types of tariff and non-tariff barriers, and their advantages and limitations.

Unit 3 *'International Trade Finance in India'* discusses the role of various financial institutions in financing international trade in India. The role of EXIM Bank in promoting international trade is discussed. This unit lists the various financing schemes extended to segments like companies, foreign governments and to Indian banks.

Unit 4 *'Balance of Payments'* deals with the basic concepts of economic transactions and principles of Balance of Payments accounting. Besides, this unit discusses the factors that affect the components of BoP and the significance of BoP statistics.

Unit 1

Introduction to International Finance

Structure

"What we know about the global financial crisis is that we don't know very much."

- Paul Samuelson, American Economist

1.1 Introduction

International trade is not only sensitive to the financial crisis in any major economy but also transmits its impact to other economies. To understand this phenomenon let's acquaint ourselves with international finance.

When a business finds green pastures for marketing their products abroad or when a business entity needs machinery equipment to be bought necessarily from other countries, then arises a need for financial transactions in different currencies. These transactions cannot happen simply at the behest of the companies. There will be a set of rules and regulations formed by the governments of the two countries by way of trade policies and exchange control regulations. Apart from business perspective of companies, a need may arise between the governments of two countries in terms of buying or selling identified goods, services and other infrastructure requirements with knowledge/technology transfer and a host of other things. This leads to financial economics across countries. International financing is concerned with international trading operations that are influenced greatly by various factors which include currency exchange rates, international monetary system, Foreign Direct Investment (FDI), and other important issues associated with international financial management.

The World Bank, the International Finance Corporation (IFC), the International Monetary Fund (IMF), and the Asian Development Bank are some of the notable international finance organizations that play an immense role in the context of globalization of world economies.

Like international trade and business, growth of international finance is due to the growth in the economic interests of businesses, governments, and organizations that exert a major influence on the comity of nations considering the inter-dependence of countries in lending and borrowing activities. In such trading, countries mostly use their own currencies which necessitates the requirement to understand how each currency compares with that of other currencies. Further, there is also the need to have a good understanding about fixation of prices of goods and determination of exchange rates of world currencies that are traded globally.

Such major issues have evolved as a part of 'International Finance'.

1.2 Objectives

After studying this unit, you should be able to:

- Identify the need for studying international finance
- Express the meaning and implications of globalization
- Discuss the scope of a firm's finance manager in international financial operations
- Narrate how the integration of financial markets determine the scope of transmission effect
- State the development and benefits of integration of financial markets
- Describe the costs, risks and effects involved in integration and deregulation of financial markets

1.3 Need for International Finance

Financial management of every company is a complex process, in view of each company's unique methods and procedures. It is made even more complex due to increased globalization, wherein the world's financial and commodity markets are getting more and more integrated. Such integration is both across countries and markets. Along with the markets, the companies are also becoming international in their approach and operations. This changing scenario makes it imperative for a student of finance to study international finance.

When a firm's operations are restricted to only the domestic market, both for procuring inputs as well as selling output, it needs to deal only in the domestic currency. As companies attempt 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. With each country having its own currency, the question arises about having a common currency for settlement of trade. Such “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 rates between these currencies (i.e., the value of one currency in terms of another) is determined, along with the levels and the variability of the exchange rates, can have a profound effect on the sales, costs and profits of a firm. Globalization of 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.

Example: International Finance Spill Out - China facing the heat of American inflation

By July 2022 the factories in China were feeling the heat of global inflation, as the demand in the US and Europe started to slow down. After a rebound from the pandemic shock, the demand increased in 2021, and factories in PRC were working at full capacity. But soon inflation started to rise and people from developed countries decreased their spending, especially on consumer goods. This retreat of demand was forcing factories in China to reduce production resulting in engaging a lesser number of workers and lower capacity utilization.

Source: https://www.cnbc.com/2022/07/11/china-factories-are-feeling-some-heat-as-us-europe-demand-slows.html, (PUBLISHED JULY 10, 2022) (Accessed on 11 July, 2022)

1.4 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 essential for establishing oneself as a global player. Globalization is the free movement of goods, services and people across the world in a seamless and integrated manner. This facilitated by the countries by liberalizing the regulatory framework for the business.

A study of international finance helps a finance manager to understand the complexities of various operations in international economies impacting the operations of his/her firm. It also helps him/her to identify and exploit opportunities, while safeguarding against the harmful effects of international operations. A thorough understanding of international finance will also assist the finance manager in anticipating international operations and analyzing their possible effects on his/her firm. He/she would thus get a chance to maximize profits from opportunities and minimize losses from such operations which are likely to affect his/her 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 complexities of issues involved though their operations are only domestic. For instance, some of their inputs (raw materials, machinery, technological know-how, capital, etc.) may be imported from other countries, which exposes them to the risks involved in dealing with foreign currencies. Though they may not source anything from abroad, they could have foreign companies competing with them in the domestic market. As a result of understanding their competitors' strengths and weaknesses, awareness and an understanding of international operations gains importance.

The companies that deal only domestic trade also need to have basic knowledge in international trade.

Globalization and deregulation have resulted in various markets becoming interlinked. Any event occurring in, say in Japan, is likely to affect not only the Japanese stock markets, but also the equity and money markets the world over. The changes in the prices of metals in the international market will have impact in the domestic metal prices and consequently the change in the raw materials for Indian metal industries.

Another example is the forex markets (which operate globally) and money markets in India. These markets 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 only the forex markets, the above mentioned domestic firm would also feel its indirect effects through the money markets. The same holds good for international operations, thus, the need for studying international finance.

Example: How Globalization was Causing Ukraine War to Inflict Inflation Everywhere

There was mild inflation in the US at the beginning of CY 2022. But the Ukraine war in Feb 2022 squeezed the supply of crude oil in the international market and the prices of gasoline in the US were up at an average of 48% affecting all other prices. The war forced developing countries to pay more to import staples at a time when they were already struggling with increased debts taken on to pay for pandemic responses. The inflation of the US reached 8.5% in March 2022, the highest since 1981. Europe and India also were battling historically high inflation rates.

Sources: i) https://economictimes.indiatimes.com/markets/stocks/news/how-will-the-us-federal-reserve-rate-hike-impact-overseas-portfolios/articleshow/91520997.cms (PUBLISHED May 12, 2022) (Accessed July 18, 2022)

ii) https://indianexpress.com/article/explained/united-states-inflation-explained-7868771/ (PUBLISHED April 14, 2022) (Accessed July 18, 2022)

iii) https://www.theguardian.com/global-development/2022/apr/29/inflation-bites-hardest-in-developing-world-as-ukraine-war-raises-prices (PUBLISHED April 29, 2022) (Accessed July 18, 2022)

Activity 1.1

Raffles Enterprises, the manufacturers of silicon chips in India, had decided to internationalize its business operations by setting up a manufacturing plant in Canada. Describe the impeding aspects that the firm would face and the implications that the firm's finance managers had to materialize with regard to the firm's strategic and financial decisions?

Answer:

1.5 Integration of Financial Markets

In the changed scenario of globalization and integrated financial markets, learning international finance (of which exchange risk management and interest risk management are an integral part) becomes essential for a finance manager.

What exactly do we mean by globalization? It essentially involves the various markets getting integrated across geographical boundaries. Let us discuss the integration of financial markets first. What does it involve? Integration of financial markets provides opportunity to raise funds and to invest anywhere in the world, through any type of instrument. Though the degree of freedom differs from country to country, the globalization trend is towards having a reduced control by the regulatory authorities in 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". The higher is the integration, the greater is the transmission effect.

Example: Impact of the Rise of Interest Rates by the Federal Reserve on Global Financial Markets

On June 16, 2022, the US Federal Reserve raised its main interest rate by three-quarters of a percentage point, the biggest increase since 1994. Another 75 basis point hike was expected in the last week of July. The US Dollar Currency Index, which tracks the greenback against six major currencies, was on the rise. In July, the Japanese yen, Euro, and even the Indian rupee were touching their lowest ever rates against the USD.

Contd….

Although gold is seen as an inflation hedge, higher rates hurt the appeal of bullion, which bears no interest. The stock markets in India were taking a hit as FPIs were preferring to park their funds in US securities than Indian stocks.

Sources: i) https://economictimes.indiatimes.com/markets/forex/yen-dives-hits-new-24-year-low-vs-dollar/articleshow/92363607.cms (PUBLISHED June 21, 2022) (Accessed July 18, 2022)

ii) https://www.livemint.com/market/stock-market-news/us-fed-set-to-announce-interest-rate-decision-live-updates-11655313981726.html (PUBLISHED June 16, 2022) (Accessed July 18, 2022)

iii) https://economictimes.indiatimes.com/markets/expert-view/we-expect-rupee-to-weaken-towards-79-79-50-vs-dollar-post-us-fed-outcome-gaurang-somaiya/articleshow/92272750.cms (PUBLISHED June 17, 2022) (Accessed July 18, 2022)

iv) https://economictimes.indiatimes.com/markets/commodities/news/gold-gains-on-dollar-retreat-fed-rate-hike-in-focus/articleshow/92943825.cms (PUBLISHED July 18, 2022) (Accessed July 18, 2022)

v) https://economictimes.indiatimes.com/markets/stocks/news/fed-officials-still-leaning-to-75-basis-point-rate-hike-in-july/articleshow/92912587.cms (PUBLISHED July 16, 2022) (Accessed July 18, 2022)

Let us look at the reasons for this integration.

1.5.1 Development

The most important reason is the remarkable development of technology for transfer of money and information, which now happens much quicker and at considerably reduced cost. This has resulted in the co-ordination of activities in various centers across national boundaries too. Another significant development has been the sudden increase in the inflation levels of industrial economies which resulted in huge price-changes of various financial assets in response to the changes in domestic inflation rates and interest rates. These developments contributed further to the process of globalization.

These being:

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 perspectives, it has been substantial enough to make operations in foreign markets a lucrative affair.

iii. **Increased cross-penetration of foreign ownership:** This has helped countries in developing an international perspective while deciding on various factors influencing the process of globalization.

The following Figure 1.1 depicts triggers for integration of financial markets.

Figure 1.1: Triggers for Integration of Financial Markets

Source: ICFAI Research Center

<u>Check Your Progress – 1</u>

1. Which of the following results in increased opportunities and risks on account of the possibility of overseas borrowing and investments by a firm?
   a. Nationalization
   b. Internationalization
   c. Trans nationalization
   d. Globalization
   e. Privatization
2. Finance Manager of international firms is exposed to various complexities in terms of international financing decisions. Which of the following elements is not true to the functions of the firm's finance manager in international financing operations?
   a. Understand the complexities of various economies
   b. Understand the effect of various events across the world that affects the operations of the firm
   c. Assist to identify and exploit the opportunities causing harmful events.
   d. Helps to anticipate the international events and its possible effects on the firm's operations
   e. Gets opportunity to maximize firm's profits and minimize losses from international events
3. What involves the freedom and opportunity to raise funds and to invest anywhere in world through any type of instrument?
   a. Globalization of financial markets
   b. Internalization of finance

   c. Deregulation of financial markets
   d. Integration of financial markets
   e. Liberalization of financial markets
4. While the transmission effect causes a drastic change in international finance, which of the following is true to transmission effect?
   a. The lower the integration, greater the transmission effect
   b. The higher the integration, the greater the transmission effect
   c. The higher the integration, the lesser the transmission effect
   d. The lower the integration, the lesser the transmission effect
   e. The higher the integration, the more stable the transmission effect
5. From the following factors, identify the element that is not a significant factor to the development of integration of financial markets.
   a. Development in technology
   b. Changes in domestic inflation rates
   c. Development of new financial instruments
   d. Price level changes in various financial assets across countries
   e. Decreased cross-penetration of foreign ownership

1.5.2 Benefits

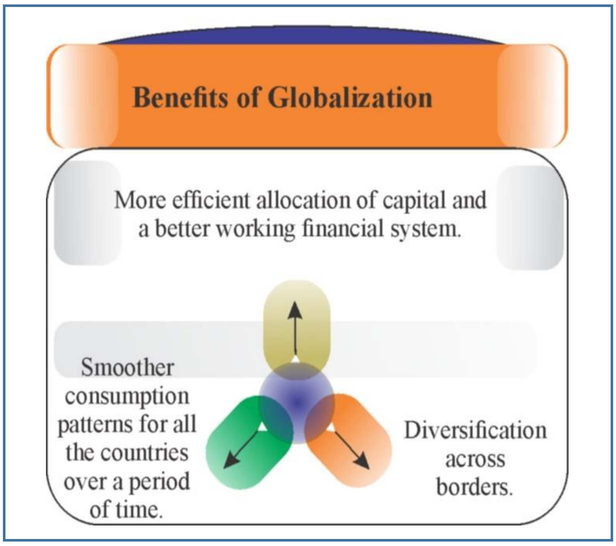
A major function of the financial system is to efficiently transfer resources from the surplus units to the deficit units. Greater integration of financial markets helps in performing this function better. Just like natural resources are distributed unequally among various countries, some countries are 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.

Diversification across borders is possible only when the economic conditions of the countries involved are not perfectly positively correlated with each other. (Refer Figure 1.2)

Figure 1.2: Benefits of Globalization



Source: ICFAI Research Center

The following provides insights on the developments that have taken place in some of the Asian markets.

1.5.3 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 a host country's sudden change in 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 factors 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 faced in the last few decades like the stock market crash of 1987, or the South-East Asian currency crisis of 1997, which got reflected in the stock markets worldwide or the German banks that were hit by US subprime losses in 2007 which was a clear instance in which cross-border financing transmitted financial instability as well. After the global financial crisis in 2008, one would have hoped the naive and misleading view that less regulation is always better for business to have lost traction. But to the Asian and other emerging economies, the financial instability had not been a threat after the crisis, though some economic and trade problems did occur in these regions. Brexit in 2016 created lot of uncertainties among the European trade partners. Experts voiced the opinion that this uncertainty may result in Britain losing out its trade partners to USA or the existing business connections inside the EU may continue the trade with Britain on different terms.

The Covid 19 pandemic and the Russia-Ukraine war in 2022 made the markets extremely volatile in 2022. Most economies around the world faced high inflation and a slowdown of their economies amid fears of recession[1]. Russia declared a war against Ukraine on February 24, 2022. The war was the second largest armed conflict in Europe in decades. While Ukraine launched a worthwhile defensive, it received extensive military and financial support from the US and Europe. The US Congress appropriated $ 113 billion to Ukraine for military, economic and humanitarian aid. The US, EU and the other countries in Europe levied economic sanctions. The US measures include[2]:

- Restricting the Russian Central Bank from drawing on its dollar-denominated reserves
- Prohibiting most major Russian banks from conducting transactions in U.S. dollars or with U.S. persons

[1] https://www.imf.org/en/Publications/GFSR/Issues/2022/10/11/global-financial-stability-report-october-2022#:~:text=Global%20financial%20stability%20risks%20have,among%20emerging%20and%20frontier%20markets.

[2] https://crsreports.congress.gov/product/pdf/IF/IF12277

- Barring new U.S. investment in Russia
- Expansion of export controls impacting Russia's access to sensitive or needed U.S.-origin technologies
- Banning the import of certain goods from Russia
- Prohibiting Russian use of U.S. airspace and ports
- Imposing economic sanctions on about 1,900 Russian individuals and entities and banned entry into the United States for several thousand Russian officials, military personnel, government connected businesspeople, and others
- Suspension of normal trade relations with Russia and its ally Belarus
- Prohibiting the import to the United States of Russian oil and other energy products
- Establishing sanctions on foreign persons who engage in gold transactions with Russia.

European Union also countered the Russian invasion of Ukraine with several economic sanctions such as[3]:

- Freezing the assets of 171 entities (including key banks) and 1,386 individuals (primarily Russian officials and elites), to whom travel bans also apply.
- Imposing debt and equity restrictions on certain banks and companies.
- Restricting transactions with Russia's central bank and blocking access to its reserve holdings.
- Banning transactions with certain Russian state-owned military-industrial enterprises.
- Disconnecting 10 leading Russian financial institutions—including Sberbank, Russia's largest bank—from SWIFT (the world's dominant international financial messaging system).
- Broadening export controls on dual-use goods and technologies.
- Banning certain exports in the aviation, maritime, and technology sectors (e.g., semiconductors) and the export of drone engines and luxury goods to Russia.
- Prohibiting imports of steel and other raw materials, spirits, seafood, and gold from Russia.
- Closing EU airspace, seaports, and roads to Russian aircraft, ships, and freight operators, respectively.

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[3] https://crsreports.congress.gov/product/pdf/IN/IN11897#:~:text=Through%20its%20European%20Peace%20Facility,mission%20for%20Ukraine's%20armed%20forces.

EU energy dependence on Russia has made targeting its energy sector challenging, but the EU has approved progressively tougher sanctions, including:

- Prohibiting most imports of Russian crude oil and petroleum products, with an exemption for crude oil delivered by pipeline. The EU expects these sanctions, which began taking effect in December 2022, to apply to around 90% of Russian oil imports.
- Banning oil transport services. An exemption finalized in December 2022 allows EU companies to provide such services for Russian crude oil sold to non-EU countries at or below a price cap of $60 a barrel. In February 2023, the EU set price caps for Russian petroleum products. EU caps are established in cooperation with the Group of Seven (G7) price cap coalition (aimed at reducing Russia's oil revenues while keeping global energy markets stable).
- Banning EU exports of oil refining technologies.
- Prohibiting Russian coal imports.

India and China which were also energy dependent on Russia, became the largest buyers of Russian Oil post the Western nations imposing trade restrictions. [4]In March 2022, the combined oil imports of China and India from Russia overtook EU. One primary reason was the cheaper rate at which the Russian crude was available at nearly $30 a barrel less than Brent crude. In December, 2022 India and Russia reached a bilateral trade settlement agreement through which Euro and Dollar will not be used for settling the foreign trade payments. Instead six Indian banks were provided with the permission to open correspondent accounts in Indian rupees with Russian banks for arranging Rupee–Rubble Vostro account transactions.

1.5.4 Effects

The most important and visible effect of globalization and integration of financial markets is the increase in volatility. Whether it is interest rates, exchange rates or prices of financial assets, all these factors change quite frequently in response to changes taking place in different segments of the global financial markets. Such changes get initially reflected in exchange rates and in interest rates. Further, with the deregulation of the financial markets globally, the control exercised by the authorities on these variables has been reduced to a great extent, thus exposing a firm to a number of risks, hitherto unknown to it.

Activity 1.2

Suppose, an Indian company holds a certain amount of stock in US share market, yielding 5% return on invested stocks, how would it benefit the company's risk management in the forefront of integrated financial market?

[4] https://www.bbc.com/news/world-asia-india-60783874

What are the major types of risks that the company would face with regard to risk management? Discuss. **Answer:**

Check Your Progress – 2

6. What is the name given to the process by which businesses or other organizations develop international influence or start operating on an international scale?
   a. Globalization
   b. Euro-dollar dynamics
   c. Deflation
   d. Preparation of trade policies
   e. Profitability
7. What is the term used for a sudden cash crunch that is short-lived in industries or companies that arises due to any political, economic, financial or technological outburst in the financial markets?
   a. Temporary slump
   b. Market to debt obligation
   c. Credit risk
   d. Recession
   e. Rise in inflation rates
8. Which of the following is/are settlement currency between international parties to trade?
   a. Domestic currency of any one of the parties only
   b. US Dollars only
   c. Euro only
   d. Internationally accepted currency only
   e. Domestic currency of any of the parties or internationally accepted currency
9. If a business entity is having receivables denominated in foreign currency, what is the risk, the company is exposed to?
   a. Inflation risk
   b. Currency risk

   c. Increase in interest rate
   d. Settlement risk
   e. Liberalization risk

10. Multi-national companies are exposed to changes in government policies that allow/disallow repatriation of profits or disinvestment in foreign country. What is the name of such risk?
    a. International monetary system
    b. Transmission effect
    c. Country risk
    d. Deflation risk
    e. Interest rate risk

1.6 Recent Developments in International Financial Markets

Financial markets are extremely sensitive to global changes in the real economy. Prices of varied financial instruments keep changing with market information and market dynamics. Changes in macroeconomic variables such as interest rates, tax rates, inflation rates, and exchange rates can impact the worth of any financial asset, and hence its price. Efficiency in the financial markets always ensures that the price of a financial asset reflects its underlying value. This is due to the fact that if markets were inefficient, then expected returns would not be proportional to the assumed risk. Equity shares of a weak company would be overpriced for a long period while that of a strong company would be underpriced for a long period. As investors in financial assets are rational, they would sell overpriced shares and buy underpriced shares to correct the mispricing in the underpriced and overpriced shares in the marketplace.

'Market sentiment' also plays a key role in the determination of prices of varied financial securities. Market operators change their minds with changes in 'financial facts'. For example, whenever inflation goes up, interest rates have to move in tandem making bond prices to fall. A similar impact of downward price is felt in equity prices because companies would witness a rise in production costs due to high interest rates. Volume of sales may drop and pull down the profit margins resulting in lower Earnings per Share (EPS). Hence, finance professionals should stay abreast of the latest developments in the world of finance so as to appropriately price a financial asset.

Exit LIBOR, Enter RFR

One of the major developments in the world financial markets in recent times has been the search for a new interest rate benchmark that can provide financial stability. Since the creation of LIBOR (London Inter-Bank Offered Rate) in 1969 by Minos Zombanakis, it served as a benchmark for short-term interest rates to millions of financial contracts ranging from simple residential mortgage loans to complex financial derivatives. The rate was set by the British Bankers Association (BBA) as all the leading banks in London submitted their lending rates every day at 11 a.m. local time and the BBA LIBOR was determined by taking an average of these rates. BBA LIBOR became the most important number in the global financial markets and was subsequently rechristened ICE LIBOR (Inter-continental Exchange) because it was administered by ICE.

During 2012, the regulatory authorities had discovered that a dozen banks including Citibank, Barclays, and UBS colluded and rigged LIBOR to benefit from trades in the financial markets. This was not the first time LIBOR was manipulated in financial markets as during the global financial crisis of 2008 as Barclays bank understated their rates to artificially low levels. After imposing a fine of $9 billion by European Union on these bankers for the 2012 scandal, the oversight of LIBOR was transferred to the UK regulatory body. Martin Wheatley, the Managing Director of Financial Services Authority, UK opined that participating banks of LIBOR should submit actual inter-bank deposit market transactions, maintain transaction records, and publish the same after three months. He also recommended that those who are found guilty of manipulating benchmark interest rates either knowingly or willfully making false or misleading statements should be subjected to criminal sanctions.

A series of fraudulent actions from these banks made the regulatory authority in the UK, Financial Conduct Authority (FCA) to look beyond LIBOR. In 2017, the FCA stated that after the calendar year 2021, the panel banks would not be required to publish the interest rates required to calculate LIBOR. Hence, financial markets the world over aimed to replace LIBOR as a reference rate. As of June 2018, the number of financial contracts that had LIBOR reference touched around $400 trillion denominated in leading currencies. Against this backdrop, there was a fundamental shift in the financial marketplace from a regime that was based on reference rate to that centered on overnight (O/N) Risk-Free Rates (RFR). The market expectations from ‘Reference Rates’ were that the ideal reference rate should retain the best of LIBOR without being subjected to manipulations. Such a reference rate should:

a. Offer a comprehensive and accurate reflection of interest rates prevailing in the heart of money markets based on actual transactions.
b. Provide a viable reference rate not just for financial contracts in money markets but that can also be applied even for pricing interest rate derivatives and liquid market instruments.
c. Meet the requirements of not just lending but also borrowing as banks lend and fund simultaneously. If they lend for the long-term based on a reference rate, they should also borrow based on the same reference rate. (Exhibit 1.1)

Exhibit 1.1: Work Bank Approved New Reference Rates for Existing and New Loans in Preparation for End of Libor

On 22nd July 2021, the World Bank's Board of Executive Directors approved modifications for new and existing loans that will switch over to new market reference rates in preparation for the global transition away from the London Interbank Offered Rate (LIBOR).

The alternative reference rates will be Secured Overnight Financing Rate (SOFR) for USD-denominated loans, Sterling Overnight Index Average (SONIA) for GBP-denominated loans, and Tokyo Overnight Average Rate (TONA) for JPY-denominated loans. EURIBOR will remain the reference rate for EUR-denominated loans.

NEW LOANS:

Effective from January 1, 2022, new variable-spread loans IBRD Flexible Loans (IFLs) will be offered in

a. USD based on the Secured Overnight Financing Rate (SOFR);

b. GBP based on the Sterling Overnight Index Average (SONIA);

c. JPY based on the Tokyo Overnight Average Rate (TONA).

EXISTING LOANS:

Variable-spread

Reference rates for variable-spread loans will be replaced with the same reference rates listed above: SOFR for USD loans; SONIA for GBP loans, TONA for JPY loans. For existing variable-spread loans in EUR LIBOR, the reference rate will be replaced with EURIBOR, effective January 1, 2022.

Fixed-spread

a. Reference rates for fixed-spread loans in GBP, JPY and EUR will be replaced with the same reference rates listed above effective January 1, 2022.

b. Reference rates for fixed-spread loans in USD will be replaced with SOFR, effective July 1, 2022.

The adoption of new reference rates for new and existing loans by the World Bank follows the timetable established by LIBOR´s regulator, the United Kingdom Financial Conduct Authority, for LIBOR discontinuation..

The approved modifications will allow the World Bank to continue serving its clients with the financial model that is mutually beneficial to the Bank and its borrowers.

Source: https://www.worldbank.org/en/news/press-release/2021/07/22/world-bank-approves-new-reference-rates-for-existing-and-new-loans-in-preparation-for-end-of-libor; accessed on 05.12.2022

To make this a reality, the new reference rates should look at alternative reference rates in other jurisdictions to capture the following key features:

a. Move towards the short-tenor segments like O/N which are more liquid than the longer-dated tenors which lasted 3-months.

b. Look beyond inter-bank markets so as to include transactions done with non-bank intermediaries in the wholesale market such as insurance companies, money market mutual funds, etc.

c. Focus on secured transactions also and not just the unsecured ones. Inclusion of secured transactions such as repurchase agreements (Repo) transactions conducted by banks with non-bank wholesale counterparties goes a long-way in adding credibility to the reference rate.

Example: Regulations for Cryptocurrencies in International Financial Markets

2021 was a transformative year for digital assets. Due to the ambiguous nature of digital assets, the regulations in various countries were ad-hoc, rhetorical, or even driven by enforcement. The required international coordination and engagement with the industry were lacking slowing the opportunity for progress. The regulatory framework which varies from country to country was evolving rapidly and changing quickly. Some jurisdictions imposed outright bans while others were its staunch advocates.

Sources: i) https://www.thomsonreuters.com/en-us/posts/wp-content/uploads/sites/20/2022/04/Cryptos-Report-Compendium-2022.pdf (PUBLISHED April 2022) (Accessed on July 18, 2022)

ii) https://complyadvantage.com/insights/cryptocurrency-regulations-around-world/ (PUBLISHED 2022) (Accessed on July 18, 2022)

1.7 Summary

- Globalization is a continuous process and its pace is increasing with the passage of time. While it brings along with it a lot of opportunities, it is also accompanied by a number of problems and risks, which we will have to learn to handle.
- The international developments in the last few years have made the study of international finance extremely important.
- 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.
- The most important reason for financial market integration is the remarkable development of technology for transfer of money and information, making the same possible in the shortest possible time and at considerably reduced cost.

- Another significant development has been the sudden increase in the inflation levels of various industrial economies which resulted in the prices of various financial assets changing widely in response to changes in the domestic inflation rates and global interest rates.
- Capital-rich countries generally enjoy a lower return on capital than the capital-poor countries.
- The financial markets also involve taking some additional risks – currency risks and country risks.
- The most important and visible effect of globalization and integration of financial markets is the increase in volatility. 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.

1.8 Glossary

Country Risks 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.

Currency Risks denote the risk of the value of a foreign liability increasing in terms of the domestic currency. This happens due to change in the exchange rates.

Deflation refers to the overall decrease in the price level of the economy so that inflation rate becomes negative.

De-regulation is the process of revision, reduction or elimination of rules and regulations that hinder free competition in demand and supply of goods and services in a particular industry.

Exchange Rate is the rate at which one currency is converted into another currency.

Globalization is a process of integration of nations driven by international trade and investment.

Inflation refers to increase in the price level changes in an economy and decline in the purchasing value of money.

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.

International Finance is the study of financial management that determines and involves issues related to monetary transactions between two or more countries.

Transmission Effect - In integrated financial markets, any change affecting one part of the world will also affect the rest of the world. This is called as transmission effect, and (the so) the higher the integration, the greater higher will be the transmission effect.

1.9 Self-Assessment Test

1. What is meant by International Finance? Explain its scope and need.
2. Enumerate the need and the implications for companies going global.
3. How does international financing enhance the scope of a finance manager?
4. State the limitations that a globalization process encounters due to integration of financial markets.
5. Describe the benefits involved in integration of financial markets.
6. What are risks? Discuss the various types of risks that arise due to globalization of financial markets.

1.10 Suggested Readings/Reference Materials

1. Francis Cherunilam, International Business - Text and Cases, 6th Edition, PHI Learning.
2. P G Apte (2020), International Financial Management, McGraw Hill Education (India) Private Limited.
3. Madhu Vij (2021). International Financial Management – Text and Cases. 4th edition. Taxmann.
4. Charles W. L. Hill, G. Tomas M. Hult (2021). International Business. 12th edition. McGraw Hill Education (India) Private Limited.
5. Choel S. Eun & Bruce G. Resnick (2022). International Financial Management. 8th edition. McGraw Hill Education (India) Private Limited.
6. K. Aswathappa (2020). International Business. 7th edition. McGraw Hill Education (India) Private Limited.

1.11 Answers to Check Your Progress Questions

1. (d) Globalization

Globalization of financial markets also results in increased opportunities and risks on account of the possibility of overseas borrowing and investments by the firm. Further, exchange rates have a great impact on the various financial decisions. their movements can alter the profitability of these decisions.

2. (c) Assist to identify and exploit the opportunities causing harmful events

The given is incorrect. Because, the finance manager function is to assist to identify and exploit opportunities preventing harmful effects of international events.

3. (d) Integration of financial markets

Integration of financial markets involves the freedom and opportunity to raise funds from different economies and to invest anywhere in world through any type of instrument.

4. (b) The higher the integration, the greater the transmission effect

In integrated financial markets, any change affecting one part of the world will affect the rest of the world also. This is called as transmission effect, and so the higher is the integration, the greater will be the transmission effect.

5. (e) Decreased cross penetration of foreign ownership

It was increased cross penetration of foreign ownership that was one of the influences to the process of globalization that has led to integration of financial markets.

6. (a) Globalization

Globalization is the free movement of goods, services and people across the world in a seamless and integrated manner. This facilitated by the countries by liberalizing the regulatory framework for the business.

7. (a) Temporary slump

A sudden cash crunch that is short-lived in industries or companies, which arises due to any political, economic, financial or technological outburst in the financial markets is referred to as temporary slump. In cross-border capital flows, in the event of temporary slump in income, a nation can borrow abroad and maintain its consumption at normal level, paying back later when income stabilizes.

8. (e) Domestic currency of any of the countries or internationally accepted currency

Since different countries have different domestic currencies, the question arises as to which currency the trade should 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.

9. (b) Currency risk

Currency risk denotes the risk of the value of a foreign liability increasing in terms of the domestic currency. This happens due to change in the exchange rates.

10. (c) Country risk

Country risk is the risk of not being able to disinvest at will due to a host country's sudden change in attitude towards foreign investment, or due to some other factors.

Unit 2

Theories of International Trade

Structure

"The only way in which a durable peace can be created is by worldwide restoration of economic activity and international trade."

- James Forrestal, First United States Secretary of Defense

2.1 Introduction

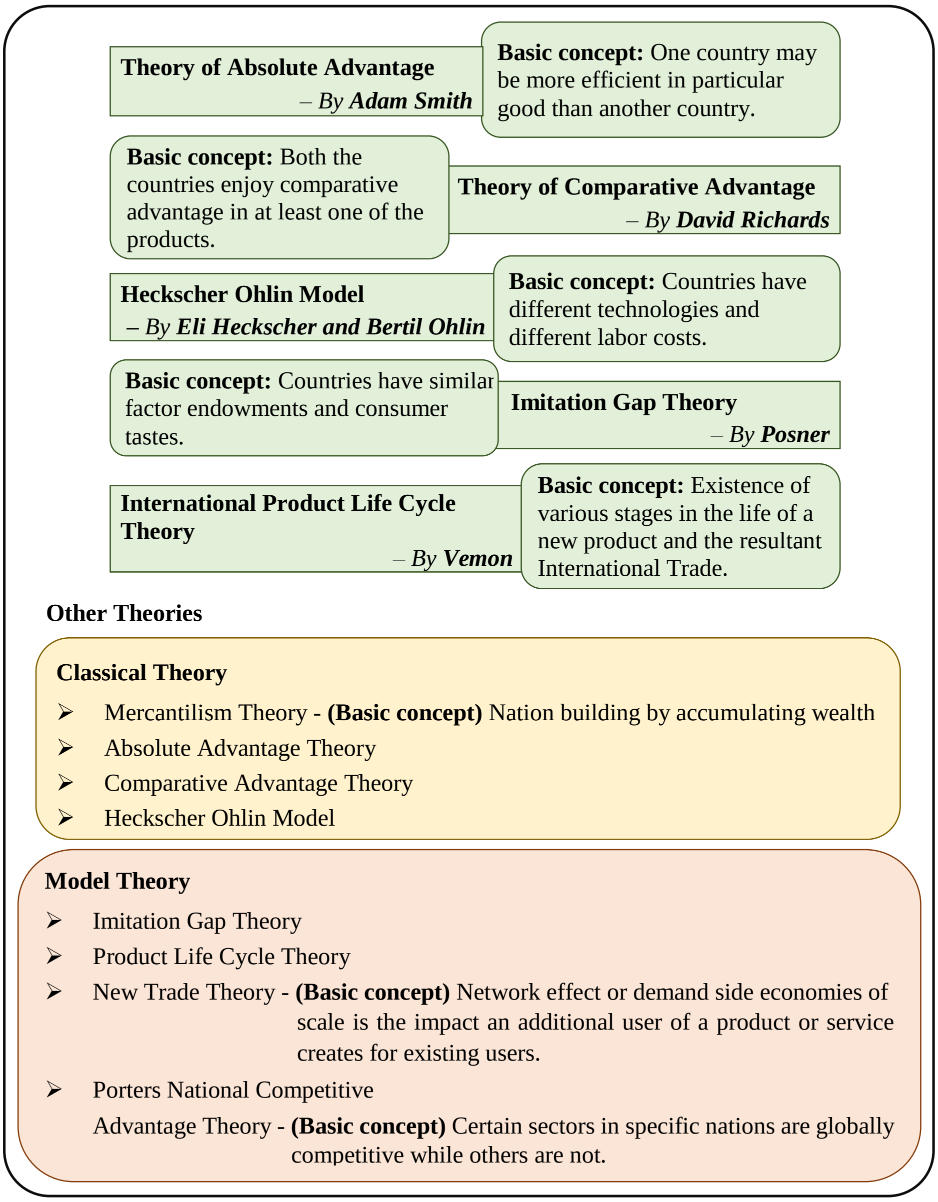
But why would countries engage in international trade? Let's study some of the important theories that explain international trade and its rationale.

In the previous unit, we discussed the need for globalization, integration of financial markets, the benefits and costs thereof.

One important stimulant for the integration of markets was the increase in trade among different countries. A well-developed global financial system becomes essential for supporting such increased volumes of 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. However, 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 it is decided as to which country should export a particular good and which country should import it? Who gains from such a trade? A number of theories have been propounded in an effort to answer these questions. Some of the major theories will be explained in this unit as precisely explained in Figure 2.1.

Figure 2.1: Theories of International Trade



Source: ICFAI Research Center

2.2 Objectives

After studying this unit, you should be able to

- List the theories of international trade
- Distinguish between the theories of absolute advantage and comparative advantage

- Narrate on the stages of 'International Product Life Cycle' and its significance
- Trace the developments in the international trade scenario
- State the various types of non-tariff barriers
- Explain in detail the causes for imposition of trade barriers and its relative costs

2.3 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 goods 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.

Illustration

Let us elaborate with an example. Suppose there are two countries – Angelland and Babel. Angelland can produce a super-computer 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 aircraft. According to Adam Smith, in such a scenario, Angelland will restrict itself to producing super-computers and Babel to aircraft. These goods will then be traded between these two countries. Let us assume that the countries exchange 1 super-computer for 1 aircraft. Angelland will then be able to produce a super-computer using 10 units of labor, exchange it for one aircraft and use the remaining 10 units of labor to produce a super-computer for its own consumption. This way it will be able to derive the satisfaction of using a super-computer 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 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 a certain extent. The kind of adaptability required for labor to be perfectly mobile cannot actually exist.

Example: Absolute Advantage Driving the Trade between Australia and China

Low labor costs, pre-built industrial zones, strong business ecosystem, lack of regulatory compliance, low taxes and duties, competitive currency practices, etc., made China the factory of the world. Almost every major international manufacturer moved into the free trade zones of China. Australia is rich in minerals and forests. So, Australia exports Iron Ore, gas, coal, whine, timber, etc., to China and imports computers, telephones, semiconductors, furniture, etc., from China.

Source: https://www.shieldworksmfg.com/2021/12/16/made-in-china-how-chinese-factories-became-the-worlds-factories/, dated: 16th December, 2021. (Accessed on 19th July, 2022)

2.4 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 the 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 and 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 2.1.

Table 2.1: 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

Source: ICFAI Research Center

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 less 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 2.2.

Table 2.2: 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

Source: ICFAI Research Center

Enjoying comparative advantage for a country means having a less opportunity cost in producing a commodity than the other country. As we can see from Table 2.2, 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 2.1, 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.

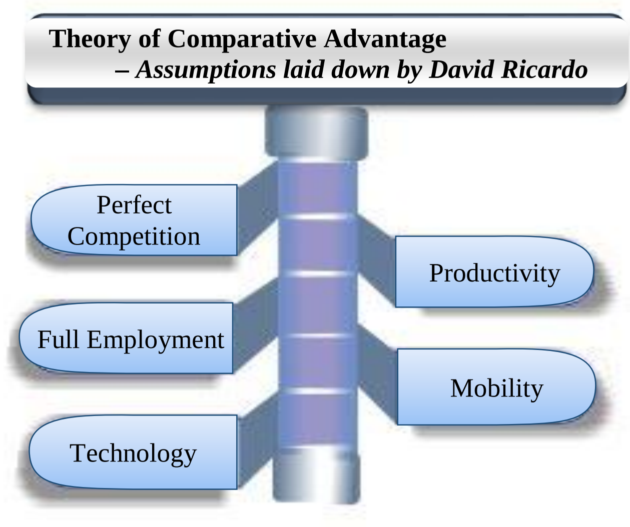
The analysis of comparative advantages, thus tells us as to which country should produce which commodity. Now, we have to understand how this specialization in production and the consequent trade will help the two countries in increasing their standard of living. Assume the state of *autarky*, i.e., 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 x 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 x 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. The same is also precisely explained in Figure 2.2.

Figure 2.2: Theory of Comparative Advantage



Source: ICFAI Research Center

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 productions 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. Hence, the comparative advantages are 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 the 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 state 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 makes 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.

Example: Comparative Advantage making US Import Crude Oil Despite Self Sufficiency

American crude oil is lighter (easier to lift) and sweeter (cheaper to refine) than the one it imports. For the year 2021, the gross imports of crude oil per day were 8.47 million barrels while the gross exports are 8.63 billion barrels per day. The country that declared itself to be energy self-reliant still imported oil. This happened for a combination of economics and chemistry. Environmental and other regulations, land and lease prices, labor costs, transportation, etc., make lifting and transporting lighter US oil costlier than importing heavier oil from outside. The pipeline infrastructure was built to transport imported oil from the coast than transport that was produced in Texas. The refineries were also configured to refine heavier imported oil than lighter American oil. Compared to using its own oil, it is cheaper for the US to import crude oil.

Sources: i) https://www.eia.gov/tools/faqs/faq.php?id=727&t=6, year 2021. (Accessed on 19th July, 2022)

ii) https://www.nasdaq.com/articles/america-produces-enough-oil-to-meet-its-needs-so-why-do-we-import-crude, dated: 8th March, 2022. (Accessed on 19th July, 2022)

2.5 Heckscher-Ohlin Model

The theory of comparative advantage assumes a single factor of production, i.e., labor. The theory describes the situation where trade takes place between countries having different technologies and different labour costs. It means 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. This 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.

Example: Heckscher-Ohlin Model explains Trade Between Germany and Bangladesh

Capital-rich countries like the US and Western Europe as they could afford R&D were becoming synonymous with technology-rich countries. In 2020, Germany was the world's biggest exporter of motor cars and other motor vehicles. Germany was the largest trading partner of Bangladesh in Europe. South Asia is labor rich. Most of the exports of Bangladesh are knitted or crocheted apparel & clothing. As Germany was capital rich it invested in the automaking industry. As Bangladesh was labor rich it employs a lot number of tailors to make readymade garments.

Sources: i) https://oec.world/en/profile/country/deu, year: Copyright 2022. (Accessed on 19th July, 2022)

ii) http://www.bangladeshembassy.de/bangladesh-german-trade-facts/, year: Copyright 2022 (Accessed on 19th July, 2022)

2.6 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 times 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. They are:

- 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 adopt the existing plant and machinery to it
- Simplicity or otherwise of the innovation, and
- 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
- Readiness of the consumers in the second country to use innovative products

- Speed with which they react to changes in technology, and
- 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.

Activity 2.1

Which theory of international trade implements the strategy that two companies forming alliances can leverage the advantages of each other enjoying trade benefits catering to manufacturing of specific goods or services at a competitive advantage? State its underlying assumptions.

Answer:

2.7 International Product Life Cycle Theory

The International Product Life Cycle (IPLC) theory, proposed 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 innovations 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 end 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, the producers enjoy high profits. 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. 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.

For example, Apple products seem to be all about imagination, design and innovation. It is with innovative technology base and differentiated market structure base. This has captured people to connect emotionally with the brand, creating a mass community and wide international consumer base.

Example: International Product Life of Mobile Handset Industry

In the 80s and 90s mobile phone, technology was with the US and Western Europe. Although in the late 90s mobile phones became popular in Asian countries like China and India, the handsets made by Motorola, Nokia and Simens were to be imported from North America and Europe. In 2013 Nokia announced a cut of 10,000 jobs in Europe to close facilities in Ulm, Germany and Burnaby in Canada. Now the company gets its phones manufactured through other OEMs operating in Asia. Simens stopped producing mobile phones while Motorola was acquired by Chinese company Lenovo. By 2021, more than 80% of the mobile phones in the world are manufactured in Asia, completing the international product life cycle.

Sources: i) https://www.cnet.com/tech/mobile/nokia-plans-10000-layoffs-cuts-second-quarter-outlook/, dated: 14th June, 2021. (Accessed on 20th July, 2022)

ii) https://www.semiconductor-technology.com/projects/nokia/#:~:text=Nokia%20Mobile%20Phones%20manufactures%20products,Beijing%20and%20Dongguan%20in%20China.&text=China.,-Nokia%20reports%20that, dated: Copyright 2022. (Accessed on 20th July, 2022)

iii) https://www.worldstopexports.com/cellphone-exports-by-country/, dated: Copyright 2022. (Accessed on 20th July, 2022)

Check Your Progress -1

1. Which of the following theories of international trade proposes the capability of one country to produce more of a given product efficiently with the given resources optimally than the other country?
   a. Absolute advantage
   b. Comparative advantage
   c. Heckscher-Ohlin model
   d. Imitation-gap theory
   e. International product lifecycle theory
2. Which of the following theories admits to take advantage of opportunity cost in leveraging the benefits of countries involved?
   a. Theory of absolute advantage
   b. Theory of comparative advantage
   c. Heckscher-Ohlin model
   d. Imitation-Gap theory
   e. International Product lifecycle theory
3. Heckscher-Ohlin model proposes two types of products namely capital-intensive and labor-intensive. Identify the proposition that is not a considerate to this model.
   a. There is no obstruction of trade
   b. Both commodity and factors markets are perfectly non-competitive
   c. There is constant or decreasing returns to scale
   d. Countries having same technology, operate at same level of efficiency
   e. Labor and capital are perfectly immobile for inter-company transfers and inter-sector transfers
4. Which of the following terms refers to the difference between the times, a new or improved product is released in one country while it is already demanded by another country?
   a. Demand lag
   b. Time lag
   c. Supply lag
   d. Imitation lag
   e. Service lag
5. Which of the following theories to international trade deals with two important factors namely technological innovation and market structure?
   a. Theory of absolute advantage
   b. Theory of comparative advantage
   c. Heckscher-Ohlin model
   d. Imitation-gap theory
   e. International product lifecycle theory

2.8 Other Theories of International Finance

Broadly, international trade theories can be grouped into:

i. Classical: These theories are based on individual notions such as Mercantilism, Absolute Advantage, Comparative Advantage, and Heckscher-Ohlin models.

ii. Modern: These theories are based on individual firms such as Imitation Gap Theory, Product Life Cycle, New Trade Theory, and Porters National Competitive Advantage.

There are other theories of international trade which are also equally relevant as they provide additional perspective. These theories cut across both classical and modern segments. A holistic picture of the economic thoughts that evolved on the trade front is provided by segregating and sequencing it appropriately. Having already covered classical theories like Absolute Advantage, Comparative Advantage, and Heckscher-Ohlin models, the theory of Mercantilism which is the foundation for classical theories of international trade has been brought in. One of the oldest theories of trade, Mercantilism needs to be understood in its proper perspective because it is still relevant in the current context. Trade in agriculture is globally protected even to this day thanks to Mercantilism.

Mercantilism Theory

The rise of China into a global economic superpower was because of a religious application of the mercantilist approach to accumulate huge war chest of foreign exchange even at the expense of other nations. Chinese economy became export-driven because of:

a) Holding artificially on to a weak home currency

b) Leveraging dirt cheap labor and

c) Attracting foreign direct investments.

Even Donald Trump administration had recently applied Mercantilism to strengthen the market position of the USA in the steel and aluminum sectors even at the cost of straining their relationship with NAFTA partners like Canada and Mexico.

Mercantilism theory which prevailed during the mid-16th century had advocated nation building by accumulating wealth. This theory was propagated by Thomas Mun and others on the firm belief that the power of a nation was measured by its wealth reflected in the reserves of precious metals like gold and silver. Mercantilism or commercialism is basically an approach in which a country used trade as a weapon to amass wealth. The idea was to generate trade surplus by maximizing exports and minimizing imports. The boost to exports was made possible through subsidizing the domestic industry. All kinds of incentives were provided to the local players so that they go the extra mile to post trade surplus. Imports were restricted through various quotas and tariffs. There is a high threat of retaliation because of high tariffs from affected nations leading to a 'tit for tat' trade policy. Essential goods were only permitted to be imported and luxury goods were either banned or discouraged.

Key assumptions of Mercantilism are:

- There is a limited amount of wealth available globally.
- A country can become wealthy only by eroding the wealth of other nations.
- A country should try to attain trade surplus (import lesser than exports).

International trade according to the Mercantilism theory was a zero-sum game as nothing was win-win situation but only win-lose situations. Just like in trading, an operator gains at the cost of the other, even nations should try to gain at the cost of other nations. This philosophy was practised by the European nations during 1500-1800 to regulate trade which resulted in surplus at the cost of other nations. During this period, strong monopoly positions were created in the mother country, they exported as much finished goods as was possible and imported primary goods from their colonies to enrich the former.

This economic thought was popular during the colonial era when empire building was the norm. The objective was not to solve problems of world GDP and its growth but to impoverish the trade partners using positional superiority. The fact remains that such practices of Mercantilism through government regulations and natural monopoly creation would result in complacency and corruption. There was no incentive to stretch resources and improve efficiency of operations and corrupt officials benefitted immensely due to the absence of free trade mechanism. Towards the end of the 18^{th} century and the beginning of the 19^{th} century, neo-mercantilists emerged on the scene.

Neo-Mercantilism Theory

In this theory, Neo-mercantilists argued that a nation following the Mercantilism approach would be tempted to intervene and influence other nation's trade policies in their favor. The policy of the state to encourage and assist the domestic industry is 'neo-mercantilism'. The proponents of this theory revived mercantilism with an intention to enhance domestic income and employment by imposing trade restrictions. Nevertheless, both mercantilism and neo-mercantilism suffered from the following drawbacks:

a. Mercantilism was not sustainable as every nation cannot have trade surplus.
b. Wealth of a nation eroded because of trade restrictions.
c. Key factors such as natural resources, capital resources, human skill set were completely ignored.
d. Trade policies that promoted exports and restricted imports erected barriers to trade.
e. Exploitation of colonies of the mother country.

We should not be under the mistaken assumption that mercantilism as an economic philosophy prevailed between 17th and 18th century. During May 2018, President Trump imposed new tariffs on steel and aluminum supplied by the closest allies - Canada, European Union, and Mexico. The harsh reality was that more than half of these metals were supplied by these nations. Interestingly, Mexico and Canada are the members of the trade bloc called NAFTA (North American Free Trade Agreement). The White House, however, maintained that alienating these critical military allies was required to protect "America's national security". No wonder all the three nations have vowed to initiate retaliatory measures. The trade policy of America was lopsided as it failed to recognize mutual gains from trade and was determined to create a 'win-lose' situation.

The emphasis of classical theories of international trade was in shaping the foreign trade policies so that nations focused on producing and exporting those goods where they have a cost or a natural advantage over other nations. Though European Union (EU) and the USA are not agrarian nations, they still dominate the market for farm products because of the strong subsidy support provided by their respective governments to farmers.

Modern theories of international trade such as the 'New Trade Theory' and 'National Competitive Theory' (Porter's Diamond Theory of National Advantage, discussed below) brought in new factors that drive trade across the borders.

These modern theories help businesses in choosing the right location and produce more efficiently to expand into new geographical markets to gain competitive advantage. We shall cover these two theories which are relevant from the perspective of a domestic company that intends to be export-oriented.

New Trade Theory

Classical international trade theory propounded by David Ricardo in 1817, explained why nations were engaged in trade even though one country had efficient labor that could produce everything that they needed at a lower cost. This comparative advantage theory was based on the following key assumptions:

- There are only two countries and they produce only two goods.
- Labor is the only factor of production and labor cost is expressed in labor units.
- Both the countries engaged in trade operate at full employment.
- Law of constant returns to scale operates in the industry.

Unlike the Ricardian model, the Heckscher-Ohlin model assumed that there were two factors of production namely labor and capital. These two factors were mobile within the country but not internationally. But just like the classical model, 'H-O model' also assumed that the markets were perfect and there is no room for any gains in producing higher volumes of output.

Due to rapid industrialization across the world, the dependence on manual labor got reduced and deployment of capital equipment had increased. Generally, larger firms invested in state-of-the-art technology and were more cost competitive than smaller firms. Hence, they enjoyed increasing returns to scale even at higher capacity utilization and attained lower costs. It means that if the factor inputs are tripled, the output will be more than tripled. Due to the sheer scale of operations, they reaped economies of scale and had incentives to trade this surplus production in international markets. To sustain this economic activity, the increase in production by the industry should match with the increase in the size of the potential market. Thus, they had to look beyond the domestic markets and trade internationally.

In the late 1970s and early 1980s, a new trade theory emerged which was essentially a collection of economic models initiated by Paul Krugman. New trade theory firmly believed in increasing returns to scale and network effects. A network effect or demand side economies of scale is the impact an additional user of a product or service creates for existing users. Unlike the Ricardian model of constant returns to scale, the new trade theory propounded that protectionist measures towards an industry during the infant stage would enable it to attain a global scale to dominate the world in future. These international trade models tracked industry specialization of specific countries such as watches in Switzerland, movies in Hollywood etc., to predict the shape of things to come.

According to this theory, nations engaging in international trade reap two types of economies of scale. Internal economies which are reflected in lower average costs for individual firms because of an increase in their scale of operations and external economies that drive down the average cost of the entire industry in that nation because of the increase in the size and growth of output.

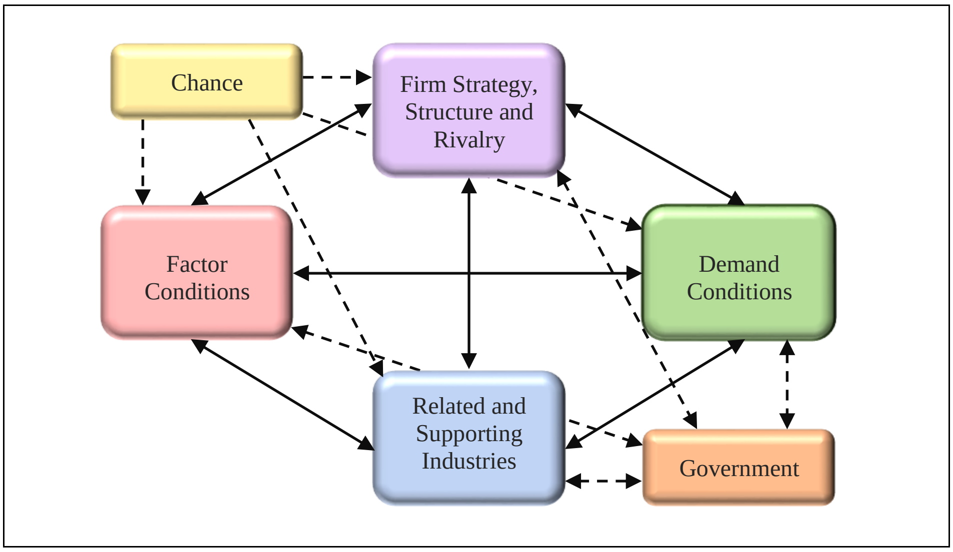
Another dimension of this new trade theory is that firms which entered an industry early would enjoy first mover advantages and would attain substantial scale to become dominant players. New entrants cannot challenge these well entrenched incumbent firms as the latter enjoy low cost of operations. Thus, the theory argued that a nation may dominate export market for a good not because it was endowed with factors of production but because it was lucky enough to have one or more companies among the first to producing them. For example, [5]Airbus Industrie, European aircraft-manufacturing consortium is a leading exporter of commercial aircraft as it was amongst the first few players who entered the industry.

[5] https://www.britannica.com/topic/Airbus-Industrie

Michael Porter's Diamond Theory of National Advantage or National Competitive Theory

Michael Porter's 'Diamond Theory of National Advantage' also known as the 'Porter's Diamond Model' is a frame-work that explains only why certain sectors in specific nations are globally competitive and others are not. Also, it reasons out as to why particular companies in particular countries have the capability to innovate consistently while others might not. According to Porter, the ability of a company to compete in the global markets is basically a function of inter-related set of location advantages (refer Figure 2.3) that certain sectors in certain countries possess.

Figure 2.3: Michael Porter's Diamond Theory of National Competitive Advantage



Sources: https://www.business-to-you.com/porter-diamond-model/
http://www.careratings.com/upload/NewsFiles/Studies/Ship%20Breaking%20Industry.pdf

Each of these factors is explained in finer details as under:

A) Firm Strategy, Structure, and Rivalry: The national eco-system in which corporates are created, organized, and managed to a larger extent influences its strategy and structure. Rivalry in the home market forces business firms to look for alternatives in search of competitiveness. Rivalry is believed to be the trigger to aggressively compete on the international front. For example, Toyota was the world's leading automaker for 2018 because of the fierce rivalry it had with players like Honda, Mitsubishi, Nissan, and Suzuki in the home markets.

B) Factor Conditions: Some nations are endowed with *natural resources* like coal, crude oil, diamonds etc. and hence, industries set up in such countries became global exporters of downstream value-added products. This explains why De Beers led the world for mining and trading diamonds. The developed world is more active in the capital-intensive sectors as capital resources are in abundance. In case of nations rich in human resources, nations that created and nurtured world-class educational infrastructural facilities benefitted people-intensive businesses.

Example: International Finance Situation Opening Doors for India to Become a Manufacturing Hub

Raghuram Rajan the former governor of the Reserve Bank advocates that India should continue to invest in the service industry which is its strength and should not blindly pursue manufacturing in India.

India grew with its service sector a couple of decades back due to the factor conditions at that time. Having moderate infrastructure but having abundant skilled and English-speaking human resources led to the development of the services industry in India. But both India and the world due to the disrupted supply chains from China were looking for a second manufacturing hub. The new demand conditions and the altered factor conditions (better infrastructure) were forcing India to focus on manufacturing too.

Sources: i) https://www.timesnownews.com/business-economy/economy/article/for-budget-2022-23-rajan-advises-against-hard-manufacturing-binge-prescribes-soft-service-diet/849554, dated: 15th January, 2022. (Accessed on 20th July, 2022)

ii) https://economictimes.indiatimes.com/news/economy/indicators/india-should-focus-on-building-human-capacities-not-chips-says-raghuram-rajan/articleshow/90095759.cms?from=mdr, dated: 9th March, 2022. (Accessed on 20th July, 2022)

iii) https://www.thehindubusinessline.com/opinion/why-india-should-go-for-a-manufacturing-pushep/article38093737.ece, dated: 3rd January, 2022. (Accessed on 20th July, 2022)

C) **Demand Conditions:** Where customers in the home markets are extremely sophisticated and demanding, companies that could meet and exceed their expectations are rightly positioned to replicate the success story in the overseas markets.

D) **Related and Supporting Industries:** The foundation on which the target industry would excel depends upon the related and supporting industries. At the dawn of the new millennium, Nokia had dominated Finland's 'Wireless Valley of ICT' (Information and Communications Technology) cluster where 6,000 odd players across the telecom value chain contributed meaningfully. They provided quality inputs and timely information about the emerging trends which was critical for innovation. These industries supplemented and complemented each other to script a global success story of Finnish telecom industry.

E) Government: Porter did not believe that the "invisible hand" of the market-place would operate as the government would intervene and direct scarce economic resources. Government can be an 'enabler' or play the 'inhibiter role' in the Porter's diamond model. Government cannot create and sustain competitive industries but they can raise the bar and push the industries to move to higher levels of competitiveness. Government policies can positively and/or negatively impact all the four factors of the diamond model which can make or break the industry. For example, the global ship-recycling or ship-breaking industry is concentrated in Asia (India, Bangladesh, China, and Pakistan) as bulk of the ships are broken in this part of the world. Due to environmental concerns associated with this polluting industry, China had banned import of foreign-flagged vessels for recycling. This would benefit other ship-recycling countries like India which is already a leader in this market

F) Chance: Michael Porter was originally silent about the 'chance' factor in shaping up the industry cluster in a specific nation. The role of chance is embedded in the diamond model because of the presence of external factors. Natural or man-made disasters can adversely or positively affect an industry. For example, when the ATMs across the length and breadth of the country were running dry in the aftermath of demonetization, the digital wallet app industry benefitted the most.

Finally, when these four conditions (firm strategy, structure, and rivalry; factor conditions; demand conditions; and related and supporting industries) are positive for an industry, the domestic players will be on their toes at all times to upgrade and innovate.

2.9 Developments on the International Trade Front

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.

2.9.1 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.

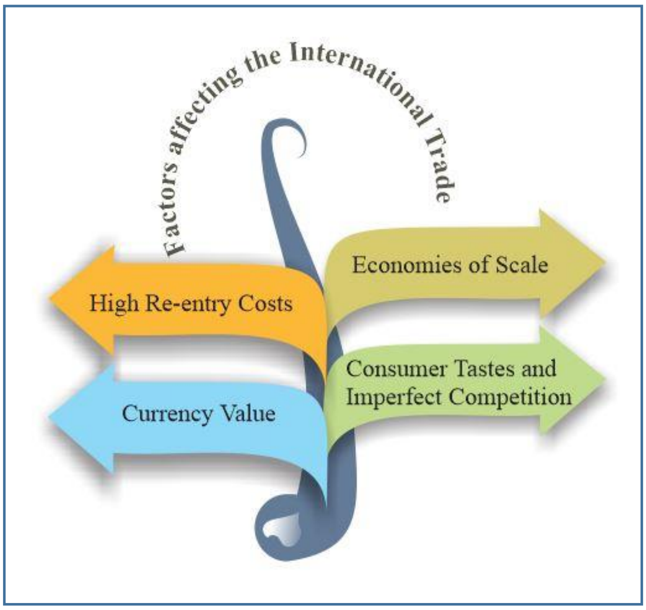
- Seasonal differences provide another reason for intra-industry trade. A country may import a particular foodstuff when it is not in season in that part of the world and may export it when it comes in season.
- Product differentiation also promotes such trade. It is generally observed that capital-rich 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 exists 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 and imports another brand.

In addition to the above theories, there are a few more factors affecting international trade. This is explained precisely in the Figure 2.4.

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.

Figure 2.4: Factors affecting the International Trade



Source: ICFAI Research Centre

- **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.

Example: Reasons behind China's Rise on International Trade Front

From 2005 to 2015, the Chinese Yuan Renminbi (CNY) appreciated by 33%, but in August 2015 the Chinese central bank PBOC went for 3 consecutive devaluations eroding 3% of the CNY. China directly affects the U.S. dollar by loosely pegging the value of its currency, CNY, to the USD. In August 2019, the US called China's devaluation moves as currency manipulation just to boost exports. In 2020 the PBOC abandoned the use of the countercyclical factor showing its confidence in letting more market forces set the yuan's daily parity amid appreciation pressure on the yuan. As part of the phase one trade deal signed in January 2020, China promised not to engage in competitive currency devaluation.

China through its huge manufacturing facilities in SEZs leveraged economies of scale and was estimated to have wiped out one million jobs in the US. The other countries in Asia and Europe also had to close their manufacturing facilities, for the operating costs at their facilities couldn't match those in the Chinese large SEZs.

Sources: i) https://www.scmp.com/economy/china-economy/article/3153177/what-does-stronger-us-dollar-yuan-exchange-rate-mean-and-why, dated: 22nd October, 2021. (Accessed on 20th July, 2022)

ii) https://www.thebalance.com/how-does-china-influence-the-u-s-dollar-3970466, dated: 4th March, 2021. (Accessed on 20th July, 2022)

- **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.
- **Bilateral and Regional Agreements:** International trade in recent times can be attributed to the promotion of bilateral and regional agreements between nations. In the wake of the Russia-Ukraine war and the sanctions on Russia imposed by US, EU and other NATO member nations, Asian countries such

as India and China fostered bilateral trade with Russia. India entered into a bilateral trade payment settlement agreement that enabled India importers of crude oil from Russia to make payments in Indian rupees. In December, 2022 India entered into a bilateral trade with Australia, referred to as India-Australia Economic Cooperation and Trade Agreement (IndAus ECTA). This agreement will save Australian exporters around US$2 billion a year in tariffs, while consumers and businesses will save around US$500 million in tariffs on imports of finished goods, and inputs to "our manufacturing sector". It will promote Indian exports and eliminate double taxation issues. In May, 2022 India had signed a Comprehensive Economic Partnership Agreement (CEPA) with UAE that benefited both countries by removal of tariff on more than 80% of products, removal of technical barriers, etc.

2.9.2 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 the 1930s, rather than out of any general disinclination towards trade. In fact, during the last 50 years, the 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.

2.9.3 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/her 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.

2.10 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.

2.10.1 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 instance, the Biden Government in US levied several tariff barriers on Russia in the aftermath of its war declaration against Ukraine. The US government increased the applicable rates on 570 tariff line items to 35%. UK too responded by a 35% tax on some imports from Russia. In addition, the G7 group of nations agreed to cap the price of Russian Oil and petroleum products. The cap has been set at USD 60$ per barrel. This cap is targeted to reducing the export revenues of Russia and thereby making it difficult to finance the war.

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 Curbs 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. Higher import duty would increase the cost of the imported items, it would increase the cost to importer and domestic goods would provide competitive price. Higher import tariffs 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.

2.10.2 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 whereas for the OPEC countries sales of refined products in the international market are not subject to quotas.

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 States has a decades old embargo on trade with Cuba as a part of economic sanctions.

For instance, after Russia declared war against Ukraine, many countries including UK, Japan, and Canada, the United States banned the import of newly mined or refined gold from Russia.

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.

Subsidies to Local Goods

Governments may directly or indirectly subsidize local production in an effort to make it more price-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. Incentives schemes and subsidies are provided to start-up Indian manufacturers' plants in the Special Economic Zones (SEZ) to commensurate with the essence to meet the domestic needs of the country.

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.

For instance, the Government of India's 'Make in India' programme was designed to transform the nation into a global manufacturing hub. This has enabled to obtain regulatory clearances in 25 different sectors including the Information Technology (IT) and Business Process Management (BPM), to create more jobs and for skill enhancement. This sector is permitted with 100% FDI under the automatic route. This paves a direct way for the Indian manufacturing companies and the foreign investors to produce goods and services domestically with international business environment, creating more business and employment opportunities within India.

Example: US CAATSA, a unilateral Barrier

The Countering America's Adversaries Through Sanctions Act (CAATSA) is a United States Federal Law that allows the United States to punish countries, through sanctions, that carry out 'significant transactions with Iran, North Korea and Russia. Earlier in accordance with the CAATSA, the US imposed sanctions on Turkey for its acquisition of Russian-made S-400 missile defense systems. On July 15, 2022, the US House of Representatives passed a legislative amendment by voice vote to waive punitive sanctions against India under CAATSA for the latter's purchase of the S-400 missile defense system from Russia.

Sources: i) https://economictimes.indiatimes.com/news/defence/caatsa-what-it-is-why-it-is-in-news-how-it-can-hurt-india/articleshow/89986708.cms, dated: 8th March, 2022. (Accessed on July 21, 2022)

ii) https://www.cnbctv18.com/india/us-congress-votes-to-waive-sanctions-against-india-over-s-400-missile-deal-with-russia-14143932.htm, dated: 15th July, 2022. (Accessed on July 21, 2022)

2.10.3 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 negates 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 licence. Secondly, quotas are enforced by allowing imports only against import licences, which are issued on a selective basis. Since the basis of selection for the grant of import licences 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.

Activity 2.2 Identify and assess the tariff and non-tariff barriers to trade between India and Bangladesh. **Answer:**

2.10.4 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 interests 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 environmental 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 unit).
- 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 a 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 an exporting 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 exporter 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. Economic sanctions can take a number of forms.

2.10.5 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.

Activity 2.3

The Government of India continues to limit or prohibit Foreign Direct Investments (FDI) in sensitive sectors such as retail trade and agriculture. As both government-owned and private companies run a small amount of counter trade practices, ascertain the reasons or implications to trade barriers in these sectors.

Answer:

Check Your Progress - 2

6. Which of the following terms represent a tax levied on goods traded internationally?
   a. Re-entry fee
   b. Customs fee
   c. Tariffs
   d. Excise duty
   e. Import duty
7. Which of the following terms represent the trading activities that are fully or partially prohibited by countries?
   a. Exchange controls
   b. Technical barriers
   c. Embargo
   d. Export restraint
   e. Country risks
8. Which of the following inter-governmental organizations protects the supplies and prices of the global LPG and LNG producers of member states and non-members?
   a. Organization for Economic Co-operation and Development (OECD)
   b. Organization of the Petroleum Exporting Countries (OPEC)
   c. BRICS Association
   d. European Union (EU)
   e. Federal Energy Regulatory Commission (FERC)

9. Which of the following terms represents a limit that is imposed to number of units imported or market share held by foreign producers?
   a. Tariff
   b. Quota
   c. Subsidy
   d. Duty fee
   e. Export restraint
10. What is the benefit of imposing tariffs on the imported goods?
   a. In generating revenue to the government
   b. In generating cost to the government
   c. In generating demand to the foreign producers
   d. In depleting demand for foreign consumers
   e. In depleting revenue to the government

2.11 Summary

- World trade has grown rapidly in the last few decades. Latest developments can be reasonably expected to make it grow at a 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.
- Intra-industry trade refers to the phenomena of a particular country simultaneously importing and exporting the same product. 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.
- Risks and rewards always go hand-in-hand. There are two types of risks that have to be taken care of while trading across nations – exchange risk and country risk.
- Trade barriers have three effects on the economy. Firstly, it increases the cost of foreign goods and shift the domestic demand towards domestically produced goods (which are not competitive, implying a higher cost of production), by encouraging inefficient production by local producers.

Secondly, the country is faced with a higher price that paves the way for domestic consumers to reduce the consumption of that good, and lastly, tariffs generate revenue to the government.

- 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. Over the last few decades, tariffs have been losing their importance as barriers to trade, their place being taken by 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. Certain Non-Tariff Barriers (NTBs) like tax breaks for firms producing in certain backward areas of the country (i.e. local production) are put in place in an attempt to reduce regional income disparities.
- 'Quotas' and 'Tariffs' cause barriers to efficient allocation of world resources and the achievable level of standard of living. The fallacy that a country's economic condition can be improved only if the country enjoys a trade surplus, tempts governments to put up such trade barriers.

2.12 Glossary

Absolute Advantage is the capability of a country or company to produce a good or service efficiently with available resources at a lower cost per unit than the cost at which any other entity produces that same good or services.

Comparative Advantage is applied by countries to determine what goods and services they specialize in producing goods or services at lesser opportunity cost.

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.

Economic Cost is the cost involved in the discretion of one course of action with another in combining the profits and losses of goods and services that have a value attached to it.

Embargo refers to ban or prohibition to trading activities among countries.

Exchange Risk is the uncertainty of returns induced by unexpected changes in exchange rates.

Imitation Lag is the difference between the time of introduction of the product in one country and time when the producers in the other country start producing it.

Intra-Industry Trade refers to the trading activities involved in export and import of goods and services in same industry.

Market Structure comprises the collective factors with reference to changes taking place between the buyers' and sellers' interactions in a market.

Non-tariff Barriers are the rules, regulations and bureaucratic delays which keep foreign goods out of the domestic markets.

Quota is the limit that is imposed to the number of units imported or market share held by foreign producers.

Tariff is a tax levied on goods traded internationally.

Technological Innovation encompasses new products and processes that add significant technological changes to products and processes involved.

2.13 Self-Assessment Test

1. The 'Information Technology Services' in India has seen an enormous growth across nations with doubling of revenues and cheaper labour resources in the last 10 years. Explain the theory that substantiates the statement.
2. Briefly explain the underlying assumptions of Heckscher-Ohlin model with an example.
3. Give a detailed note on Posner's Imitation-Gap Theory and its implications.
4. Narrate on the various facets of International Product Life Cycle (IPLC) theory.
5. Discuss in detail the trade developments on the international trade front.
6. What are trade barriers? Briefly explain the reason for imposition of trade barriers to international trade that affects companies in making a global presence.
7. Enumerate on common type of tariff barriers that hugely influence the global economy at large.
8. How are non-tariff barriers classified? Elucidate with necessary examples.

2.14 Suggested Readings / Reference Materials

1. Francis Cherunilam, International Business - Text and Cases, 6th Edition, PHI Learning.
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5. Choel S. Eun & Bruce G. Resnick (2022). International Financial Management. 8th edition. McGraw Hill Education (India) Private Limited.
6. K. Aswathappa (2020). International Business. 7th edition. McGraw Hill Education (India) Private Limited.

2.15 Answers to Check Your Progress Questions

1. **(a) Absolute advantage**

   Absolute advantage theory to international trade proposes the capability of one country to produce more of a given product efficiently with the given resources optimally than the other country.

2. **(b) Theory of Comparative advantage**

   Comparative advantage theory admits to take advantage of opportunity cost in leveraging the benefits of countries involved. According to this theory, as proposed 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, allowing both the countries enjoy comparative advantage in at least one of the products.

3. **(b) Both commodity and factors markets are perfectly non-competitive**

   Heckscher-Ohlin model is based on the assumption that both commodity and factor markets are perfectly competitive.

4. **(a) Demand lag**

   Demand lag refers to the difference between the time a new or improved product is released in one country while it is already demanded by another country.

5. **(e) International Product lifecycle theory**

   International Product Life Cycle theory (IPLC) given by Vernon explains various stages in the life of a new product and the resultant international trade considered on two main factors namely technological innovation and market structure.

6. **(c) Tariffs**

   Tariff refers to tax levied on goods traded internationally.

7. **(c) Embargo**

   When imports from a particular country are totally banned it is called an embargo.

8. **(b) Organization of the Petroleum Exporting Countries (OPEC)**

   Organization of the Petroleum Exporting Countries (OPEC) is an inter-governmental organization. It protects the supplies and profits of the global LPG and LNG producers of member states and non-members. It limits surplus production and increased changes in price levels.

9. (b) Quota

A limit that is imposed to number of units imported or market share held by foreign producers is referred to as quota.

10. (a) In generating revenue to the government

Imposing tariff benefits the domestic producers on the economic front in generating revenue to the government.

Unit 3

International Trade Finance in India

Structure

"India is a good growth opportunity, will receive a lot of FDI."

- Dr Ram Charan (Ram Charan is a world-renowned business advisor, author and speaker who has spent the past 35 years working with many top companies and CEOs)

3.1 Introduction

In this unit, let's study the opportunities, channels and regulations of trade and finance in India with foreign countries.

In the previous unit, we studied about various theories of international trade. We also discussed how various economies use trade barriers – both tariff and non-tariff based – to their advantage and protect their own economies. In this unit, we will study about the institutional frame-work which facilitates international trade in our country.

The Export Import Bank of India, popularly called the EXIM Bank of India, was established by the Government of India in the year 1982 under the Export-Import Bank of India Act, 1981. This financial institution serves as a growth engine for industries and small medium enterprises (SMEs), by offering a wide range of products and services through export credit, mirroring the global export credit agencies. EXIM Bank has made a transition from being a product-centric institution with export credits and export capability creation, to a more customer-centric one, by offering a comprehensive range of products and services empowering the businesses at all stages of a business cycle. It aims to enhance the internationalization efforts by offering leadership and expertise in India's export finance for making a lasting difference in the industry. Their flagship programs include: corporate banking, buyer's credit under National Export Insurance Account (NEIA), line of credit, overseas investment finance and project financing[6].

3.2 Objectives

After studying this unit, you should be able to

- Define the role of EXIM Bank of India in trade finance.
- Explain the lending function of EXIM Bank to Indian companies.
- Analyze the mechanism of forfaiting transactions for financing export related receivables.
- Narrate the function of EXIM Bank as a guarantor.
- Discuss the regulatory controls with respect to exchange in merchant transactions.
- Describe the investment opportunities in India and its regulatory environment.
- Discuss the features of the International Financial Centre and Gujarat International Finance Tech City (GIFT).
- Discuss the working of an offshore banking unit.

3.3 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. The following shows the launch of new online portal that facilitates the exporters in making sound rational financing decisions on overseas contracts.

EXIM Mitra - A Facilitator to India's Export Import Community

The Export-Import Bank of India (EXIM Bank), had come up with a digital initiative in consonance with the 'Digital India' campaign, EXIM Mitra, a one-stop solution for the export and import community. EXIM Mitra (meaning a friend for exporters and importers) was launched on 6th January 2017 in Mumbai. This endeavor of EXIM Bank, aimed to benefit firms, especially Small Medium

[6] https://www.eximbankindia.in/organisation

Enterprises (SMEs), is to make sound business decisions during their overseas expeditions.

This online platform extends its services by providing preliminary assistance to a large number of exporters and importers, to have access to an array of crucial trade related information under a single roof. The digital portal acts as a gateway for traders to identify potential global markets and products, understand the product standards across the globe, introduce exporters and importers to available credit and insurance facilities, identify agencies and estimate freight cost apart from other value added services. Thus, it fulfils the twin objectives of providing information on financial products, to facilitate exports, and deliver trade related information apart from consultancy and advisory services.

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.

The same is discussed below:

I. To Indian companies	**II. To foreign govt., foreign companies**	**III. To Indian banks**
1. Direct assistance 2. Consultancy and technology services 3. Overseas investment finance 4. Pre-shipment credit 5. Deemed exports 6. 100% export oriented units and free trade zones 7. Forfaiting	1. Buyers’ credit 2. Lines of credit 3. Relending facility	1. Bill rediscounting 2. Refinance

3.3.1 Lending to Indian Companies

There are different ways of lending to Indian companies as explained below:

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 per cent of the contract value.

Consultancy and Technology Services

Indian companies executing overseas contracts involving consultancy and technology services can avail of EXIM Bank'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 INR (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 (Export Credit Guarantee Corporation) insurance cover and assign it in favor of the bank.

Overseas Investment Finance

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 10 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 per cent 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.

Research and Development Finance for Export Oriented Units

To encourage Indian exporters to invest more in their R&D spend, EXIM provides finance to dedicated R&D programs of Indian companies.

This finance has the following features:

- Eligibility: Export oriented firms with exports (actual or projected) of at least 20% of annual turnover.
- R&D finance is generally extended up to 7 years. However, longer tenors with suitable interest rates are considered on a case-to-case basis. A company can opt for our structured repayment option to match its cash flow.
- Upto 80% of the total project cost can be funded.
- Security to include, appropriate charge on the assets, corporate guarantee, charge/assignment on the regulatory approval/IPR, personal guarantee etc.

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 per cent ‘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 10 years are provided in exceptional cases. Credit is normally secured by a Bank Guarantee (BG).

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 Bank’s finance will have to establish the technical, economic and financial feasibility of their projects.

Export Project Cash Flow Deficit Finance (EPCDF)

'Export Project Cash Flow Deficit Finance' (EPCDF), is a type of fund-based facility provided by the Export Import Bank of India (EXIM Bank) to those Indian project export companies that are engaged in overseas turnkey projects, civil construction contracts, technical and consultancy service contracts as well as services. This financing facility which is either denominated in local currency or foreign currency enables the exporters to meet the short-term deficits arising out of mismatch of cash flows during the execution stage of the contract. Specifically, the funding is for covering the cost of acquisition/mobilization of equipment, materials, and personnel denominated in either home currency or host currency.

Project finance is basically funding of long-term infrastructure, industrial, power, telecom, road, railways, and other public service ventures where the cash flows originating from the project would be able to repay all the loans/equity. It is financed sequentially in various stages across the project lifecycle. Project financing is tricky as they have long gestation period when there are no cash inflows. Even after the cash inflows start pouring in, the magnitude of cash outflows is generally more than that of cash inflows. This creates negative cash flows at different points of time. This necessitates deficit financing at critical junctures during the execution phase of the project. In the absence of such deficit financing facilities, a project may be vulnerable for either time overrun, or cost overrun or both.

Project financing is unique in a sense because it is non-recourse in most of the cases. It means that lenders would get repaid from the cash inflows generated from the particular project only. In case the project fails for any reason whatsoever, then the lenders get paid back from the value realized from disposal of project assets. Sometimes, lenders may have limited recourse to the unencumbered assets of the parent company which is sponsoring the project. Other features of the project financing include: high capital intensity, highly leveraged (where debt equity may reach 6:1), long-term nature (15-40 years life), independent entity of a larger corporate with a limited life, multiple participants (more than 10 parties may be involved in project execution), and allocated risk (varied risks are identified and allocated across different stake-holders). Hence, EPCDF provided by the EXIM Bank during deficit scenarios comes in very handy, more so because of its local/foreign currency funding.

The reason why EXIM Bank provides funding in home currency also under this scheme is because of the fact that some of the Indian corporates are engaged in deemed project exports. In case of "Deemed Exports", the project execution is within the country and the payment for the same is collected either in free foreign exchange or in Indian Rupees. Alternatively, such deemed project exports should have been financed by either bilateral or multi-lateral agencies such as the World Bank group like IMF, IBRD, ADB, and IFC. The concept of deemed exports was launched in India as an instrument of import substitution during the economic liberalization of 1991. This was to provide a level-playing field for Indian exporters who are participating in a global tender for supplies within the national frontiers.

Finance for Export Oriented MSMEs

[7]The Interest Equalization Scheme (IES) came into effect on April 1, 2015, to provide exporters with pre and post-shipment export credit in rupees. To claim this benefit, an eligible exporter must submit a certification from an external auditor to the relevant bank. Banks offer Interest Equalization Scheme benefits to eligible exporters and claim reimbursement from the Reserve Bank of India depending on the exporter's external auditor’s certification. The initiative assists the targeted export sectors in becoming more internationally competitive and improving their export performance.

Since its inception in 2015, the Scheme (IES) has been a blessing to exporters, particularly MSMEs. Exporters benefit from lower capital costs under this system. According to industry assessments, the initiative has given a large number of SME exporters some breathing room after their operating capital shrank significantly as a result of the COVID-19 pandemic.

Given the escalating degree of Covid-induced problems for the exporting sector, the government has earmarked ₹ 1,900 crore for the scheme for FY22, up from ₹ 1,600 crore (updated estimate) for FY21. Notably, the RBI, on 8th March, 2022, extended the interest equalization policy for pre and post-shipment rupee loans for MSME exporters through March 2024. The RBI has also altered the scheme's tariffs. According to the RBI notification, the new interest equalization rates under the scheme will now be 3% for MSME manufacturer exporters exporting on any HS line and 2% for manufacturer exporters and merchant exporters shipping under 410 HS lines, excluding 6 HS lines of the telecom industry.

Role of EXIM Bank in Export Financing of MSMEs

EXIM Bank provides MSMEs with direct financing facilities across all the stages of the export cycle. On deferred payment terms, EXIM Bank also offers supplier’s credit and buyer’s credit for exports. SMEs that avail these facilities can explore new export markets and offer competitive credit terms to the overseas importers.

Special facilities include:

SME-ADB Line: EXIM Bank has arranged for a special credit line from the Asian Development Bank (ADB) for providing foreign currency term loans up to 7 years to the SME borrowers in certain states of India which are lagging behind. These inclusive term loans are denominated in foreign currency to meet domestic capital expenditure of the borrowers in addition to their forex capital expenditure

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[7] https://economictimes.indiatimes.com/small-biz/trade/exports/process/interest-equalisation-scheme-how-to-apply-for-loans-from-banks-at-concessional-rates/articleshow/91249501.cms
https://www.indiafilings.com/learn/modified-norms-of-interest-equalization-scheme-for-msme-exporters/#:~:text=Extension%20of%20Interest%20Equalization%20Scheme&text=The%20extension%20takes%20effect%20from,exporting%20under%20410%20HS%20lines.

requirements. This facility would help in enhancing competitiveness in the relatively backward states of India and help in integrating them into the mainstream economy.

Cluster financing of Indian MSME EOUs: EXIM Bank not only provides financial support to standalone EOUs in the MSME but also funds to 'Special Purpose Vehicles' (SPVs) of a cluster of MSMEs for the following activities:

- Development of new cluster/industrial park, involving creation & maintenance of common infrastructure and common facilities for the benefit of industrial units within the cluster/industrial park.
- Development of anew/upgradation of industrial estate, by industrial users, industry associations and/or Government bodies.
- Development of specific infrastructure, including common effluent treatment plant, captive power plant, transportation linkages, hazardous waste disposal.
- Development of Common Facilities Centers like testing centers, cold storages for industrial clusters, industrial estates, or a group of industries with common interests.

Technology & Innovation Enhancement and Infrastructure Development Fund (TIEID): EXIM Bank has set up a TIEID fund of $500 million exclusively for MSMEs to facilitate credit flow to the MSME sector at competitive rates. TIEID had partnered with FIs/banks so as to support MSMEs export competitiveness and globalization efforts.

Eligible MSME units would be those with a minimum export orientation of 10% of annual turnover or exports of ₹ 5 crore p.a. in absolute terms, whichever is lower. The loan should be used to meet long-term foreign currency loan requirements of Indian exporting entities in the MSME sector for meeting eligible capital expenditure viz., capacity creation, common infrastructure development like captive power plant, common effluent treatment plant, hazardous waste disposal facility, technology upgradation, testing facilities etc.

Lending Programme for Financing Creative Economy: EXIM Bank wanted to have a strong presence in the creative economy space of the MSME segment and rolled out a financing program specifically for the creative economy. These industries are those which have their origin in individual creativity, skill and talent and which have a potential for wealth and job creation through the generation and exploitation of intellectual property. This would go a long way in enhancing exports and provides a strategic focus to this sector.

Forfaiting

Forfaiting is a common form of financing export related receivables. Forfaiting is a method of trade finance that allows exporters to obtain cash by selling their medium and long-term foreign accounts receivable at a discount on a "without recourse" basis.[8]

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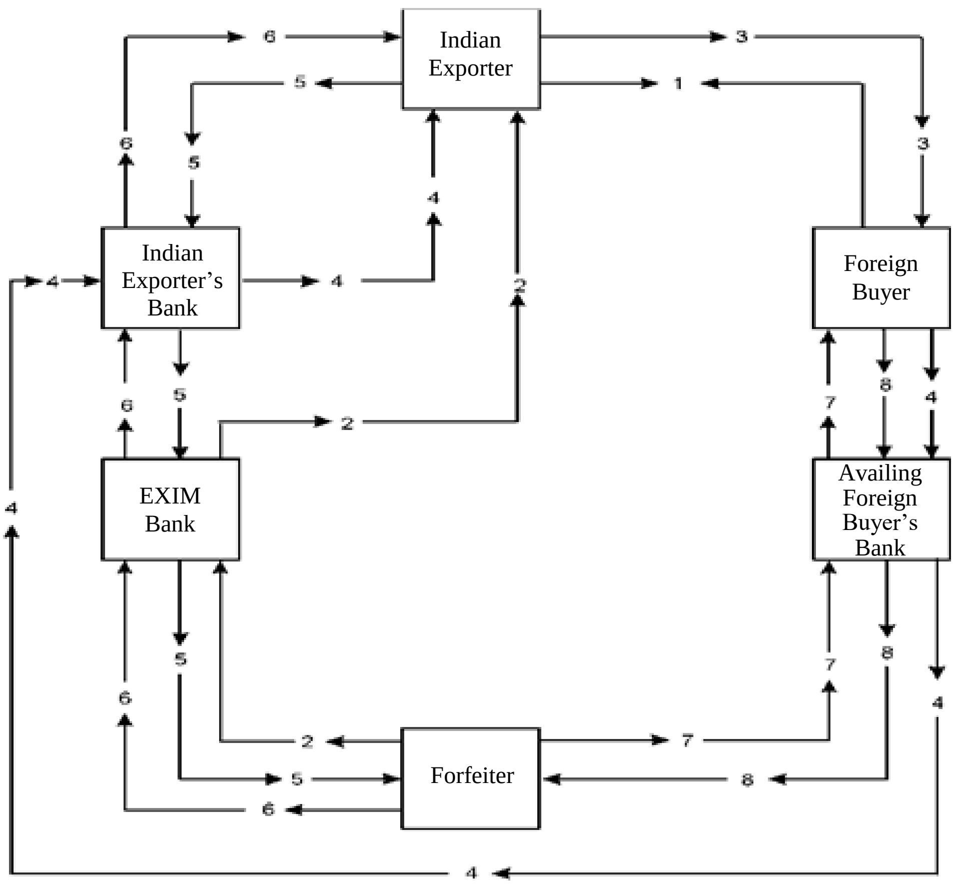
[8] https://www.export.gov/article?id=Trade-Finance-Guide-Chapter-11-Forfaiting

It is similar to Bill Rediscounting Scheme. EXIM Bank has introduced this scheme for Indian exporters. Under this scheme, the exporter after finalization of a sale (or contract) with a prospective buyer furnishes all the necessary details regarding the contract to 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 then hand over to the exporter the documents against the acceptance of the buyer and signature of 'aval[9]' or the guaranteeing bank. The exporter will thereafter submit documents to his/her bank to be forwarded to EXIM Bank which passes these documents to the forfaiting agency. Proceeds of the bills are passed from the overseas forfaiting agency to the exporter through EXIM Bank. The 'Authorized Dealers' are allowed to undertake forfaiting of medium-term export receivables.

The Figure 3.1 below portrays the flow of forfaiting transactions.

Figure 3.1: A Flow Chart of a Forfaiting Transaction



Source: ICFAI Research Center

[9] Concept of avalising: To avalize is the act of having a third party (usually a bank or lending institution) guarantee the obligations of a buyer to a seller per the terms of a contract, such as a promissory note or purchase agreement. The bank, by "avalising" the document (usually "by aval" will be written on the document itself), acts as a cosigner with the buyer in the transaction.

The above figure can be explained as follows:

1. Commercial contract between the foreign buyer and the Indian exporter.
2. Commitment to for fait 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.

Activity 3.1

As Export Import Bank of India (EXIM Bank) operates a comprehensive range of financing, advisory and support programs to promote and facilitate India's trade and investment, examine the role of EXIM Bank in providing marketing advisory services to enhance the international competitiveness of Indian companies.

Answer:

Export Advisory Services

A majority of products and services of Indian origin have vast export market potential. However, not many of these manufacturers/service providers have the general awareness. There are a variety of organizations in India both in public and private domain which cater to this need of corporates inclined towards tapping the global markets. These advisory services cut across arranging: Import Export Code Number (IECN), export incentives, export documentation, export packaging, export logistics, export regulation, deemed export benefits, export development, etc. Advisory firms have the knowledge and experience of different government regulatory agencies, individual national laws and regulations, business practices, cultural issues, and differing political and economic conditions. This depth and width of knowledge of international trade of export advisors in trade regulation of host nations, free trade agreements, global custom laws and regulations, and market entry strategies would guide corporate clients in:

a. Saving time and money
b. Attaining efficiencies
c. Staying regulatory compliant

As a result, Indian export-oriented companies can:

- Protect their privileges of exports through compliance
- Select "hubs" in nations with lowest custom duties and optimize costs
- Avoid reinventing the wheel by updating country-specific regulations which restrict their opportunities

Role of the EXIM Bank in providing 'Export Advisory Services'

Over the years, the EXIM Bank of India facilitated in creating a positive environment to support trade and investment in India. This was made possible because it had developed a network of alliance partners and a strong institutional connect with leading banks and financial institutions, trade and investment promotion boards, multilateral agencies, export credit agencies etc. The 'Export Advisory Services Group' [EAS] of EXIM Bank offers a wide range of information, advisory and support services. This helps exporters in assessing global risks, exploit international opportunities, and enhance competitiveness. As regards domestic project exporters, value added information and support services are provided on the projects financed by multilateral and bilateral agencies. Indian exporters have availed the customized research of the EAS group in the following areas:

a. Demonstrating market potential
b. Stating marketing arrangements
c. Describing channel partners
d. Planning export market entry
e. Facilitating accomplishment of global quality certification and
f. Displaying products in trade exhibitions and fairs

EXIM Bank also provides services includes market-related information, sector and feasibility studies, technology supplier identification, partner search, investment facilitation and development of joint ventures both in India and abroad. The bank also provides a package of information and support services to Indian companies to help improve their prospects for securing business in projects funded by the multilateral agencies specifically in the following sectors: construction, educational and information technology, energy, infrastructure, telecommunication, and transportation.

Example: African Continental Free Trade Area Presents Huge Opportunities for India, says EXIM Bank

A study by EXIM Bank titled "Building a Resilient Africa: Enhanced Role of India," exploring the opportunities for India in Africa was released in July 2022. The study claimed that there is was a huge trade complementarity between India and Africa. In 2021, India's total trade with Africa stood at $82.5 billion which is the highest level ever witnessed by both regions. This study using ITC's export potential methodology estimated the bilateral export potential of India and Africa at $ 48 billion. According to Harsha Bangari, managing director of EXIM Bank, India, the latent export potential of both India and Africa could be unlocked if the gaps in trade finance could be bridged. This could increase the share of both regions in global export participation.

Sources: i) https://economictimes.indiatimes.com/news/economy/foreign-trade/african-continental-free-trade-area-presents-huge-opportunities-for-india-exim-bank/articleshow/92989207.cms, dated: 19th July, 2022. (Accessed on 24th July, 2022)

ii) https://www.business-standard.com/article/economy-policy/cii-exim-bank-conclave-goyal-calls-for-deepening-trade-ties-with-africa-122071901275_1.html, dated: 19th July, 2022. (Accessed on 24th July, 2022)

[10]Export Oriented MSMEs and SIDBI Assistance Under Ubharte Sitaare Program

The Finance Minister of India, Smt. Nirmala Sitharaman, introduced the Ubharte Sitaare Programme (USP) during Budget 2021. The program which was launched in August 2021 aims to remove the barriers that small and medium-sized businesses encounter in attaining their export objectives. Along with SIDBI, India Exim Bank will serve as the Program's anchor. The 'Ubharte Sitaare Fund,' which was established in July 2021, was successfully registered with the Securities and Exchange Board of India (SEBI). India Exim Bank and SIDBI each contributed INR 40 crore. The fund's overall corpus is INR 250 crore.

The Process:

Companies with suitable technology, product, or method will be identified and will be supported by a combination of equity, financing and technical assistance. To enterprises with high export potential, this support can be extended even though they are underperforming.

Nature of Assistance – EXIM Bank

The Bank can help qualifying businesses by providing financial and consulting services through:

a) Financial assistance in the form of equity or equity-like instruments.

[10] https://www.eximbankindia.in/ubharte-sitaare#:~:text=The%20Ubharte%20Sitaare%20Programme%20(USP,of%20technology%2C%20product%20or%20process. Published 21 Aug 2021 (Accessed on 31 Dec 2023)
https://www.livemint.com/news/india/finance-minister-launches-ubharte-sitaare-scheme-for-export-oriented-msmes-11629555134446.html Published 21 Aug 2021 (Accessed on 31 Dec 2023)

b) Debt (funded / unfunded): Term loans for modernization, technology/ capacity enhancement, R&D and balancing of production facilities through investment in activities such as:
   i. Equipment and machinery;
   ii. Instruments, jigs and fittings;
   iii. Equipment for testing and quality control;
   iv. Land and building.

c) Technical Assistance (TA) for product adaptation and enhancement, certification costs, training expenses, market development activities such as abroad travel for product/market development, sector, market, and regulatory research, Techno Economic Viability (TEV) studies and so on.

Nature of Assistance – SIDBI

i. SIDBI Support for Export-Oriented MSMEs: The Ubharte Sitaare Programme scheme provides an appealing Return on Investment (ROI) and the loan will be approved fast.
ii. For greenfield units the Scheme limits promoter's contributions from 20% to 30%, respectively.
iii. SIDBI provides financial assistance through term loans and foreign currency term loans (FCTL).
iv. Under the Ubharte Sitaare Program, technical assistance for mentorship support and equity support is also provided. SIDBI additionally pays up to 25 bps performance or milestone-linked interest incentives to qualified entities.

Eligible Sectors:

Automobiles, Chemicals, Aerospace & Defence, Food Processing, Pharmaceuticals, IT & IteS, Textiles and allied sectors and precision engineering are identified as sectors with high export potential which are eligible for financial assistance under this Scheme.

Quantum, Mode, and Period of Assistance:

SIDBI provides need-based financial assistance for up to 80% of the project cost. Under the SIDBI Bharti Sitaare Programme, joint funding with EXIM Bank is also accessible. SIDBI provides financial assistance in the form of Term Loans/Foreign Currency Term Loans (FCTL). Term loans are made available to export-oriented MSMEs for the purposes of expansion, modernization, diversification, technology/capacity enhancement, product R&D, and investment in land and buildings, machinery and equipment, among other things. The interest rate will be based on the bank's MCLR / repo rate, plus any applicable margins (as per internal rating).

Under this scheme, SIDBI offers a repayment duration of up to 6 years, including a moratorium period of up to 2 years. The payback time might be extended for up to ten years.

3.3.2 Lending to Foreign Governments and Foreign Companies

There are different ways of lending to foreign governments and foreign companies as explained below:

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 (LC) or a Bank Guarantee (BG).

EXIM also provides buyer's credit under NEIA (National Export Insurance Account) for both traditional and new markets in developing countries.

Suppliers Credit

When credit is extended by the foreign supplier (seller) for import of goods into India instead of a bank or financial institution, it is called as 'Supplier's Credit'.

Lines of Credit

EXIM Bank also extends lines of credit to overseas governments or agencies nominated by them. This will 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.

The following provides you with information on the status of trade promotion program that has enhanced India's international trading activities.

The Export Import Bank (EXIM Bank) of India's Line of Credit (LOC) has been boosting India's international trade and project exports. Through this LOC Program, EXIM Bank plays an active role in supporting Indian project exporters to execute developmental projects in over 60 countries, which in turn is providing immense opportunities to Indian companies to demonstrate their project execution capabilities. Under the LOCs, on completion of specified milestones, payments are made to the Indian companies by EXIM Bank, based on the authorization of the borrower countries, thus guaranteeing payments to the Indian companies. As on Dec, 2022[11] a total of 273LOCs have been extended to various countries in Africa, Asia, Latin America, Oceania and the Commonwealth of Independent States (CIS), aggregating to USD 27.91 billion. Many Indian companies have executed and are executing projects valued around USD 7 billion under the Government of India's LOC. A minimum of 75% of goods and services need to be of Indian origin and must be procured from India. These 'Line Of Credit' (LOCs) are financial instruments that provide a risk-free, non-recourse export financing option to the Indian exporting community. The Indian Exporting Community, in turn, helps Indian companies to penetrate new markets and enhance their export volumes in overseas markets. Also, the Government of India has been supporting the development of partner countries through LOCs, under the Indian Development and Economic Assistance Scheme (IDEAS) [formerly

[11] https://www.eximbankindia.in/lines-of-credit-GOILOC.aspx

known as Indian Development Initiative (IDI)], and through the 'Development Partnership Administration Division'.

Associated supplies through sub-contractors are also increasing India's global trade and at the same time furthering the "Make in India" concept. They have commenced to generate additional employment in India.

It also offers a range of information, advisory and support services to Indian companies. This will make them effectively participate in projects funded by multi-lateral funding agencies such as the World Bank, Asian Development Bank, European Bank for Reconstruction and Development (EBRD).

Re-lending

An overseas bank can enter into a credit line agreement with EXIM Bank. The overseas bank would re-lend 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. The following details will give you a picture of how a mutual consent is agreed upon, between a buyer and seller that is drafted and cleared, using the 'Promissory Note' and 'Bill of Exchange'.

The template of Promissory Note and bill of exchange is given below (Figures 3.2 & 3.3).

Figure 3.2: Promissory Letter Template

Date:

On demand[12], I, [*borrower's name*] at [*borrower's address*], hereby promise to pay back, in full, the borrowed amount of [*borrowed amount*] plus interest, to [*lenders' name*] at [*lender's address*]. This money will be used for [*purpose of borrowed money*].

The first payment in the amount of [*amount*] plus [*%*] interest, must be paid by [*date of first payment*], and on the same date each month after, until the full amount is paid back, which must be no later than [*date when full amount is due*].

If I fail to pay back the borrowed amount by the agreed-upon date, [*lender*] will be entitled to [*%*] interest each month after that in addition to the interest already agreed upon. If I am unable to pay the interest or the owed amount, [*lender*] will be guaranteed [*goods or services*] worth [*amount of goods or services*].

If I miss a payment or am late for a payment, [*%*] more interest will be added onto the already agreed-upon interest rate.

Contd….

[12] In most of the cases, it is called demand promissory note, in which case, it starts with the wording ON DEMAND…

As the borrower, I am aware of the right to be informed that the note can be transferred by the lender to another party. The original terms and agreement will remain effective, but the debt will be payable to a different party, which will be agreed upon at the time of transfer.

Thank you for your cooperation.

Signed,

[borrower's signature]

[borrower's name]

[borrower's phone number]

[witness's signature]

[witness's name]

[witness's address and phone number]

[lender's signature]

[lender's name]

[lender's phone number]

Source: https://www.wikihow.com/Sample/Promissory-Letter-Template

Figure 3.3: Specimen Copy of a Bill of Exchange

DRAFT / BILL OF EXCHANGE

DRAWN UNDER LETTER OF CREDIT NO LC304/3610/12IC	ISSUEDAT AMSTERDAM. ON 04, FEBRUARY, 2022.
ISSUED BY COMMERZBANK AG FRANKFURT AM MAIN GERMANY.	EUR 100,000.00.

AT SIGHT PLEASE PAY AGAINST THIS THE ORDER OF OURSELVES THE SUM OF ONE HUNDRED THOUSAND EURO AND ZERO CENT ONLY.

DRAWEE:	DRAWER:
COMMERZBANK AG,	EXPORT HANDLE NV
FRANKFURT AM MAIN BRANCH	PO BOX 123 AMSTERDAM
GERMANY	HALAND
	(Signature / Stamp)

Source: https://www.letterofcredit.biz/wp-content/uploads/bill-of-exchange-sample.png

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

The re-lending facility will operate as follows:

a. The borrowing bank, upon its approval of a sub-loan to an importer, opens irrevocable Letters of Credit (LC) 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 INR 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.

3.3.3 Lending to Indian Banks

The following are the means of 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.

Given below is an innovative finance instrument as opined by the Chairman and Managing Director (CMD) of Export Import Bank of India. He suggests a funding mechanism to acquire or build ships by floating a Special Purpose Vehicle (SPV) in the forthcoming years to bring ease in shipping business.

Given below is an innovative finance instrument as opined by the Chairman and Managing Director (CMD) of Export Import Bank of India. He suggested a funding mechanism to acquire or build ships by floating a Special Purpose Vehicle (SPV) to bring ease in shipping business.

Check Your Progress – 1

1. Which of the following was year of inception of EXIM Bank?
   a. 1981
   b. 1982
   c. 1986
   d. 1984
   e. 1987

2. Which of the following documents is provided by a financial organization at the request of a buyer that envisages secure payment both in domestic and international trade?
   a. Letter of credit
   b. Bill of lading
   c. Certificate of origin
   d. Commercial invoice
   e. Consular invoice
3. Identify the financing mode that is not a form of equity contributor by Indian promoters in overseas investments.
   a. Technical know-how
   b. Capitalization of earnings such as royalty and management fees
   c. Cash remittances
   d. Capitalization of proceeds of exports in the form of plant and machinery
   e. Rupee term loans for financing equity contributions
4. What is the maximum period EXIM Bank can extend pre-shipment credit either directly or in participation with exporter's commercial banks?
   a. 180 days
   b. 360 days
   c. 120 days
   d. 90 days
   e. 150 days
5. Which of the following terms represents the sale of export receivables by an exporter to an overseas agency, usually guaranteed by bank, without recourse to the exporter?
   a. Re-lending
   b. Forfaiting
   c. Factoring
   d. Re-discounting
   e. Re-financing

3.3.4 Guarantees – Overseas Construction Projects

Guarantees are issued by EXIM Bank on behalf of exporters of turnkey projects[13] and construction contracts. Such guarantees include:

i. Bid bond guarantee
ii. Advance payment guarantee

[13] Turnkey projects are projects that involve equipment supply along with related services, like design, detailed engineering, civil construction, erection and commissioning of plants and power transmission and distribution.

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 per cent of contract value. 'Performance Guarantee' for 5 to 10 per cent 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 a contract. Up to 10 per cent of the contract value may be raised in foreign currency from a foreign bank against 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 ₹ 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 Indian software industry has been recording a decent export growth, including overseas presence, despite the moderation in the pace of global growth in the recent years. 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. [14]The schemes under project exports enable exporters to gain access to technical and consultancy services contracts that involve the provision of know-how, skills and personnel training. Typical examples of services contracts include project implementation services, management contracts, and supervision of erection of plants, CAD or CAM solutions in software exports, finance and accounting systems.

EXIM Bank provides 'Term Loans' or 'Deferred Payment Guarantees' to 100% 'Export Oriented Units', units in 'Free Trade Zones' and computer software exporters in collaboration with the International Finance Corporation[15].

[14] https://www.eximbankindia.in/project-export

[15] IFC is an institution that belongs to the World Bank Group and finances and advises for private-sector ventures and projects in developing countries. (https://www.globalnegotiator.com/international-trade/dictionary/international-finance-corporation-ifc/)

EXIM Bank provides loans to enable small and medium enterprises upgrade their export production capability, and offers facilities for deemed exports. Deemed exports are eligible for funded and non- funded facilities from EXIM Bank.

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 welcomes the association of commercial banks for providing working capital finance for software export projects assisted by it. [16]The bank provides refinancing facilities in the form of 'Term Loans' for computer software exports that enables commercial banks to extend finance for acquisition of imported and indigenous computer systems and project related assets.

Export and import transactions are governed by the EXIM policy and the RBI exchange control regulations.

While the EXIM policy regulates the movement of goods and services by prescribing the permissible exports and imports, the RBI regulations regulate the corresponding payments for these international transactions.

The following table illustrates the growth of India's total software service exports. It is as per the data survey report on 'Computer Software and Information Technology Enabled Services' exports conducted by RBI.

Table 3.1: Software Services Exports from India

Activity	**2020-21**			**2021-22**		
	₹ crore	**US$ billion**	**Share (%)**	**₹ crore**	**US$ billion**	**Share (%)**
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**
A. Computer Services	**6,47,908**	**87.3**	**65.3**	**7,90,992**	**106.2**	**67.8**
of which i) IT services	6,14,678	82.8	61.9	7,57,352	101.7	64.9
ii) Software Product Development	33,230	4.5	3.4	33,640	4.5	2.9
B. IT Enabled Services	**3,44,233**	**46.4**	**34.7**	**3,76,412**	**50.5**	**32.2**
of which: i) BPO Services	2,78,507	37.5	28.0	3,14,851	42.3	27.0
ii) Engineering Services	65,726	8.9	6.7	61,561	8.2	5.2
Total Export of Software Services (A+B)	**9.92.141**	**133.7**	**100.0**	**11,67,404**	**156.7**	**100.0**

Source: https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR840F6A458180D874C4C8CEF9 A5C3B64133F.PDF

While extending credit for any such trade, the banks need to make sure that the appropriate guidelines have been followed by the parties concerned.

[16] http://howtoexportimport.com/Financial-Assistance-from-EXIM-of-India-4611.aspx

3.4 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 USD, 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 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

The following are the foreign exchange transactions that are 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, traveller's 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' (NRIs), 'Persons of Indian Origin' (PIO) 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.

Permitted Currency

Exchange control has set out regulations governing permitted currencies. Methods of payment to be used for settlement of financial transactions between residents and non-residents through 'Authorized Dealers' (ADs).

'Permitted currency', as per the exchange control manual is a foreign currency which is freely convertible, i.e., a currency which is permitted by the rules and regulations of the country concerned to be converted into major reserve currencies like the US Dollar and/or the 'Pound Sterling' and for which a fairly active market exists for dealing against the major currencies.

[17]Authorized dealers should make remittances from India or reimburse their overseas branches and correspondents in other countries (other than Nepal and Bhutan) for payments owing for imports into India and other payments in accordance with the payment methods specified below.

Group	Permitted methods
i. All countries other than those listed under (ii) below	a. Payment in rupees from the account of a bank situated in any country in this Group b. Payment in any permitted currency
ii. Member countries in the Asian Clearing Union (except Nepal)	a. Payment for all eligible current transactions by debit to the ACU dollar account in India of a bank of the participating country in which is resident or by credit to the ACU dollar account of the authorized dealer maintained with the correspondent bank in the other participating country. b. Payment in any permitted currency in other cases

Source: https://www.rbi.org.in/scripts/ECMUserView.aspx?Id=19#ch2_1

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17 http://www.eximguru.com/exim/reserve-bank/foreign-exchange-control-manual/chapter-2-permitted-currencis-and-methods-of-payment.aspx
https://www.rbi.org.in/scripts/ECMUserView.aspx?Id=19#ch2_1

Note: In respect of imports, payment must be made in a currency appropriate to the country of shipment of the goods. In cases, however, where goods are shipped from an ACU member country (other than Nepal) but the supplier is a resident of a country other than a member country of ACU, payment can be made in the manner specified for countries in Group (i)

Importer Exporter Code Number

Every person / firm / company engaged in export business in India should obtain importer exporter code number from the Director General of Foreign Trade (DGFT) as required under the trade policy. IEC code is 10 digit number.

Exports

Export of goods is the most important foreign exchange earning activity of a country. The physical export of commodities is regulated by the offices of the Director General of Foreign Trade who may prohibit the export of certain commodities, stipulate that certain commodities be subject to license and prescribe minimum export price. Export of certain commodities might also be regulated by other statutes. The items eligible for exports and/or imports are announced through export-import policy announced by the Ministry of Commerce, GOI. Payment for exports is also regulated by FERA, 1973.

Declaration of Export Value: Under the exchange controls, it is obligatory for an exporter to declare the full export value of the goods or the value he expects to receive for the sale of goods to any place outside India other than Nepal and Bhutan. The forms in which declaration of exports to various destinations has to be made are prescribed by the Reserve Bank of India.

Export Declaration Form (EDF) / SOFTEX Forms: In order to simplify the existing form used for declaration of exports of goods / software, a common form called “Export Declaration Form” (EDF) has been devised to declare all types of export of goods from Non-EDI ports and a common “SOFTEX Form” to declare single as well as bulk software exports. The EDF replaced the earlier used GR/PP form used for declaration of export of goods. The procedure relating to the exports of goods through EDI ports (EDI: Electronic Data Interchange) will remain the same and SDF form will be applicable as hitherto. The EDF and SOFTEX forms have been given in Annexure I and Annexure II respectively.

RBI allows ‘Authorized Dealers’ (ADs) to grant permission to waive off the requirement of mandatory form EDF/SOFTEX as the transaction does not involve any commercial value. Relevant details are given below:

(a) Free sample towards business promotion

Exporters (non-status holders) may send goods on ‘free of cost basis’ for export promotion purpose up-to 2% of the average annual exports during preceding three financial years subject to a ceiling of ₹ 5 lakhs. For status holder exporters the ceiling is ₹ 10 lakhs or 2 per cent of the average annual export realization during the preceding three licensing years (April-March), whichever is higher. As an exporter only a request letter along with invoice will suffice to issue the above mentioned EDF waiver certificate subject to the adherence of the above mentioned amount/ percentage ceiling.

(b) Goods being exported for testing purpose

Cases where exporters send the goods to some foreign party / testing agencies for evaluation of their goods. Since there is no foreign exchange involved in this transaction they have to approach Authorized Dealers (AD) for issuance of the waiver certificate.

Exporter has to submit a request letter /invoice for issuance of such letter along with the declaration that the goods will be re-imported after testing or will be destroyed after testing. If the same will be destroyed then the customer has to declare that "they will submit the destruction certificate" from a certifying agency. This will be required by AD to close the contract.

(c) Goods being exported for repair / re-work / job work / replacement basis

Cases where the imported goods are found to be defective and customer requires them to be sent back to actual exporter / or their agent for repair / re-work / job work / replacement purpose. Since this does not involve any foreign exchange, AD can issue the certificate to send back the imported goods for above purpose.

Customer needs to submit request letter, invoice, proof of import, communication towards repair / re-work and a declaration that "the exporter shall produce relative bill of entry within one month of re-import" (declaration not required where replacement goods already received upfront). This will be required by AD to close the contract.

For cases where replacement goods have already been received by the customer upfront, then they have to produce 2 original BOE (Bill of Entry) to AD, i.e. one for actual import and another for replacement parts. In case the goods are to be sent to an agent rather than the one from whom the actual goods have been imported, the exporter needs to submit documentary evidence to AD to establish the business chain.

(d) EDF approval for trade fair / exhibitions abroad

Companies participating in trade fairs / exhibitions outside India can export goods and sell the same without approval from RBI, although they have to take approval from AD. AD can approve for such cases subject to following:

(i) Exporter needs to submit relative BOE (Bill of Entry) within one month of re-import into India for unsold goods.

(ii) Sale proceeds repatriated to India in accordance with the 'Foreign Exchange Management (realization, repatriation, and surrender of foreign exchange) Regulations, 2000.

Customers may also "gift" unsold goods in the trade fairs / exhibitions up to the value of US$ 5000 per exhibition / per exporter. Also they can sell the unsold goods with a discounted value (there is no such percentage ceiling).

Customer has to submit request letter, invoice, invitation letter from organizer, declaration to the above points during issuance of the approval letter from AD. Once the exhibition is over they have to produce all required documents pertaining to EDF regularization except FIRC (in case goods are not sold). Triplicate copy of BOE to be submitted in lieu of FIRC (Foreign Inward Remittance Certificate) to close the S.B / EDF. For cases where goods are gifted at the exhibition or sold at a discounted price; suitable declaration to be produced to AD with valid justification to close the contract.

(e) EDF approval for export of goods for re-imports

Cases where exporter exports some goods and found defective and they need to send replacement for the same.

Exemptions:

Some categories of exports are exempted from declarations on prescribed forms. They are as follows:

1. Trade samples supplied free of payment.
2. Personal effects of travelers, whether accompanied or unaccompanied.
3. Ships' stores, trans-shipment cargo and goods shipped on orders of the central government or the military, naval, air force authorities in India.
4. Goods for which RBI has waived such declaration.
5. Goods dispatched by air freight where sender declares that they are less than ₹ 10,000 in value, and that their dispatch does not involve any transaction in foreign exchange.
6. Parcels covered by a certificate issued by an AD that, the export does not involve any transaction in foreign exchange.

Payments

Full proceeds of payment for exports of goods from India must be realized on the due date for payment or within six months from the date of shipment of the goods whichever is earlier. However, if the goods are exported to a warehouse outside India, the period will be 15 months. The period of 6 months or 15 months, as the case may be, could be extended by RBI, if sufficient and reasonable cause is shown.

Payment for exports from India must be realized by approved methods of payment.

Consignment Exports

Where exports are made on consignment basis, the exporter continues to be the owner of the goods until they are sold in the overseas markets. The foreign consignee in such a case acts as the agent of the exporter for selling the goods. When the goods are sold, the consignee furnishes to the exporter an 'account sale' giving details of the sale proceeds realized and the various expenses incurred and remits the net proceeds to the exporter after adjusting his commission. In such cases, the AD should instruct the collecting bank / branch that the documents should be delivered only against a trust receipt / undertaking to deliver the sale proceeds within the period prescribed for the realization of export proceeds.

In view of the situation prevailing in the CIS countries (former USSR) and east European countries (formerly parts of COMECON) and with a view to supporting the revival and growth of India's exports to those countries, the time for realization of export proceeds has been increased. However, this will be done in consultation with the Government of India, in deserving cases and on application by the individual exporter with a satisfactory track record, to permit longer period upto 12 months on consignment basis to these countries.

Accordingly, it would be necessary for the individual exporters desirous of exporting goods to these countries on consignment basis, on credit terms extending beyond six months, to apply to the Reserve Bank of India for permission to realize export proceeds beyond six months even before the shipments are made.

Imports

Import of raw materials and/or capital goods is a major activity in international trade. These transactions require funding at some point of time. Generally all international trade transactions are covered under Letters of Credit or on confirmed order basis. The following paras explain how financing activities take place in imports.

Imports are mostly routed through Letters of Credit (LC). A LC is a non-fund based facility provided by the banks. Though LC, per se, is not a financing instrument, it is an important document which facilitates financing. Normally, exporters do not take up the transaction without LC being opened in their favour by the importer. LCs are a sort of guarantee for payment issued by the importer's banker. Let us understand the concept of LCs and important operational issues in imports.

Every importer has to obtain importer exporter code number from DGFT.

Import Letter of Credit: Payment for import of goods into India constitutes the major part of outgo of foreign exchange. Import of any type of goods is also regulated by the Government through the office of the Director General of Foreign Trade. Terms of payment to be made for imports are governed by FEMA, coupled with exchange control regulations.

Goods can be imported into India freely except to the extent such imports are regulated by the 'Negative List'[18] of imports or any other law for the time being in force. In such cases of an importer not willing to pay cash in advance and demanding for credit terms, the Letter of Credit (LC) offers the greatest degree of safety to the exporter. If the importer is a new customer for the exporter, or if there are exchange rate regulations in the importer's country, the exporter, in order to sell the goods, may require the importer's promise of payment backed by a foreign or a domestic bank. The importer may also be not certain about the exporter until he/she receives the merchandise. Thus, the LC satisfies the needs of both the exporter and the importer.

Therefore, a LC is a letter addressed to the seller, written and signed by a bank, acting on behalf of the importer / buyer. Here, the bank promises that it will honor drafts drawn on its name, if the seller conforms to the specific conditions set forth in the LC. Through a LC, the bank substitutes the buyer's commitment with its own commitment to pay the customer.

ADs are permitted to open Letters of Credit (LCs) on behalf of their customers, subject to the normal banking procedures and other provisions. However, ADs are not allowed to open Letter of Credit or remit for import of goods included in the restricted list unless the importer submits a license marked 'For Exchange Control Purposes'.

Letters of Credit (LCs) can be opened by ADs against specific licenses or OGLs, only on behalf of their customers, who maintain accounts with them and are known to be participating in the trade. LCs should not be opened in favor of importer himself or his nominee. Without RBI's approval, LCs should also not be opened in favor of overseas buying agents of importers. LCs should not be opened by ADs against guarantees offered or margins deposited by third parties.

Before opening LCs, the underlying sales contract in original should be verified. In the absence of a sale contract, ADs may accept any of the undernoted documents:

a. Order together with the confirmation of overseas supplier.
b. Pro forma invoice of overseas supplier duly countersigned by importer.
c. Indent/offer from overseas supplier or his agent.

LCs must provide for payment against delivery of shipping documents.

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[18] Negative list consists of goods, the import or export of which is prohibited, restricted through licensing, or canalized

Opening of revolving LCs should as far as possible be avoided. However, in exceptional cases they may be opened with adequate safeguards / conditions subject to trade controls, particularly with reference to aggregate drawings under LCs and shipment dates.

The CIF value of import licenses does not include premium for war risk insurance. LCs can therefore, be opened for the CIF value of the license, plus any amount required to meet the cost of war risk premium.

A statement to this effect must be made by the AD on Form A1, to be forwarded to the RBI covering the remittance.

ADs may make remittances in excess of the CIF value of the import license where the excess payment is solely on account of:

i. Increase in freight charges, banker's surcharges or congestion surcharges at foreign ports, subsequent to the placement of firm orders by importers.

ii. Adverse fluctuations in exchange rates taking place after irrevocable LCs were opened or, if no LC was opened after shipment.

iii. A shortfall in the license in spite of (ii) above.

Advance Remittances: Advance remittances against goods to be imported into India are permitted. However, in case of import of capital goods, it is restricted to 15% of the value. In addition to the above ceiling, advance remittances are allowed subject to the following conditions:

a. Order placed by the importer and demand by the overseas supplier for advance payment has to be verified.

b. Remittance should be made direct to the suppliers.

c. The importer should hold the EC copy of a valid import licence, if the goods to be imported are those included in the negative lists of imports given in the EXIM policy.

d. Guarantee from an international bank of repute situated outside India should be obtained, if the amount of advance exceeds US$ 15,000.

e. Physical import of goods should be made within 3 months (12 months in case of capital goods) from the date of remittance.

f. Evidence regarding the terms of payment to the supplier, in case of import of capital goods should be submitted.

g. List of books to be imported **-** in case of import of books, should be obtained.

Payment for Imports: Payments to retire import bills, either under LC or on collection basis should be debited to the account of the importer with the AD or by means of a crossed cheque drawn by him/she on his/her other bankers.

Payments against bills should not be accepted in cash. Even in the case of private imports, if the amount involved is ₹ 20,000 or more, the above procedure is to be followed.

The payments for imports into India must be made within six months from the date of shipment in the case of "cash" licenses. In case, settlement is delayed on account of disputes, financial difficulties, etc., remittances can be made even after the period of six months, provided:

a. Authorized Dealer is satisfied about bona fides of the circumstances leading to delay in payment.

b. No payment of interest is involved for the delayed period.

In the case of import documents negotiated under LCs, if reimbursement was given to overseas banks within six months from the date of shipment and even if the documents are retired by the importer after expiry of six months, the payment is considered to be in order. However, all cases of extended payments require RBI's approval.

Attestation of Invoices

Under customs regulations, importers have to submit to the customs authorities at the time of clearance of goods, a copy of the invoice attested by the AD through whom remittance has been / will be made, as corroboratory evidence of the value of the goods declared in the customs bill of entry.

ADs can freely make remittances against documentary bills received for collection in respect of imports by sea or air freight. In respect of clean bills, either the importer must produce "Exchange Control", copy of 'Customs Bill of Entry', or if goods have not arrived, he/she must produce documentary evidence that the goods for which remittance is required to be made have been shipped. The imports must, of course, comply with trade control regulations.

Example: USD 40 million LoC to the Government of the Republic of Maldives for the Development of Sports Infrastructure

Beginning on February 8, 2022, the line of credit (LoC) to Maldives will be in operation. The terminal utilisation period would be 60 months as per the LoC. Exports of qualified products and services from India would be permitted under the terms of this agreement, and Exim Bank fund the purchase. A minimum of 75% of the contract price in goods, works, and services must be supplied by the seller from India in order to receive the full amount of Exim Bank's credit under the terms of the agreement. The remaining 25% of the goods and services for all eligible contracts may be purchased by the seller from foreign sources.

Source: https://www.rbi.org.in/scripts/FS_Notification.aspx?Id=12232&fn=5&Mode=0, dated: 17th February, 2022. (Accessed on 25th July, 2022)

Activity 3.2
The forex market in India is regulated by the Reserve Bank of India Act, 1934 that deals with authorized money changers and dealers in the foreign exchange transactions. List down the regulatory controls related to forex transactions. **Answer:**

3.5 Investment Opportunities in India

In fast growing countries like India, domestic capital may be inadequate and many a time, technology support along with financial support may be required. In such situations, foreign investment fills the gaps in management, entrepreneurship, technology and skills. Forms of foreign investment include 'Foreign Direct Investment' (FDI) and 'Foreign Portfolio Investment' (FPI).

India encourages FDIs and acknowledges its importance as an economic growth driver. Foreign Institutional Investors (FIIs) are allowed to operate in the stock and bond markets. However, they are perceived to be short-term players chasing interest rates and hot money. FDIs on the other hand are considered as long-term players who bring into India, investment funds, technology and management skills. (Refer Figure 3.4)

Figure 3.4: Investment Opportunities in India

Source: ICFAI Research Center

An overseas corporate can enter into India either to open a liaison office or branch office or project office. They are permitted to set up wholly owned subsidiary companies subject to FDI guidelines. They are permitted to source funds both local and foreign either through equity or debt, and internal accruals. They have to abide by the Indian transfer pricing regulations. However, there are no restrictions on repatriation of dividends.

Foreign companies can also set up joint ventures in India with Indian partnership. The laws applicable to domestic companies are equally applicable to them.

Example: India Recording Highest Ever FDI in 2020-21 Indicating Rising Investment Opportunities

With an annual inflow of $ 81.97 billion, India has recorded the "highest ever" annual FDI (foreign direct investment) 2020-21. This proved that India is one of the most preferred destinations for foreign investments. When compared to 2020–21 ($12.09 billion), FDI equity inflow in the manufacturing sector has increased by 76 percent in 2021–22 ($21.34 billion).

The global FDI recovered to pre-pandemic levels in 2021, reaching about $1.6 trillion, but this is unlikely to be sustained in 2022, according to UNCTAD (United Nations Conference on Trade and Development). But according to the famous Management Guru Ram Charan, India has got a great growth opportunity and will receive a lot of FDI.

Sources: i) https://www.business-standard.com/article/markets/fdi-inflow-at-all-time-high-of-83-57-bn-in-2021-22-led-by-manufacturing-122052001043_1.html, dated: 20th May, 2022. (Accessed on 25th July, 2022)
ii) https://economictimes.indiatimes.com/news/international/business/ukraine-war-to-hit-foreign-direct-investment-un/articleshow/92108548.cms, dated: 9th June, 2022. (Accessed on 25th July, 2022)
iii) https://www.businesstoday.in/opinion/interviews/story/india-is-a-good-growth-opportunity-will-receive-a-lot-of-fdi-dr-ram-charan-342488-2022-07-23, dated: 25th July, 2022. (Accessed on 25th July, 2022)

3.6 Regulatory Environment

All foreign exchange transactions have to be conducted within the defined regulatory framework.

The following paras discuss the general provisions in a regulatory framework.

The regulatory framework governing Foreign Direct Investment (FDI) and Foreign Portfolio Investments (FPI) in India consists of various Acts, regulations, and regulatory bodies.

Government of India has framed three distinct policies namely, Foreign Direct Investment (FDI), state policies and EXIM policies.

Effective from 7th June 2016, a consolidated FDI policy has been enunciated, with a view to attract and promote FDI in order to supplement domestic capital besides accessing technology and human skills so that growth could be accelerated.

Certain sectors are prohibited from accessing FDI funds. They are lottery business, gambling and betting including casinos, chit funds and ‘Nidhi’ companies trading in 'Transferrable Development Rights' (TDRs), real estate business or construction of farmhouses, manufacture of cigars and other tobacco products.

Additionally, the following activities which are not open to private sector are also not open to the FDI route: atomic energy and certain railway operations.

3.6.1 Permitted Sectors

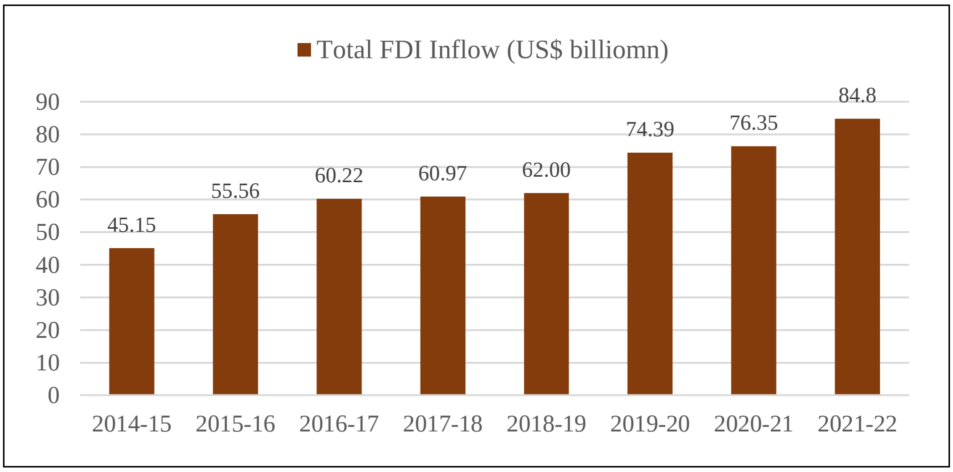
The following sectors are allowed 100% FDI access under automatic route: agriculture and animal husbandry, mining, petroleum and natural gas, coal and lignite.

The Government of India has approved 100 per cent FDI in other financial services carried out by Non-Banking Finance Companies (NBFCs), which is expected to attract more foreign capital into the country.

The government has allowed 100 per cent FDI in Asset Reconstruction Companies (ARC) under automatic route, which will help to tackle the issue of declining asset quality of banks. The Government of India has amended the FDI policy regarding construction development sector. The amended policy includes easing of area restriction norms, reduction of minimum capitalization and easy exit from project.

The Government of India has recently relaxed FDI policy in 15 sectors, such as raising the foreign investment limit for some sectors, easing the conditions for others and putting many on the automatic route for approval. The sectors that benefited from the relaxation include defence, real estate, private banking, civil aviation, single brand retail and news broadcasting. The new rules provide for easier exit from investment in the construction sector while foreign investment limit in defence and airlines was allowed up to 49 per cent through the automatic route. Banks were allowed fungible FDI investment up to 74 per cent, which means that FII investment in private banks can rise to this limit.

Figure 3.5: FDI Inflow in India 2014-2022



Source: https://dpiit.gov.in/sites/default/files/FDI_Factsheet_March_2022_23May2022.pdf

3.6.2 State Policies

Individual states are free to enunciate their own industrial policies and Public Private Partnership (PPP) policies. Even union territories have this privilege.

3.6.3 EXIM Policies

This is otherwise called Foreign Trade Policy (FTP). Under this policy, certain sectors receive interest subvention benefits, zero duty benefits, incentives for promoting labour incentive units, encouragement for manufacturing sector in domestic markets, etc. The government had unveiled an action plan in May 2011 for doubling India's merchandise exports to US$ 500 billion. For achieving this objective, the following strategies have been enunciated.

- Developing products with a considerable growth potential
- Market diversification strategy
- Nurturing high technology exports and
- Building brand India

The exhibit below shows the initiatives of Ministry of Commerce and Industry in furtherance of international trade in 2021-22.

Exhibit 3.1: India's International Trade in 2021-22

India's merchandise export stood at USD 263.3 billion during April-October, 2022-23 as compared to USD 234.0 billion during the period April-October, 2021-22, registering a positive growth of 12.6%.

India's services export stood at USD 181.39 billion during April-October, 2022-23 as compared to USD 138.01 billion during the period April-October, 2021-22, registering a positive growth of 31.43%.

India's overall export (Merchandise plus Services) increased to US$ 444.74 billion during April-October, 2022-23 as compared to USD 371.98 billion during the period April-October, 2021-22, registering a positive growth of 19.56%.

India-UAE CEPA which came into force on 1st May, 2022 to help increase bilateral trade from the current USD 60 bn to USD 100 bn in the next 5 years.

India and Gulf Cooperating Council (GCC) announce the intent to pursue negotiations on the India-GCC FTA.

India-Canada CEPA negotiation re-launched on the side-lines of 5th India-Canada MDTI (Ministerial Dialogue on Trade and Investment) with the possibility of EPTA (Early Progress Trade Agreement).

Contd….

India actively engaged in bilateral FTA negotiations including in trade in services with the UK, Canada, the EU and Israel.

- **Districts as Export Hubs -** Department of Commerce through Directorate General of Foreign Trade is working with the States and the districts to channelize the potential and diverse identity in each district of our country to make them export hubs.
- **Rupee Trade -** The Directorate General of Foreign Trade (DGFT) had amended the Foreign Trade Policy, to allow for International Trade Settlement in Indian Rupees (INR) i.e., invoicing, payment, and settlement of exports / imports in Indian Rupees.
- **New Foreign Trade Policy -** The government has received requests from Export Promotion Councils and leading exporters that we should continue with current Foreign Trade Policy (2015-20), which had been extended from time to time.
- **SCOMET – India's Export Control Framework -** SCOMET (Special Chemicals, Organisms, Materials, Equipment and Technologies) is India's National Export Control List of dual use items - munitions and nuclear related items. The SCOMET List has been notified by DGFT under Appendix 3 to Schedule 2 of ITC (HS) Classification of Export and Import Items.
- **NIRYAT Portal -** In order to supplement the offline monitoring of export performance, a real time online monitoring system for the designated export target (for 200 countries/territories by 31 commodity groups), via a digitized data-driven framework for facilitating timely policy making/ interventions in international trade, the DoC has developed a portal - NIRYAT (National Import-Export Record for Yearly Analysis of Trade).
- **Developments in Plantation Sector –** Digital platforms have been launched for ease of doing business in Tea, Coffee and Spices.

Source: https://pib.gov.in/PressReleseDetail.aspx?PRID=1884123; dated 7th Feb, 2023

3.6.4 Special Economic Zones

[19]India set up its first Export Processing Zone (EPZ) in Kandla in 1965. The Special Economic Zones (SEZs) Policy was formed in April 2000 to address the weaknesses caused by the complexity of rules and clearances, the lack of world-class infrastructure and an unstable fiscal framework, as well as to attract larger foreign investments in India.

This program aimed to make SEZs an engine of economic growth, supported by high-quality infrastructure and complimented by an appealing fiscal package at

[19] http://sezindia.nic.in/cms/introduction.php
https://pib.gov.in/PressReleasePage.aspx?PRID=1703791
http://sezindia.nic.in/upload/637c92e65675eNew%20FACT%20SHEET.pdf

both the federal and state levels, with the fewest regulations possible. SEZs in India operated under the provisions of the Foreign Trade Policy from 1.11.2000 to 09.02.2006, and fiscal incentives were made effective by the provisions of applicable statutes.

To provide stability to the SEZ regime, which would foster increased economic activity and employment through the creation of SEZs, Parliament passed the Special Economic Zones Act, of 2005 in May of that year. The SEZ Act, 2005, accompanied by SEZ Rules, became effective February 10, 2006, allowing for simplification of procedures and single-window approval on subjects pertaining to both the central and state governments.

The following are the key features of the SEZ scheme:

1. A designated duty-free enclave that will be considered as a territory outside of India's customs area for the purposes of authorized SEZ operations.
2. Importing requires no license.
3. Both manufacturing and service activities are permitted.
4. Positive Net Foreign Exchange shall be achieved by the Unit over a five-year period beginning with the commencement of production.
5. Domestic sales are subject to full customs charges and the current import policy.
6. Subcontracting will be permitted in SEZ units.
7. Customs authorities do not routinely inspect export/import cargo.
8. SEZ Developers/Co-Developers and Units are eligible for tax breaks allowed by SEZs Act, 2005.

Before the SEZs Act, of 2005, was enacted, there were seven Central Government Special Economic Zones (SEZs) and twelve state/private sector SEZs. Furthermore, 425 proposals for the establishment of SEZs in the country received legal approval under the SEZ Act of 2005. By 22 November, 2022, 424 SEZs were approved, 376 SEZs were notified, and 270 of them were operational. The number of units approved in SEZs as on 30th June, 2022 was 5,620.

The investment details of SEZs are as follows:

Investment	**Investment (As of February 2006)**	**Incremental Investment**	**Total Investment (As of 30th June, 2022)**
Central Government SEZs	₹ 2,279.20 cr.	₹ 21,006.85 cr.	₹ 23,286.05 cr.
State/Pvt. SEZs set up before 2006	₹ 1,756.31 cr.	₹ 11,706.61 cr.	₹ 13,462.92 cr.
SEZs Notified under the Act	-	₹ 6,09,036.21 cr.	₹ 6,09,036.21 cr.
Total	₹ 4,035.51 cr.	₹ 6,41,749.67 cr.	₹ 6,45,785.18 cr.

The employment details of SEZs are as follows:

Employment	Employment (As of February 2006)	Incremental Employment	Total Employment (As of 30th June, 2022)
Central Government SEZs	1,22,236 persons	73,039 persons	1,95,275 persons
State/Pvt. SEZs setup before 2006	12,468 persons	97,656 persons	1,10,124 persons
SEZs Notified under the Act	0 person	25,01,857 persons	25,01,857 persons
Total	1,34,704 persons	26,72,552 persons	28,07,256 persons

Example: FDIs from Border Sharing Nations – The New Regulation

To avert any possibility of taking advantage of the economic situation when the COVID-19 pandemic, the government tweaked the FDI policy on April 18, 2020. This was to prevent the opportunistic takeover of loss-making Indian companies by foreign firms during such times. This made prior government approval mandatory for foreign direct investments (FDI) from countries that share land borders with India. Earlier, some of these proposals in non-critical sectors could be cleared under the automatic route. Since the new law, out of the 388 proposals received from the border-sharing nations, the GOI has approved only 80 by 29 July 2022.

Sources: i) https://www.business-standard.com/article/markets/fdi-inflow-at-all-time-high-of-83-57-bn-in-2021-22-led-by-manufacturing-122052001043_1.html, dated: 24th July, 2022. (Accessed on 25th July, 2022)
ii) https://economictimes.indiatimes.com/news/economy/finance/nod-for-80-fdi-proposals-from-china-entities/articleshow/92685606.cms?from=mdr, dated: 6th July, 2022. (Accessed on 25th July, 2022)

Activity 3.3

Is there any specific difference between FIIs and FDI? Discuss.

3.7 International Financial Centre (IFC)

Usually, financial institutions operate within the framework of rules and regulations under which these institutions are permitted to operate. The operational area of any financial institution is a defined one.

Financial centres that cater to customers outside their own jurisdiction are referred to as International Financial Centers (IFCs) or Offshore Financial Centers (OFCs). All these centres are ‘international’ in the sense that they deal with the flow of finance and financial products / services across borders.

The Monetary and Exchange Affairs Department of the International Monetary Fund in its working paper defines an 'International Financial Services Center / Offshore Financial Centre' as under:

Amongst the many definitions of Offshore Financial Centers (OFCs), perhaps the most practical one characterizes OFCs as centers where the bulk of financial sector transactions on both sides of the balance sheets are with individuals. The others are companies that are not residents of OFCs, where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents.

IFC is home to a cluster of nationally or internationally significant financial service providers such as banks, investment managers or stock exchanges. This is also called global financial center or a global city. Prominent international financial centers are London, New York City, Hong Kong, Singapore, Tokyo, Seoul, Zurich, Toronto, San Francisco and Washington DC. These are the top 10 ranked centers. Different centers operate under different legal, tax and regulatory environments. For example, Amsterdam is known for pension fund market and banking and trading activities. Chicago is famous for derivatives market and Dubai is known for Islamic finance, Dublin is the home for diverse financial services.

The acronym IFC is also used for International Finance Corporation, a sister organization of World Bank. IFC is a sister organization of the World Bank and member of the World Bank Group—is the largest global development institution focused exclusively on the private sector in developing countries.

3.7.1 Functions of IFC

International Finance Corporation (IFC) performs different functions. Some of the important functions are explained hereunder.

- Pooling funds to act as portals for efficient collective investment into and out of the major countries,
- Funds do not stay in IFCs, of course - their markets are too small and underdeveloped to absorb the capital flows. Therefore, investment is redirected to onshore markets to procure funds for effective collective investment flows, in and out, of the major countries,
- Such funds are not retained but are redirected to onshore markets. The reason being their markets are too small and undeveloped to absorb capital flows into it,
- Facilitating the management of pension assets, promoting consumer choice and competition. This can result in reducing costs, enhancing investment returns and facilitating investment diversification; and facilitating pension assets management through promoting consumer choice and competition,

- This helps in reducing the costs, enhancing investment returns and facilitating investment diversification,
- Encourage allowing companies to manage sudden risks, like foreign exchange fluctuations,
- Provision of insurance and reinsurance facilities to meet for onshore risks, and
- Provision of liquidity to markets, lowering the cost of capital to business.

3.7.2 International Financial Centres (IFC) Forum

Various offshore financial centres have joined together to set up IFC forum as a multi-jurisdictional private sector organization. IFC acts as a knowledge base and coordinator for various offshore financial centres.

3.7.3 Offshore Financial Center (OFC)

An Offshore Financial Center (OFC) is a small low-tax jurisdiction specializing in providing corporate and commercial services to non-residents in the form of offshore companies and the investment of offshore funds. Many offshore finance centers are regarded as tax heavens.

Example: The Global Financial Centers Index - GFCI Ranking

Centre	GFCI 31 Rank	GFCI 31 Rating	Rank (+/-)	Rating (+/-)	Region
New York	1	759	0	-3	North America
London	2	726	0	-14	Western Europe
Hong Kong	3	715	0	-1	Asia/Pacific
Shanghai	4	714	2	1	Asia/Pacific
Los Angeles	5	713	2	1	North America
Singapore	6	712	-2	-3	Asia/Pacific
San Francisco	7	711	-2	-3	North America
Beijing	8	710	0	-1	Asia/Pacific
Tokyo	9	708	0	2	Asia/Pacific
Shenzhen	10	707	6	8	Asia/Pacific
Paris	11	706	-1	1	Western Europe
Seoul	12	705	1	3	Asia/Pacific

Source: https://www.longfinance.net/programmes/financial-centre-futures/global-financial-centres-index/gfci-31-explore-data/gfci-31-rank/, dated: 24th March, 2022. (Accessed on 26th July, 2022)

Activity 3.4 Correlate International Finance Corporation with Offshore Financial Centers (OFCs). **Answer:**

3.8 Offshore Banking Units (OBU)

An Offshore Banking Unit (OBU) is an innovative banking activity which facilitates the intermediary activity between overseas savers and borrowers.

The following paras provide operational issues related to OBUs.

An OBU is a financial service unit (normally a branch or subsidiary of a non-resident bank), which plays an intermediary role between non-resident borrowers and lenders. Generally, an OBU is located in an international financial center or in Special Economic Zones – as in the case of India. Very selected OBUs are there in our country.

OBUs can be opened in the SEZs with the permission of Government of India. These units are almost like foreign branches of Indian banks. The only difference is their location is in India. These OBUs would be exempt from statutory pre-emptions like CRR and SLR. They give access to SEZ units and SEZ developers to international finance at international rates.

Banks operating in India - public, private or foreign banks - are entitled to carry out foreign exchange dealings and are qualified for establishing OBUs. Banks having overseas branches and possessing appropriate experience in running OBUs are given preference. The eligible banks are given permission to set up an OBU, i.e., only one. They have to obtain prior permission from RBI for opening an OBU in SEZ areas. Foreign currency funds should be accessed by the OBUs only from external sources. However, funds from resident sources subject to their compliances are permitted under the existing exchange control regulations to maintain foreign currency accounts abroad. Deployment of funds would be restricted to lending to units located in the SEZ and SEZ developers. In fact, large companies within the local domestic area can meet their foreign currency requirements with the service of OBUs. This is subject to their compliance with the relevant exchange control regulations.

The OBUs are expected to follow the best international practices with regard to asset classification, income recognition and provisioning. The parent bank has to prescribe credit risk management policy and exposure limits for their OBU. The liquidity and interest rate risk management policies as applicable to overseas branches of Indian banks are applicable to OBUs as well. Comprehensive overnight limits for each currency have to be fixed by the banks' boards. It is a statutory obligation on the part of OBUs to strictly follow "Know Your Customer Norms" (KYC norms) and anti-money-laundering instructions issued by RBI from time to time. OBUs are prohibited from undertaking cash transactions and transactions with individuals.

OBUs will be regulated and supervised by the RBI to whom they have to report the relevant information.

3.8.1 Ring Fencing the Activities of OBUs

OBUs operate and maintain balance sheets only in foreign currency. They are not allowed to operate in Indian currency. However, they are allowed to have a special rupee account out of convertible funds, to meet their day- to-day expenses. They can't participate in domestic markets like call market, notice money market, term money market, etc. They are not part of the domestic payment system. They are permitted to maintain separate Nostro accounts with the correspondent banks. These are distinct from the Nostro accounts maintained by other branches of the same bank. 'Loans and Advances' of OBUs would not be reckoned as net bank credit for computing priority sector lending requisites. Deposits of OBUs will not be covered by the deposit insurance scheme.

State Bank of India (SBI), India's largest bank, set up its OBU (Offshore Banking Unit), in the SEZ (Special Economic Zone) in Kochi on April 17, 2004. This is SBI's first OBU. This is in addition to its first offshore banking unit set up in SEZ, Mumbai which was opened on July 17, 2003.

Private sector lender, Axis Bank opened offshore banking unit at the International Financial Services Centre (IFSC) at Gujarat International Finance Tec-City (GIFT City) in Feb 2018.

The offshore banking unit is capable to trade in foreign currency in overseas markets and also with Indian banks, raise funds in foreign currency in deposits and borrowings from non-residential sources and provide loans and liabilities products for clients.

Example: Growing Offshore Banking Units in GIFT City

As Banking Units in the GIFT City are mandated to maintain neither the Capital Reserve Ratio nor the Statutory Liquidity Ratio, many banks are setting up their Offshore Banking Units (OBUs) and International Banking Units (IBUs) in it. In January 2021 Global financial services major HSBC inaugurated its International Banking Unit (IBU) in GIFT City.

Contd….

In August 2021, German banking major Deutsche Bank got approval to set up an IFSC-Banking Unit (IBU) at GIFT. IFSC becoming the 17th IBU to operate there. In April 2022, an international banking unit was launched by the Punjab National Bank (PNB) at GIFT City in Gujarat.

Sources: i) https://www.livemint.com/opinion/online-views/ifsc-gift-city-unlocking-potential-for-financial-services-11638782203187.html, dated: 6th December, 2021. (Accessed on 26th July, 2022)
ii) https://www.business-standard.com/article/companies/hsbc-inaugurates-international-banking-unit-at-gift-city-in-gujarat-121012601041_1.html, dated: 26th January, 2021. (Accessed on 26th July, 2022)
iii) https://www.thehindubusinessline.com/money-and-banking/deutsche-bank-to-start-ifsc-banking-unit-at-gift-city/article35874725.ece, dated: 12th August, 2021. (Accessed on 26th July, 2022)
iv) https://www.cnbctv18.com/finance/pnb-opens-international-banking-unit-at-gift-city-in-gujarat-13097742.htm, dated: 12th August, 2021. (Accessed on 8th April, 2022)

3.9 Gujarat International Finance Tech City (GIFT)

Several developed countries have successfully established high-tech financial hubs, which over time have catered as international financial services centers. These centers provide suitable regulatory regimes and create a business environment to promote talent and increase capital flow. Keeping this idea as a trigger point Gujarat International Finance Tech City (GIFT) was proposed to cater to India's large financial services potential by offering global firms a world-class infrastructure and facilities to attract the top talent in the country by providing the finest quality of life.

GIFT has been commissioned to serve India's large financial services potential by offering global firms, a world class infrastructure and facilities. It aims to attract the top talent in the country by providing the finest quality of life. The GIFT location is 12 kilometers from the Ahmedabad international airport and 8 kilometers from Gandhinagar. Its total land area is 273 hectors and total built-up area is 62 million square feet split into commercial, residential and social space.

GIFT has been promoted by Gujarat Urban Development Company Limited (GUDCL) and Infrastructure Leasing and Financial Services Limited (ILFS) as a 50:50 joint venture company. Its business structure includes multi-service SEZ, domestic finance center along with associated infrastructure, housing and social facilities. SEZ provides fiscal incentives, regulatory freedom and supportive infrastructure leading to increased investment, increased exports, large-scale developments, and low cost manufacturing hubs, employment generation for skilled and unskilled workforce. GIFT aims at intelligent urbanization through efficient, safe and smart buildings and green buildings.

GIFT is a public-private partnership unit. The proposed infrastructure includes water, power, ICT, solid waste management, cooling system and transport. The management consists of chairman, a nominee of the Government of Gujarat, a managing director, and three independent directors and three nominee directors from Gujarat apart from nominee directors of IL and FS Limited.

Example: GIFT City, India's International Finance Center

In July 2022, India International Bullion Exchange (IIBX) and NSE IFSC-SGX Connect were launched in GIFT City. JPMorgan Chase, Deutsche Bank and Japan's MUFG were launching operations at the International Financial Services Centre (IFSC) in July 2022. These institutions were some of the biggest in the global loans and derivatives markets that run into trillions of dollars. As of June 2022, 310 entities had set up their operations under IFSCA. 22 banks created a consolidated asset base of more than 32 billion USD and facilitated 207 billion USD worth of banking transactions.

Sources: i) https://economictimes.indiatimes.com/news/company/corporate-trends/gift-city-all-set-to-get-the-biggest-push-in-july/articleshow/92660409.cms, dated: 4th July, 2022. (Accessed on 26th July, 2022)

ii) https://indianexpress.com/article/cities/ahmedabad/pm-modi-to-visit-gift-city-in-gujarat-8050847/, dated: 25th July, 2022. (Accessed on 26th July, 2022)

iii) https://www.deshgujarat.com/2022/07/25/over-300-entities-set-up-operations-in-gift-city-under-ifscas-watch/, dated: 25th June, 2022. (Accessed on 26th July, 2022)

Check Your Progress - 2

6. What is the name used if a credit is availed from EXIM Bank for import of eligible goods from India on deferred payment terms?
   a. Line of credit
   b. Pre shipment credit
   c. Buyers credit
   d. Suppliers credit
   e. Post shipment credit
7. Which of the following terms is used if a project that involves equipment supply along with related services, like design, detailed engineering, civil construction, erection and commissioning of plants and power transmission and distribution, is funded by EXIM Bank?
   a. Turnkey projects
   b. Construction projects
   c. Technical and consultancy service
   d. Supplies of capital and manufactured
   e. Overseas joint ventures
8. Which of the following is not a guarantee issued by EXIM Bank on behalf of exports of turnkey and construction contracts?
   a. Bid bond guarantee
   b. Advance payment guarantee
   c. Performance guarantee
   d. Retention money guarantee
   e. Guarantee for lending abroad

9. Which of the following terms is used if EXIM Bank extends support to overseas governments or agencies for export of projects, equipment, goods and services from India?
   a. Line of credit
   b. Pre shipment credit
   c. Buyers credit
   d. Suppliers credit
   e. Post shipment credit
10. Which of the following Acts / regulatory bodies deal with regulatory frame work for all types of foreign exchange transactions in India?
   a. Reserve Bank of India Act, 1964
   b. Foreign Exchange Management Act, 1999
   c. Foreign Investment Promotion Board
   d. Export-Import Bank of India Act, 1981
   e. Foreign Contribution Regulation Act 2010

3.10 Summary

- Export Import Bank of India (EXIM Bank) was established by an Act of Parliament on 1st January 1982.
- EXIM Bank of India is a wholly government owned financial institution, set up for the purpose of financing, facilitating and promoting India's 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 or construction projects abroad.
- EXIM Bank precisely lends to the Indian companies, Indian banks, foreign governments, and foreign companies.
- EXIM Bank also issues various guarantees.
- There are two aspects of EXIM policy namely the import policy which is concerned with regulation and management of imports and the export policy which is concerned with promotion and regulation of exports.
- The main objective of the government's EXIM policy is to promote exports to the maximum extent possible.
- Exports are promoted in such a manner that the economy of the country remains unaffected though unregulated exports take place of exportable items specially needed within the country.
- The diversified lending program of EXIM Bank focuses on export of manufactured goods, project exports, exports of technology, services and export of computer software.

3.11 Glossary

Buyer's Credit is a loan facility secured by a Letter of Credit (LC) or a Bank Guarantee (BG), for import of eligible goods on deferred payment terms. The loan facility is secured by a LC or a BG.

Joint Venture is a cooperative enterprise entered into by two or more business entities for the purpose of a specific project or other business activity.

Letter of Credit (LC) is also known as Documentary Credit. It is a widely used term to make payment secure in domestic and international trade.

Line of Credit (LOC) is a financing mechanism through which EXIM Bank extends support to overseas governments or agencies for export of projects, equipment, goods and services from India.

Post-Shipment Credit is a facility provided to an exporter or seller against shipment that has already been made.

Pre-Shipment Credits are usually extended by exporters' commercial banks for a period up to 180 days.

Promoter is a person who promotes a company.

Supplier Credit is a facility which enables Indian exporters to extend term credit to overseas buyers of eligible goods at the post-shipment stage.

Turnkey Projects are projects that involve equipment supply along with related services, like design, detailed engineering, civil construction, erection and commissioning of plants and power transmission and distribution.

Working Capital is the capital of a business which is used in its day-to-day trading operations, calculated as the current assets minus the current liabilities.

3.12 Self-Assessment Test

1. Explain the role of Export-Import Bank of India in financing international trade to Indian companies.
2. Discuss in detail the functions of EXIM Bank in lending finance to Indian companies.
3. Illustrate the process flow of forfaiting mechanism in EXIM Bank of India.
4. Describe the function of EXIM Bank in providing assistance to overseas governments, agencies or companies in extending credits.
5. State briefly the role of EXIM Bank of India in extending guarantee to overseas projects.
6. Narrate the scenario and influencing factors of software exports in Indian information technology industry.
7. Identify the purpose for which the 'Foreign Exchange Management Act, 2000' got enacted.

3.13 Suggested Readings/Reference Materials

1. Francis Cherunilam, International Business - Text and Cases, 6th Edition, PHI Learning.
2. P G Apte (2020), International Financial Management, McGraw Hill Education (India) Private Limited.
3. Madhu Vij (2021). International Financial Management – Text and Cases. 4th edition. Taxmann.
4. Charles W. L. Hill, G. Tomas M. Hult (2021). International Business. 12th edition. McGraw Hill Education (India) Private Limited.
5. Choel S. Eun & Bruce G. Resnick (2022). International Financial Management. 8th edition. McGraw Hill Education (India) Private Limited.
6. K. Aswathappa (2020). International Business. 7th edition. McGraw Hill Education (India) Private Limited.

3.14 Answers to Check Your Progress Questions

1. (b) 1982

Established by the Government of India, EXIM Bank had commenced its operations in the year 1982 under the Export-Import Bank of India Act, 1981 as a purveyor of export credit, mirroring global export credit agencies.

2. (a) Letter of Credit

Letter of Credit (LC) is also known as Documentary Credit. LC is a widely used term to make payment secure in domestic and international trade. This document is issued by a financial institution at the buyer’s request who also provides the necessary instructions in preparing the document.

3. (e) Rupee term loans for financing equity contributions

Rupee term loans are given by EXIM Bank to finance equity contributions to Indian promoters and is not one of the equity contributions to Indian promoters.

4. (a) 180 days

EXIM Bank's ‘Pre-shipment Credit’ facility, in Indian Rupees and foreign currency, provides access to finance at the manufacturing stage - enabling exporters to purchase raw materials and other inputs. ‘Pre-shipment Credits’ are usually extended by exporters’ commercial banks for a period up to 180 days.

5. (b) Forfaiting

Forfaiting is the sale by an exporter of export trade receivables, usually bank guarantees, without recourse to the exporter.

6. (c) Buyer's Credit

Overseas buyers can avail of 'Buyer's Credit' from EXIM Bank, for import of eligible goods from India on deferred payment terms. The loan facility is secured by a LC or a BG.

7. (a) Turnkey Projects

Turnkey projects are projects that involve equipment supply along with related services, like design, detailed engineering, civil construction, erection and commissioning of plants and power transmission and distribution.

8. (e) Guarantee for lending abroad

EXIM Bank provides guarantee for borrowing abroad on behalf of exporters and not for lending purpose on turnkey and construction projects.

9. (a) Line of Credit

A Line of Credit (LOC) is a financing mechanism through which EXIM Bank extends support to overseas governments or agencies for export of projects, equipment, goods and services from India.

10. (b) Foreign Exchange Management Act, 1999

Foreign Exchange Management Act, 1999, is an Act to consolidate and amend law relating to foreign exchange with the objective to facilitate external trade and payment, to promote orderly development and maintenance of forex market in India.

Unit 4

Balance of Payments

Structure

“For every rapture, there is a price, and nothing is sustained forever. The path that destiny takes, in the end, leads to a balance of payments. No one remains overdrawn forever. Destiny’s bank is inexorable, all accounts must balance.”

- Dorothy Fuldheim, American Journalist

4.1 Introduction

This leads us to study the various elements of Balance of Payments Statement, in the context of a country, and how they affect the economic variables.

In the previous unit, we discussed some of the aspects of International Trade Finance and role of EXIM Bank in Indian scenario. Trade and other financial transactions of one country with another country results into different type of foreign exchange transactions. Consequently, there will be inflow and outflow of foreign exchange between the economies.

In any economy, the supply and demand of foreign exchange arise from its trade/financial transactions and the market forces. 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. (Various exchange rate systems are discussed in the next unit).

All these financial (trade or otherwise) transactions of one economy with the rest of the world 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 the 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' (BoP) is described by the IMF in its Balance of Payments Manual as a statistical statement for a given period showing the transactions in goods, services and income between an economy and the rest of the world; 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 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.

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' book-keeping 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.

4.2 Objectives

After studying this unit, you should be able to

- Comprehend the prescribed concept of economic transactions, resident and non- resident entities
- Assess the principle of valuation of transaction and balance of payment accounting
- Explain the various components of Balance of Payments (BoP)
- Discuss the factors that affect the components of Balance of Payments Accounting
- Discuss the compilation process of BoP and preparation of BoP statement
- Identify the limitations of BoP and discuss the relationship between BoP variables and other economic variables

4.3 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/she 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/she 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 (foreign currency non-resident deposit) in USD with SBI (State Bank of India) which he/she 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 an item 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".

4.3.1 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 as 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.

4.3.2 Concept of 'Non Resident Entities'

The Balance of Payments (BoP) is a monetary statement that captures all the monetary and economic transactions between the resident entities of a nation with the rest of the world during a given period. In international trade, there are economic transactions involving an agreement to import/export goods or services. This is captured in the current account of the BoP statement. If the exports exceed imports during a particular period, it means 'Current Account Surplus' (CAS), otherwise 'Current Account Deficit' (CAD).

The capital account deals with international investment which takes the shape of either 'Foreign Direct Investment' (FDI) or 'Foreign Portfolio Investment' (FPI) in financial instruments. FDI is done by companies in the real sector that either produce goods or render services. The objective is to gain managerial control over the assets so that operational cash flows and profits can be earned over a long period of time. FPI is made by companies in the financial sector to hold financial securities in debt or equity or derivatives so as to earn dividends, interest, and capital appreciation during short-to-medium term holding period. On the capital account front also, there is a possibility of surplus or deficit depending on whether the inflows are greater than outflows or vice versa.

The concept of residence is not based on nationality or legal criteria but depends on transactor's centre of pre-dominant economic interests. The non-resident entities are all those institutional units that either have economic linkages with residential entities or enter into transactions with them. Non-resident entities are not a separate sector for which complete sets of financial accounts have to be compiled and reported. But for administrative convenience, the rest of the world is described as if it were a sector. However, accounting treatment for this purpose is restricted to those which record transactions between residents and non-residents or other economic relationships, such as claims by non-residents on residents, and vice versa. Sometimes, the non-resident institutional units may also be physically located and operate within the geographic boundary of a nation. For example, international organizations such as a consulate, embassy, or military base, etc.

For instance, non-resident entities seeking to enter Indian markets can set up a liaison office to collect market intelligence to provide information about their company's products/services to prospective customers in India. However, such 'Liaison Offices' would not be permitted to earn in India. On the contrary, if a non-resident entity chooses to establish a branch office, it can engage in a wide range of economic activities.

Those include:

a. Export and import goods.

b. Provide technical/professional consultancy services.

c. Participate in R&D activities that are of interest to their parent companies.

d. Promote collaboration - technical or financial between Indian resident entities and other non-resident entities (parent company).

e. Represent their parent companies (non-resident entities) in India and act as their trading agent in the country.

f. Provide services such as Information Technology and software development in India.

g. Offer technical support for products supplied by their parent or group companies (non-resident entities).

h. Act as foreign airlines or shipping companies.

Transfers of economic values or international exchanges are conducted by institutional units (transactors) that may be either persons or legal entities. Legal entities cover a wide range of arrangements, from unincorporated enterprises to legal and social entities such as enterprises, non-profit institutions and all levels of government. However, in the balance of payments statement only those transactions conducted between resident and non-resident entities are recorded. Hence, the importance of 'residency' to the balance of payments accounts and the need to clearly demarcate between non-resident and resident transactors. Indian resident entities are those institutional units whose main centre of economic interest is in India. The main centre of economic interest means that institutional units live, invest, consume, produce, and/or earn revenue in India.

For example, eligible resident entities in India can raise commercial loans in the shape of 'External Commercial Borrowings' (ECBs) from recognized non-resident entities. These loans are subject to guidelines on a variety of parameters viz., minimum maturity, permitted/non-permitted end uses, and maximum all-in-cost ceiling. The RBI took various measures to liberalize ECBs to ease the pressure on BoP which included:

(i) Rationalized all-in-cost under all tracks and rupee denominated bonds

(ii) Increased the ECB 'Liability to Equity Ratio' for borrowings from foreign direct equity holder under the automatic route

(iii) Expanded the list of eligible borrowers and

(iv) Rationalized end-use norms.

Non-resident entities such as multi-national corporations (MNCs) operate through their subsidiaries in India. MNCs regularly supply inputs/buy output from them at transfer prices (not market-based prices). Such a transaction with related parties which do not maintain 'arms-length' pricing is looked through a microscope by customs authorities because of the possibility of money laundering. Hence, the 'Organization for Economic Co-operation and Development' (OECD) had rolled out 'Country by Country Report' (CbCR) transfer pricing document standards. Globally, MNCs are obligated to comply with these CbCR standards. In the Indian context, CbCR will ordinarily be filed by the parents/designated entities in their home countries. Tax authorities in India will have access to CbCR-related information through mutual exchange of information agreements with such countries, failing which their Indian subsidiaries (non-resident entities) will have to provide the reports.

Example: Resident and non-resident in Economic Transactions

Among the 83 unicorns in India as on 28th January 2022, Airtel has got five subsidiaries: Airtel Payments bank, Nxtra, Wynk, Airtel Ads and Airtel IQ. While Airtel Payments Bank was the only profitable bank as of that date, Wynk had over 2.8 billion monthly streams, making it the largest music streaming service in the country. Airtel has also got many 100 % subsidiaries abroad. Some of them include

- Bharti Airtel (France) SAS
- Bharti Airtel (Hong Kong) Limited
- Bharti Airtel (Japan) Private Limited
- Bharti Airtel (UK) Limited
- Bharti Airtel (USA) Limited
- Bharti International (Singapore) Pte Ltd
- Bharti Airtel International (Mauritius) Limited
- Bharti Airtel Lanka (Private) Limited

While all the Indian unicorns above would be 'Resident' entities, all the foreign subsidiaries of Bharti Airtel would be 'Non-Resident Entities'.

Source: https://telecomtalk.info/bharti-airtel-subsidiaries-alone-add-5-unicorns/495191/, dated: 28th January, 2022. Accessed on 29th July, 2022

4.4 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.

Example: Xiaomi Accused of Violating the Principles of Valuing Transactions

On April 30, 2022, the Enforcement Directorate seized ₹5,551.27 ($725 million) in the Indian bank accounts of Xiaomi Corp., accusing it of breaking the country's foreign exchange laws by making illegal remittances abroad, to three foreign-based entities, with one of those including a company within the Xiaomi group, under the guise of royalty payments. Keeping the Indian laws and legal implications aside, this is the case (accusation) of Xiaomi making royalty payments not at market prices but at inflated prices, to siphon money to China, which is in clear violation of principles recommended by IMF.

Sources: i) https://www.reuters.com/world/india/india-seizes-725-mln-xiaomi-funds-foreign-exchange-case-2022-04-30/, dated: 30th April, 2022. Accessed on 29th July, 2022.

ii) https://www.zdnet.com/home-and-office/networking/directorate-of-enforcement-seizes-725-million-from-xiaomi-india/, dated: 1st May, 2022. Accessed on 29th July, 2022.

4.5 Accounting Principles in BoP

The foremost principle of BoP accounting is the use of the 'Double-entry Book-keeping' system. Thus it 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 a 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 on 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.

Example: Debits and Credits in BoP Accounting

(US$ Billion)

Bop: January - March 2021-22		
	Value	**Debit/ Credit**
Current Account:		
1. Goods		
Imports	172.5	Debit
Exports	118.0	Credit
2. Services		
Imports	41.6	Debit
Exports	69.9	Credit
Current Account Total Imports	214.1	Debit
Current Account Total Exports	187.9	Credit

These would be adjusted against primary and secondary incomes to arrive at the current account deficit for the quarter.

Source: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=53906#:~:text=Net%20ECBs%20to%20India%20recorded,(on%20a%20BoP%20basis), dated: 22nd June, 2022. Accessed on 29th July, 2022.

4.6 Balance of Payments (BoP)

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 'Balance of Trade' refers to merchandise imports and exports (visible trade), 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 book-keeping. 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.

4.6.1 Components of Balance of Payments

The BoP statement is usually divided into three major groups of accounts. The construction of these accounts can best be appreciated by examining Table 4.1 given below.

Table 4.1: Major Items of India's Balance of Payments

(US$ billion)

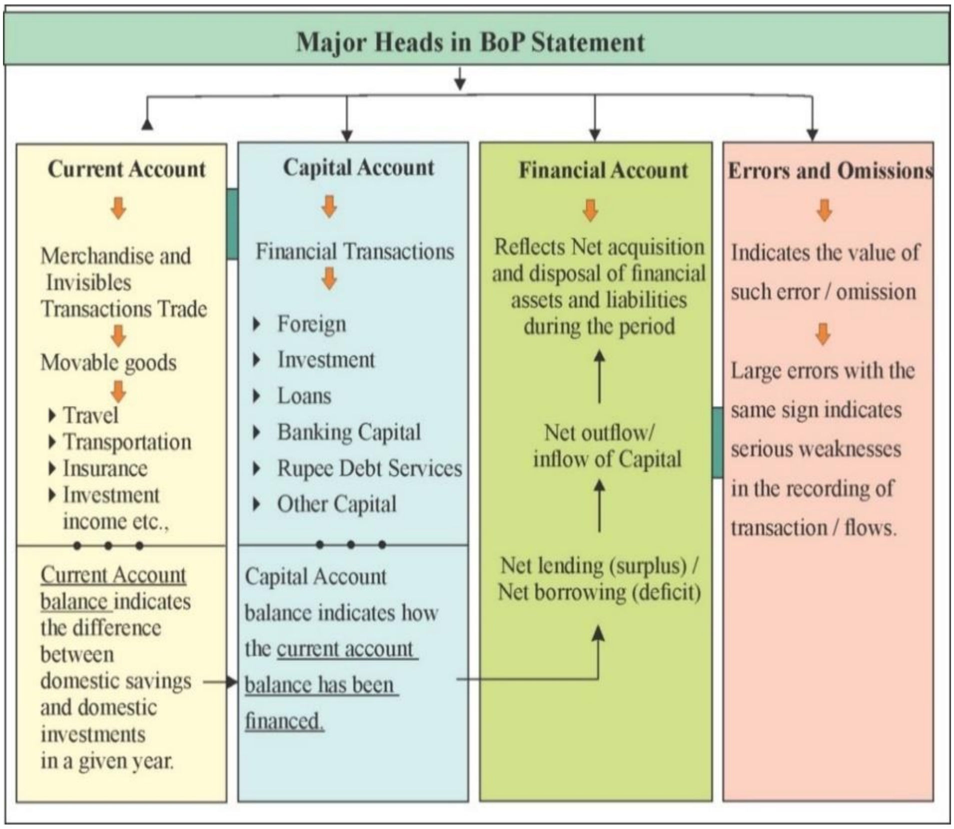
	April-June 2022 P			**April-June 2021**		
	Credit	**Debit**	**Net**	**Credit**	**Debit**	**Net**
A. Current Account	231.0	254.9	-23.9	180.1	173.5	6.6
1. Goods	123.0	191.5	-68.6	97.4	128.2	-30.7
Of which:						
POL	27.1	60.6	-33.6	12.9	30.9	-18.0
2. Services	76.1	45.0	31.1	56.2	30.4	25.8
3. Primary Income	6.3	15.5	-9.3	5.5	13.1	-7.5
4. Secondary Income	25.6	2.8	22.9	20.9	1.9	19.0

Contd.....

B. Capital Account and Financial Account	197.7	174.4	23.3	164.0	170.5	-6.5
Of which:						
Change in Reserves [Increase (-)/Decrease (+)]	0.0	4.6	-4.6	0.0	31.9	-31.9
C. Errors & Omissions (-) (A+B)	0.5	0.0	0.5	0.0	0.1	-0.1
P: Preliminary						
Note: Total of sub-components may not tally with aggregate due to rounding off.						

Source: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=54455#:~:text= India's%20current%20account%20balance%20recorded,Q1%3A2021%2D22%5D

Figure 4.1: Major Heads in BoP Account



Source: ICFAI Research Center

From the above Table 4.1 and Figure 4.1, we can identify three major heads in BoP statement and Errors and Omissions:

- Current account
- Capital account and
- Financial account

a. Current Account

The 'Current Account' records 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/her will appear as a debit item.

Transfers may be of two types: Official and private. A debit entry under the heading 'Official Transfers' constitutes 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.

Investment income payments represent India's external liabilities, while investment income receipts refer to India's external assets including foreign exchange reserves. It represents the servicing of capital transactions in the nature of both debt and non-debt categories. They are in the form of interest, dividend and profit for servicing of capital. Dividends and profit payments reflect the servicing of non-debt liabilities transactions whereas interest payments represent the servicing of debt liabilities. According to the Balance of Payment manual, "Compensation of Employees" has been shown as income with effect from the financial year 1997-98.

b. Capital Account

In the case of '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.

c. Financial Account

The financial account reflects net acquisition and disposal of financial assets and liabilities during the period. The transactions under financial account appear both in the BoP and in the integrated IIP statement owing to their effect on the stock of assets and liabilities. The sum total of net transactions under the current and capital accounts represents net lending (surplus) or net borrowing (deficit) by the economy from the rest of the world, which is reflected in the financial account as net outflow or inflow of capital. Thus, the financial account shows how the net lending to or borrowing from the rest of the world has occurred.

Conversely, it shows how the current account surplus is used or the current account deficit is financed. The financial account together with the "other changes account" explains the change in the IIP (international investment position) between the beginning and end-periods.

In contrast to the current and capital accounts which show transactions in gross terms, the financial account is recommended to show transactions on a net basis, separately for financial assets as well as liabilities (i.e., net transactions in financial assets show acquisition less disposal of assets and not assets net of liabilities). Incidentally, the transactions relating to merchanting and re-exports under the current account are also recorded on a net basis.

Errors and Omissions

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.

Tables 4.2 & 4.3 provide an explanation to the above.

Table 4.2: Standard Presentation of BoP in India as per BPM6

1. Current Account (1.A+1.B+1.C)	**2. Capital Account (2.1+2.2)**
1.A Goods and Services (1.A.a+1.A.b)	2.1 Gross acquisitions (DR.)/disposals (CR.) of non-produced nonfinancial assets
1.A.a Goods (1.A.a.1+1.A.a.2+1.A.a.3)	2.2 Capital transfers
1.A.a.1 General merchandise on a BOP basis	2.2.1 General government
Of which:	2.2.1.1 Debt forgiveness
1.A.a.1.1 *Re-exports*	2.2.1.2 Other capital transfers
1.A.a.2 Net exports of goods under merchanting	2.2.2 Financial corporations, nonfinancial corporations, households, and NPISHs
1.A.a.2.1 Goods acquired under merchanting (negative credits)	2.2.2.1 Debt forgiveness
1.A.a.2.2 Goods sold under merchanting	2.2.2.2 Other capital transfers
1.A.a.3 Nonmonetary gold	

Contd….

1.A.b Services	**3. Financial Account (3.1+3.2+3.3+3.4+3.5)**
1.A.b.1 Manufacturing services on physical inputs owned by others	3.1 Direct Investment
1.A.b.1.1 *Goods for processing in reporting economy*	3.1.1 Equity and investment fund shares
1.A.b.1.2 *Goods for processing abroad*	3.1.1.1 Equity other than reinvestment of earnings
1.A.b.2 Maintenance and repair services	3.1.1.1.1 Direct investor in direct investment enterprises
1.A.b.3 Transport	3.1.1.1.2 Direct investment enterprises in direct investor (reverse investment)
1.A.b.3.1 Sea transport	3.1.1.1.3 Between fellow enterprises
1.A.b.3.1.1 Passenger	3.1.1.2 Reinvestment of earnings
1.A.b.3.1.2 Freight	3.1.2 Debt instruments
1.A.b.3.1.3 Other	3.1.2.1 Direct investor in direct investment enterprises
1.A.b.3.2 Air transport	3.1.2.2 Direct investment enterprises in direct investor (reverse investment)
1.A.b.3.2.2 Freight	3.2 Portfolio Investment
1.A.b.3.2.3 Other	3.2.1 Equity and investment fund shares
1.A.b.3.3 Other modes of transport	3.2.1.1 Central bank
1.A.b.3.3.1 Passenger	3.2.1.2 Deposit-taking corporations, except the central bank
1.A.b.3.3.2 Freight	3.2.1.3 General government
1.A.b.3.3.3 Other	3.2.1.4 Other sectors
1.A.b.3.4 Postal and courier services	3.2.1.0.1 Equity securities other than investment fund shares
1.A.b.3.4.1 Sea transport	3.2.1.0.2 Investment fund shares/units
1.A.b.3.4.2 Air transport	*Of which*:
1.A.b.3.4.3 Other modes of transport	3.2.1.0.2.1 Reinvestment of earnings
1.A.b.3.0.1 Passenger	3.2.2 Debt securities
1.A.b.3.0.2 Freight	3.2.2.1 Central bank
1.A.b.3.0.3 Others	3.2.2.2 Deposit-taking corporations, except the central bank
1.A.b.4 Travel	3.2.2.3 General government
1.A.b.4.1 Business	3.2.2.4 Other sectors

Contd….

1.A.b.4.2 Personal	3.3 Financial derivatives (other than reserves) and employee stock options
1.A.b.4.2.1 Health-related	3.3.1 Central bank
1.A.b.4.2.2 Education-related	3.3.2 Deposit-taking corporations, except the central bank
1.A.b.4.2.3 Other	3.3.3 General government
1.A.b.5 Construction	3.3.4 Other sectors
1.A.b.5.1 Construction abroad	3.4 Other investment
1.A.b.5.2 Construction in the reporting economy	3.4.1 Other equity
1.A.b.6 Insurance and pension services	3.4.2 Currency and deposits
1.A.b.6.1 Direct insurance	3.4.2.1 Central bank
1.A.b.6.2 Reinsurance	3.4.2.2 Deposit-taking corporations, except the central bank
1.A.b.6.3 Auxiliary insurance services	3.4.2.3 General government
1.A.b.6.4 Pension and standardized guarantee services	3.4.2.4 Other sectors
1.A.b.7 Financial services	3.4.3 Loans
1.A.b.7.1 Explicitly charged and other financial services	3.4.3.1 Central bank
1.A.b.7.2 Financial intermediation services indirectly measured (FISIM)	3.4.3.2 Deposit-taking corporations, except the central bank
1.A.b.8 Charges for the use of intellectual property n.i.e.	3.4.3.3 General government
1.A.b.9 Telecommunications, computer, and information services	3.4.3.4 Other sectors
1.A.b.9.1 Telecommunications services	3.4.4 Insurance, pension, and standardized guarantee schemes
1.A.b.9.2 Computer services	3.4.4.1 Central bank
1.A.b.9.3 Information services	3.4.4.2 Deposit-taking corporations, except the central bank
1.A.b.10 Other business services	3.4.4.3 General government
1.A.b.10.1 Research and development services	3.4.4.4 Other sectors
1.A.b.10.2 Professional and management consulting services	3.4.5 Trade credit and advances

Contd….

1.A.b.10.3 Technical, trade-related, and other business services	3.4.5.1 Central bank
1.A.b.11 Personal, cultural, and recreational services	3.4.5.2 General government
1.A.b.11.1 Audiovisual and related services	3.4.5.3 Deposit-taking corporations
1.A.b.11.2 Other personal, cultural, and recreational services	3.4.5.4 Other sectors
1.A.b.12 Government goods and services n.i.e.	3.4.6 Other accounts receivable/payable—other
1.B Primary Income (1.B.1+1.B.2+1.B.3)	3.4.7 Special drawing rights
1.B.1 Compensation of employees	3.5 Reserve assets
1.B.2 Investment income	3.5.1 Monetary gold
1.B.2.1 Direct investment	3.5.2 Special drawing rights n.a.
1.B.2.1.1 Income on equity and investment fund shares	3.5.3 Reserve position in the IMF n.a.
1.B.2.1.2 Interest	3.5.4 Other reserve assets
1.B.2.2 Portfolio investment	3.5.4.1 Currency and deposits
1.B.2.2.1 Investment income on equity and investment fund shares	3.5.4.2 Securities
1.B.2.2.2 Interest	3.5.4.3 Financial derivatives
1.B.2.3 Other investment	3.5.4.4 Other claims
1.B.2.4 Reserve assets	3. Total assets/liabilities
1.B.3 Other primary income	*Of which: (by instrument):*
1.C Secondary Income (1.C.1+1.C.2)	3.0.1 Equity and investment fund shares
1.C.1 General government	3.0.2 Debt instruments
1.C.2 Financial corporations, nonfinancial corporations, households, and NPISHs	3.0.3 Other financial assets and liabilities
1.C.2.1 Personal transfers (Current transfers between resident and non-resident households)	4.0 Errors and Omissions
Of which: 1.C.2.1.1 Workers' remittances	
1.C.2.2 Other current transfers	

Source: https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/T41_18112022BF2C8D61B03449768DFBF68663DDCEF4.PDF

Table 4.3: Standard Components of Capital and Financial Accounts of BoP

Capital Account			
		BPM6	**India**
1	Gross acquisitions (DR.)/ disposals (CR) of non-produced non-financial assets	Yes	No
2	Capital transfers	Yes	No
Financial Accounts			
A.	**Foreign Direct Investment**		
1	Equity Capital	Yes	Yes
2	Reinvested Earnings	Yes	Yes
3	Other Capital	Yes#	Yes
B.	**Portfolio Investment**		
I.	**Equity**		
1	Central Bank	Yes	Not Applicable
2	Commercial Banks	Yes	Yes
3	Government	Yes	Yes
4	Other financial Corporations	Yes	Yes
5	Non-financial Corporations	Yes	Yes
6	Financial Derivatives	No@	No
II.	**Debt**		
1	Central Bank	Yes	Not Applicable
2	Commercial Banks	Yes	Yes
3	Government	Yes	Yes
4	Other financial Corporations	Yes	Yes
5	Non-financial Corporations	Yes	Yes
6	Financial Derivatives	No@	No
C	**Other Investment**		
1	Other equity	Yes	No
2	Currency and Deposits	Yes	Yes*
3	Loans	Yes	Yes
4	Trade Credits	Yes	Yes
5	Insurance, pension, and standardised guarantee schemes	Yes	No
6	Other accounts receivable/payable-other	Yes	Yes
7	Special drawing rights	Yes	No

Classified as debt instruments in BPM6.

@ Financial derivatives are separately presented in the capital and financial accounts in BPM6 as "Financial derivatives (other than reserves) and employee stock options" and not as part of portfolio investment as in BPMS.

* NRI Deposits in the Indian case, which is a part of banking capital.

Source: RBI. Balance of Payments Manual for India, https://m.rbi.org.in/scripts/publicationsview.aspx?id=13013, accessed on Feb 9th, 2023.

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 Reserve Bank of India 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 (BoP) 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. Trade balance is 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.

Monthly Data on India's International Trade in Services is compiled by RBI with a lag of around 45 days. The data in Table 4.4 is sourced from RBI website

Table 4.4: International Trade in Services

	Receipts (Exports) (US$ Million)	Payments(Imports) (US$ Million)
July-2022	23,265 (20.2)	13,929 (22.3)
August-2022	25,416 (24.3)	15,080 (27.1)
September - 2022	28,026 (29.7)	16,117 (28.1)
October - 2022	25,375 13,493 (24.6)	13,493 (15.9)

Source: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=5478, December 1, 2022

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

Solution

At first instance this may look beneficial, but 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 increase, 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. The table below gives index number of India's terms of trade average

Table 4.5: Index Numbers of Foreign Trade

(Base: 2012-2013=100)

Year	Unit Value Index		Volume Index		Terms of Trade		
	Export	Import	Export	Import	Gross	Net	Income
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
2014-15	109	100	155	10	467	109	169
2015-16	104	85	186	111	60	123	228
2016-17	108	88	224	112	50	123	274
2017-18	110	92	200	123	62	120	240
2018-19	124	109	125	126	101	114	142
2019-20	125	103	145	125	86	121	176
2020-21	140	105	116	107	92	133	155

Source: https://www.indiabudget.gov.in/economicsurvey/doc/stat/tab66.pdf

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 savings and domestic investments in a given year. A deficit on current account means that 'domestic savings' 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 are 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 is 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.

4.6.2 The Balance of Payments always 'Balances'

On the whole 'Balance of Payments' (BoP) 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 excess expenditure by drawing on its savings or borrowing from the bank or some other creditors. Then the amount dis-saved 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 BoP 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.

Example: Balance of Payments (BoP) of India

Major items of India's Balance of Payments for 2021-22 and 2020-21 (US$ Billion)

	2021-22 P			2020-21		
	Credit	**Debit**	**Net**	**Credit**	**Debit**	**Net**
A. Current Account	798.7	837.4	-38.7	603.5	579.5	24.0
1. Goods	429.2	618.6	-189.5	296.3	398.5	-102.2
Of which:						
POL	67.5	161.8	-94.3	25.8	82.7	-56.9
2. Services	254.5	147.0	107.5	206.1	117.5	88.6
3. Primary Income	25.8	63.0	-37.3	20.8	56.8	-36.0
4. Secondary Income	89.3	8.8	80.5	80.3	6.8	73.6
B. Capital Account and Financial Account	777.4	739.2	38.2	599.0	622.7	-23.7
Of which:						
Change in Reserves [Increase (-) /Decrease (+)]	16.0	63.5	-47.5	0.0	87.3	-87.3
C. Errors & Omissions (-) (A+B)	0.5		0.5		0.3	-0.3

The debits are deducted from credits to obtain the net. We can see that the current account deficit is balanced by the Capital account surplus. For 2021-22 the total net is 0.5 (instead of zero) which is justified by Errors & Omissions of the debit. Thus, the BoP account always balances itself.

Source: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=53906#:~:text=Net%20ECBs%20to%20India%20recorded,(on%20a%20BoP%20basis), dated: 22nd June, 2022. Accessed on 30th Julyy, 2022.

4.6.3 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 respective 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 transactions in the same time period to balance the BoP statement. 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 a 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.

Check Your Progress – 1

1. Which of the terms refers to the merchandise of visible trade that gets translated between the buyer and the seller?
   a. Balance of payments
   b. Balance of trade
   c. Balance of investments
   d. Balance of exchange reserves
   e. Balance of transactions
2. Which of the following statements refers to the transaction entry recorded as debit entry in the balance of payment statement, representing the use of foreign exchange reserves?
   a. Increase in internal purchasing power of a country
   b. Decrease in external purchasing power of a country
   c. Increase in external purchasing power of a country
   d. Decrease in internal purchasing power of a country
   e. Decrease in purchasing power of a country
3. Which of the following heads is not a classification of capital account of the balance of payment statement?
   a. Foreign investment
   b. Loans

c. Banking capital

d. Rupee debt service

e. Investment income

4. Which of the following terms is used when a foreign investor directly purchases financial assets in the Indian securities market?

a. Foreign direct investment

b. Foreign portfolio investment

c. Foreign capital investment

d. Foreign exchange management

e. Foreign debts and reserves

5. Which of the following terms describes recording of India's transactions with International Monetary Fund and India's foreign exchange reserves - gold and foreign asset holdings held by RBI?

a. Current account

b. Capital account

c. Monetary movements

d. Trade balances

e. BoP balances

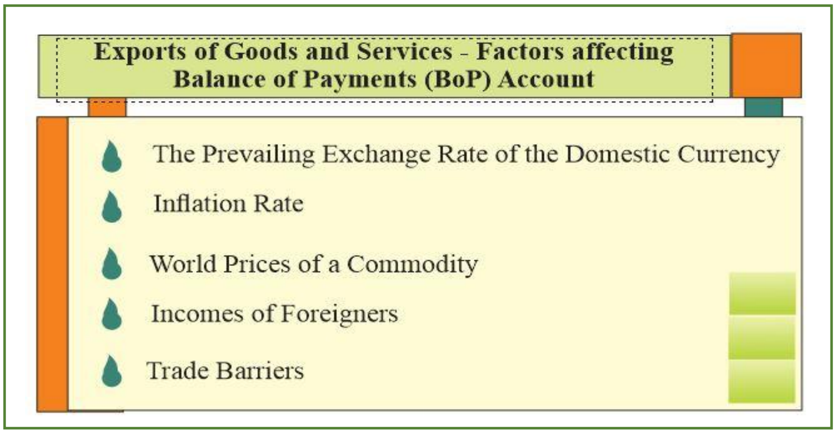
4.7 Factors Affecting the Components of BoP Account

The following are the factors affecting the components of BoP Account:

4.7.1 Exports of Goods and Services

Exports of goods and services are affected by the different factors. (Refer Figure 4.2), as explained below:

Figure 4.2: Exports of Goods and Services –
Factors affecting Balance of Payments (BoP) Account



Source: ICFAI Research Center

Example: Exports and Imports affecting the BoP of India

Despite India surpassing its goal of $ 400 billion in merchandise exports, India's trade deficit widened by 87.5 percent to US$192.41 billion in FY 2021-22 as against US$102.63 billion in the previous fiscal. The trade deficit for non-oil and non-gold/jewelry items stood at $55 billion. As the economy reopened and business and consumption activity stabilized there was a sudden rise in imports of crude oil, coal, gold, electronics and chemicals. Rising prices of commodities, including crude oil and coal, played a significant role in inflating India's import bill.

Sources: i) https://www.thehindu.com/business/Economy/imports-hit-record-610-bn-in-2021-22/article65290161.ece, dated: 4th April, 2022. Accessed on 30th July, 2022.
ii) https://www.hindustantimes.com/business/indian-exports-set-to-cross-650bn-in-fy22-as-services-hit-record-250bn-101649902129253.html, dated: 15th April, 2022. Accessed on 30th July, 2022.
iii) https://www.india-briefing.com/news/indias-export-import-trends-in-fy-2021-22-24682.html/, dated: 6th April, 2022. Accessed on 30th July, 2022.

- **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 ₹ 500 per quintal. Further, assume that due to domestic inflation, the price increases to ₹ 530 per quintal and there is a resultant fall in the quantity demanded to 96 quintals. The exports would then increase from ₹ 50,000 to ₹ 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.

4.7.2 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:** A rise 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 demand being elastic, the effect on the supply of 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 – the higher are the barriers, the lower are the imports, and hence, lower the supply of the domestic currency.

4.7.3 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.

4.7.4 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.

4.7.5 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 Payment Crisis in India 1990-91

The Balance of Payment (BOP) crisis had hit the country in the year 1990-91 but the journey of the crisis had been building for at least a half a decade preceding the year 1991. The rising of the fiscal deficit and gradually increasing overvaluation had all resulted and contributed to the rising imbalance in the balance of payments of the country. Improper exchange rate adjustment with respect to the external and domestic shocks during 1990-91 was an add-on to the crisis.

Before 1991, all major post-Independence economic crises in India were caused by exogenous forces. The contribution of policy errors towards their severity was not able to withstand the underlying cause whether triggered by war or drought or global commodity shocks.

Since 1976, there was a gradual import liberalization that had quietly manifested itself in the rapid growth of imports, especially that of intermediate and capital goods. Unfortunately, export growth failed to keep up. For the time being, the escalating issue on remittance flows from workers in the Persian gulf plugged the current account hole and facilitated a strong buildup of foreign reserves. There was more than USD 7 billion in reserves by 1978, which was enough to pay for nine months of imports. This unsterilized reserve accumulation reflected in an increase in total money supply (dollar inflows were accumulated by the central bank, while it paid out rupees in exchange).

The broad money growth averaging 20% during the then Janata government's rule was further fuelled by increased Reserve Bank of India (RBI) overdraft to the central and state governments. Later that year, India and the International Monetary Fund (IMF) started negotiations for a larger loan, to the tune of USD 1 billion to meet the funding needs of the sixth Five-Year Plan. Rather than advocating fiscal restraint as usual, the IMF helped finance the successful development of the Oil and Natural Gas Commission, or ONGC. A modest pre-crisis current account surplus turned into a deficit in 1979 and continued to deteriorate throughout the 1980s, peaking at 3.5% of the Gross Domestic Product (GDP) in 1990-91. Using current account deficit as a percentage of exports rather than GDP, a more suitable metric for India gave them eager foreign earnings, where the situation looked even blunter. The current account deficit remained between 40% and 50% of the exports during the second half of the 1980s, implying that foreign exchange earnings could cover only about 50-60% of foreign currency expenses. As a result, total external liabilities more than doubled as a percentage of the Gross National Income (GNI) from 11% to 26%, between 1980 and 1990, where half of these liabilities were owed by the public sector. Since imports remained within the 8-9% range of GDP, it was the growth in overall output that drove the surge in imports. The nature of import liberalization was such that it only made the processes less cumbersome, and imports were still mostly confined to essentials.

Hence, it was said that the root of the balance of payments crisis was due to:

- The investment-savings deficit driven by fiscal extravagance.
- The reliance on non-concessional external borrowings to fund that deficit.
- The inability of export growth to keep pace with the growth in imports.

Climbing down from the highs of the 1979-81crisis, Wholesale Price Index (WPI) remained relatively subdued for the decade. The government, therefore, presumed that it had fiscal space and all the government had to do was to look at the debt figures. From 1980-81 to 1990-91, domestic public debt grew almost 40%, from 40% of GDP to 55%, while external public debt rose from 8.7% of GDP to 12.7%. While the latter figure may not look menacing in itself, in the context of an export sector that contributed less than 8% to GDP, which was quite alarming.

The step taken as a result of the BOP crisis was liberalization of the economy. This economic liberalization in India referred to the continuing economic liberalization which was started in the year 1991. This liberalization was with the aim of creating a flexibility in the economy focusing on being more market-oriented and expanding the role of private and as well as foreign investments. Specific changes included: reducing tariffs in the imports and to focus on deregulation of markets and also the reduction of taxes and exemptions in tax and also an increase in foreign investments. Reforms in the country after the BoP crisis include trade reforms, custom tariff reforms, foreign investment reforms, debt reforms and export reforms.

Thus, liberalization had been credited by its proponents for the high economic growth recorded by the country in the 1990s and 2000s. For the public, it meant to be the global oil shock during the First Gulf War that had caused the 1991 BoP crisis, but it is found to be that it was only a mere trigger. It was the extended years of short-sighted policy that led up to the crisis.

Activity 4.1

How do exchange rate changes affect a change in the BoP? Analyze the critical factors effecting changes in BoP statements, due to changes in currency exchange rates.

Answer:

4.8 Balance of Payments Compilation

The BoP account is compiled using various sources of information. The most important source is the R-Returns which the Authorized Dealers (AD) 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 4.1

An Indian resident exports goods to a US 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 4.2

The 'Bill of Exchange' mentioned in illustration 4.2 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 the one hand, this reduces the holdings of foreign assets (in the form of 'Bill of Exchange'), and on the other hand, it increases the same (in the form of deposit). The impact will be

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

The net effect on the BoP would be nil.

Illustration 4.3

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 4.4

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 4.5

An Indian resident imports goods from Germany and signs a 'Usance Bill of Exchange' denominated in German Euro 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 Euro 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 Euro – 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 Euro from the central bank to offset its earlier deal with the importer, the result will be an increase in the holdings of German Euro 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 Euro)	Dr.
Official reserves	Cr.

Illustration 4.6

An Indian resident takes medical treatment in the US 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	Cr.
(Bank's holdings of Dollars)	

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

Holdings of foreign assets	Dr.
(Bank's holdings of Dollars)	
Official reserves	Cr.

Illustration 4.7

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 4.8

An Indian company issues ECBs denominated in Swiss 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 4.9

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 cancelation of SDRs. Cancelation would have a reverse effect on the BoP.

Illustration 4.10

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).

Example: Effect of the EPS and DPS of AstraZeneca in Compilation of BoP

As on 31 July 2022, the total number of shares of AstraZeneca Pharma India was 2,50,00,000. The number of shares held by the foreign promoter was 1,87,50,000 and foreign institutions were 6,20,711. The Basic EPS and DPS of AstraZeneca Pharma India, for 2020-21, were ₹ 24.60 and ₹ 5 per share. Illustrate the impact of retained earnings and dividends declared by AstraZeneca Pharma India on BOP for 2020-21.

Answer:

Number of shares held by foreign promoter	1,87,50,000
Number of shares held by foreign institutions	6,20,711
Total foreign holding of AstraZeneca Pharma India	1,93,70,711
Earnings of non-residents = ₹ 24.6 X 1,93,70,711 shares	₹ 47,65,19,490.6
(-) Dividends of non-residents = ₹ 5 X 1,93,70,711 shares	₹ 9,68,53,555.0
Retained earnings of non-residents	₹ 37,96,65,935.6

The part of non-residents' share of earnings of the company which is paid out as dividends would be recorded in the BoP as an import of services. The effect is

Trade in services Dr. ₹ 9,68,53,555

Holdings of foreign assets Cr. ₹ 9,68,53,555

(for the notional payment of earnings in foreign currency)

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

Holdings of foreign assets Dr. ₹ 37,96,65,935.6

Liability to foreigners Cr. ₹ 37,96,65,935.6

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

Sources: i) https://economictimes.indiatimes.com/astrazeneca-pharma-india-ltd/shareholding/companyid-13987.cms, dated: 2022. Accessed on 31st July, 2022.

ii) https://economictimes.indiatimes.com/astrazeneca-pharma-india-ltd/stocks/companyid-13987.cms, dated: 2022. Accessed on 31st July, 2022.

iii) https://www.moneycontrol.com/financials/astrazenecapharma/profit-lossVI/AZP, dated: 2022. Accessed on 31st July, 2022.

iv) https://www.moneycontrol.com/financials/astrazenecapharma/balance-sheetVI/AZP#AZP, dated: 2022. Accessed on 31st July, 2022.

4.9 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 4.6: Summary of Balance of Payments Account of India

India's Overall Balance of Payments					(US$ million)
	2017-18	**2018-19**	**2019-20**	**2020-21**	**2021-22 (P)**
1	**2**	**3**	**4**	**5**	**6**
A. CURRENT ACCOUNT					
1 Exports, f.o.b.	3,08,970	3,37,237	3,20,431	2,96,300	3,11,191
2 Imports, c.i.f.	4,69,006	5,17,519	4,77,937	3,98,452	4,46,835
3 Trade Balance	-1,60,036	-1,80,283	-1,57,506	-1,02,152	-1,35,644
4 Invisibles, Net	1,11,319	1,23,026	1,32,850	1,26,065	1,09,077
a) 'Non-Factor' Services of which :	77,562	81,941	84,922	88,565	79,203
Software Services	72,186	77,654	84,643	89,741	80,274

Contd….

b) Income	-28,681	-28,861	-27,281	-35,960	-29,441
c) Private Transfers	62,949	70,601	76,217	74,439	59,880
5 Current Account Balance	-48,717	-57,256	-24,656	23,912	-26,567
B. CAPITAL ACCOUNT					
1 Foreign Investment, Net (a+b)	52,401	30,094	44,417	80,092	24,947
a) Direct Investment	30,286	30,712	43,013	43,955	26,509
b) Portfolio Investment	22,115	-618	1,403	36,137	-1,562
2 External Assistance, Net	2,944	3,413	3,751	11,167	2,709
3 Commercial Borrowings, Net	-183	10,416	22,960	-134	4,863
4 Short Term Credit, Net	13,900	2,021	-1,026	-4,130	13,284
5 Banking Capital of which :	16,190	7,433	-5,315	-21,067	12,631
NRI Deposits, Net	9,676	10,387	8,627	7,364	3,075
6 Rupee Debt Service	-75	-31	-69	-64	-59
7 Other Capital, Net&	6,213	1,057	18,462	-2,143	30,935
8 Total Capital Account	91,390	54,403	83,180	63,721	89,309
C. Errors & Omissions	902	-486	974	-347	782
D. Overall Balance [A(5)+B(8)+C]	43,574	-3,339	59,498	87,286	63,524
E. Monetary Movements (F+G)	-43,574	3,339	-59,498	-87,286	-63,524
F. IMF, Net	0	0	0	0	0
G. Reserves and Monetary Gold (Increase -, Decrease +)	-43,574	3,339	-59,498	-87,286	-63,524
of which: SDR allocation	0	0	0	0	-17,862
Memo: As a ratio to GDP					
1 Trade Balance	-6.0	-6.7	-5.6	-3.8	-5.9
2 Net Services	2.9	3.0	3.0	3.3	3.4
3 Net Income	-1.1	-1.1	-1.0	-1.3	-1.3
4 Current Account Balance	-1.8	-2.1	-0.9	0.9	-1.2
5 Capital Account, Net	3.4	2.0	2.9	2.4	3.9
6 Foreign Investment, Net	2.0	1.1	1.6	3.0	1.1

P: Data are provisional and pertain to April-December 2021.
&: Includes delayed export receipts, advance payments against imports, net funds held abroad, and advances received in the pending issue of shares under FDI.
Note: 1. Gold and silver brought by returning Indians have been included under imports, with a contra entry in private transfer receipts.
2. Data on exports and imports differ from those given by DGCI&S on account of differences in coverage, valuation, and timing.

Source: https://rbi.org.in/scripts/AnnualReportPublications.aspx?Id=1364, dated: 27th May, 2022. Accessed on 1st August, 2022

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 Management Act (FEMA). According to this Act, only Authorized Dealers (ADs) are permitted to deal in foreign exchange and no one is permitted to buy or sell any currency except through the ADs.

4.9.1 The Statement

India's 'Balance of Payments' for the respective financial years is shown in Table 4.7.

Table 4.7 gives major components of BoP.

Table 4.7: Major Components of India's Balance of Payments

(US$ Billion)

Year / Item (Net)	2019-20				2020-21				2021-22 (P)	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
A. Current Account	**-15.0**	**-7.6**	**-2.6**	**0.6**	**19.1**	**15.3**	**-2.2**	**-8.2**	**6.5**	**-9.6**
A 1 Merchandise Trade Balance	**-46.8**	**-39.6**	**-36.0**	**-35.0**	**-11.0**	**-14.8**	**-34.6**	**-41.7**	**-30.7**	**-44.4**
A 1 a Merchandise Exports	82.7	80.0	81.2	76.5	52.2	75.6	77.2	91.3	97.4	104.8
A 1 b Merchandise Imports	129.5	119.6	117.3	111.6	63.2	90.4	111.8	133.0	128.2	149.3
A 2. Invisibles	**31.8**	**32.1**	**33.4**	**35.6**	**30.0**	**30.1**	**32.4**	**33.6**	**37.2**	**34.8**
A 2.a) Services	20.1	20.9	21.9	22.0	20.8	21.1	23.2	23.5	25.8	25.6
A 2.b) Transfers	18.0	20.0	18.9	18.4	17.0	18.4	19.3	18.8	18.9	18.9
A 2.c) Income	-6.3	-8.8	-7.4	-4.8	-7.7	-9.4	-10.1	-8.7	-7.5	-9.7
B) Capital Account	**28.6**	**13.6**	**23.6**	**17.4**	**1.4**	**15.9**	**34.1**	**12.3**	**25.5**	**40.1**
B.1) Foreign Investment	**18.8**	**9.8**	**17.6**	**-1.8**	**0.1**	**31.4**	**38.6**	**10.0**	**12.1**	**13.3**
B.1.a) Foreign Direct Investment	14.0	7.3	9.7	12.0	-0.5	24.4	17.4	2.7	11.7	9.5
B.1.b) Foreign Portfolio Investment	4.8	2.5	7.8	-13.7	0.6	7.0	21.2	7.3	0.4	3.9
B.2) Loans	**9.6**	**3.1**	**3.1**	**9.9**	**2.8**	**-3.9**	**0.3**	**7.7**	**2.8**	**7.6**
B.2.a) External Assistance	1.5	0.4	1.3	0.6	4.1	1.9	1.2	4.0	0.3	1.1
B.2.b) Commercial Borrowings (MT & LT)	6.1	3.3	3.2	10.3	-1.2	-4.0	-1.1	6.1	0.6	4.1

Contd….

B.2.c) Short Term Credit to India	2.0	-0.6	-1.4	-1.0	-0.2	-1.8	0.2	-2.3	1.9	2.4
B.3) Banking Capital	**3.4**	**-1.8**	**-2.3**	**-4.6**	**2.2**	**-11.3**	**-7.6**	**-4.4**	**4.1**	**0.4**
B.4) Rupee Debt Service	**-0.1**	**0.0**	**0.0**	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**	**-0.1**	**0.0**
B.5) Other Capital	**-3.1**	**2.5**	**5.2**	**13.8**	**-3.7**	**-0.3**	**2.8**	**-1.0**	**6.6**	**18.8**
C) Errors and Omissions	**0.4**	**-0.9**	**0.6**	**0.9**	**-0.6**	**0.4**	**0.6**	**-0.7**	**-0.2**	**0.7**
D) Overall Balance	**14.0**	**5.1**	**21.6**	**18.8**	**19.8**	**31.6**	**32.5**	**3.4**	**31.9**	**31.2**
E) Foreign Exchange Reserves (Increase - / Decrease +)	**-14.0**	**-5.1**	**-21.6**	**-18.8**	**-19.8**	**-31.6**	**-32.5**	**-3.4**	**-31.9**	**-31.2**

Note: P: Provisional

Source: Economic Survey 2021-22 (https://www.indiabudget.gov.in/economicsurvey/doc/eschapter/echap03.pdf);

Activity 4.2

Access India's 'Balance of Payments from RBI Database (Handbook on Statistics of Indian Economy) available from RBI website. Evaluate the trend performance of India's balance of trade for a period of five years and interpret the same.

Answer:

4.10 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 rates due to the above mentioned reasons, 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.

Example: Inflation, the Statistic which is a Concern for India's BOP

High inflation, rising interest rates and fleeing dollars pushed the rupee lower than its previous lows. This made imports, foreign travel and studying abroad more expensive. (CPI) is affected mostly by rising food and oil prices and the falling exchange rate. The supply chain disturbance due to the Russian invasion of Ukraine is making India face imported inflation in the entire country. Ukraine and Russia account for almost 90 percent of India's imports of sunflower oil. Russia, being the world's largest exporter of gas and the second largest crude oil exporter, its supply chain disruptions will affect the manufacturing and transportation costs of many goods pushing inflation higher.

Sources: https://www.businessworld.in/article/India-Is-Facing-Imported-Inflation-Experts/12-07-2022-436423/, dated: 12th July, 2022. Accessed on 1st August, 2022.

ii) https://www.thehindubusinessline.com/opinion/editorial/importing-inflation/article65198478.ece, dated: 6th March, 2022. Accessed on 1st August, 2022.

iii) https://timesofindia.indiatimes.com/india/is-india-importing-most-of-its-inflation/articleshow/91536863.cms, dated: 14th May, 2022. Accessed on 1st August, 2022.

4.11 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 the 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 movements with respect to a particular currency. That movement can be estimated only if the BoP data for both the countries are studied together.

Example: Surging Fuel Prices and Rising USD Despite the Negative Net Exports of the US

The USA doesn't import gas or crude oil from Russia and also it is a net exporter of energy. But still, gasoline index surged 60% annually. US is battling inflation like never before in the recent decades. Huge government spending during COVID 19 pandemic and increased consumer spending with boosted confidence due to early access to vaccines, triggered inflation. Despite being a net importer of goods and services, USD is on the rise almost against every major currency in the world. BoP statistics must be analyzed not in isolation, but along with other important macroeconomic metrics to make sense of imports and exports.

Sources: i) https://www.eia.gov/energyexplained/us-energy-facts/imports-and-exports.php#:~:text=The%20United%20States%20became%20a,the%20largest%20margin%20on%20record. dated: 2022. Accessed on 1st August, 2022.

ii) https://www.nytimes.com/article/inflation-us-prices.html, dated: 11th June, 2022. Accessed on 1at August, 2022.

iii) https://www.bbc.com/news/business-61569559, dated: 14th June, 2022. Accessed on 1st August, 2022.

iv) https://www.economy.com/united-states/balance-of-payments-table-11-us-international-tranctions-balances-balance-on-current-account-line-1-less-line, dated: 2020. Accessed on 1st August, 2022.

v) https://www.bloomberg.com/news/articles/2022-07-13/gasoline-prices-at-record-added-pain-to-hot-us-june-cpi-report#xj4y7vzkg, dated: 13th July, 2022. Accessed on 1st August, 2022.

4.12 Relationship between BoP Variables and Other Economic Variables

As we have seen in the earlier paragraphs, the inflow and outflow of foreign exchange is dependent on many macroeconomic parameters like growth of economy, inflation, interstate structure etc. Let us discuss few of the points on BoP and Economic variables.

Implications of a Recurring Current Account Surplus/Deficit

As we know, the 'National Income' of a country is given by the equation:

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

Where,

Y = National Income

C = Consumption

I = Investment

X = Exports

M = Imports

G = Government Expenditure

This equation can be rewritten as:

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

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 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:

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

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

$$X - M = (C + T + S) - (C + G + I)$$

$$= (S - I) + (T - G) \qquad \text{(Eq. 4)}$$

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 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. Condition 1 is that the difference between national product and national spending should be made positive. Condition 2 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.

Example: How China's Exports made it the Fastest Growing Economy- The Relationships

The single most contributing factor to China's rise as a superpower is its overwhelming trade surplus in the last few decades. Post-1978 welcoming of foreign investment, through China's open-door policy, has added power to the economic transformation. By joining WTO in 2001, China could leverage its cheap labor and huge SEZs to turn into the factory of the world and flood the US and Europe with its ultra-cheap goods in almost every sector. Even in 2020 while all other major economies were witnessing negative growth China could register positive growth of 2.3 percent. Despite the property slump in 2021, China's GDP grew at 8.1 % because of its net positive exports.

Sources: i) https://www.thebalance.com/china-s-economic-growth-cause-pros-cons-future-3305478. dated: 23rd October, 2020. Accessed on 1st August, 2022.

ii) https://www.everycrsreport.com/reports/RL33534.html#:~:text=Economists%20generally%20attribute%20much%20of,gone%20together%20hand%20in%20hand. dated: 25th June, 2019. Accessed on 1st August, 2022.

iii) https://www.bloomberg.com/news/articles/2022-01-18/how-china-s-economy-grew-in-2021-despite-a-property-slump, dated: 18th January, 2022. Accessed on 1st August, 2022.

iv) https://www.wsj.com/articles/china-is-the-only-major-economy-to-report-economic-growth-for-2020-11610936187, dated: 18th January, 2021. Accessed on 1st August, 2022.

Check Your Progress - 2

6. Which of the following is the important parameter that impacts the prices of the domestic goods and affects the international competitiveness of the domestic goods and their demand?
   a. Gross national income
   b. Inflation rate
   c. Consumer price index
   d. Foreigners income
   e. Trade barriers
7. Which of the following determinants is true in respect to the international pricing of a commodity that is wholly dependent on international demand and supply positions?
   a. Optimal international pricing gets translated to a higher domestic price
   b. Higher international pricing gets translated to a higher domestic price

   c. Optimal international pricing gets translated to a lower domestic price
   d. Higher international pricing gets translated to an optimal domestic price
   e. Higher international pricing gets translated to a lower domestic price

8. Identify the factor that does not influence the capital account transactions of a balance of payment statement.
   a. Rate of return
   b. Diversification
   c. Transfer payments
   d. Risk
   e. Exchange rate movements

9. Which of the following notations will be used to record the prices of the import goods in the Indian BoP statement?
   a. F.O.B value
   b. C.I.F value
   c. Market price
   d. Actual price
   e. C & F price

10. Which of the following principles will be used to take the exchange rate for all import and export transactions to convert into Indian rupees from foreign currencies?
   a. Monthly
   b. Annual
   c. Quarterly
   d. Half yearly
   e. Average

4.13 Summary

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

- 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.
- Any measure which does not have the desired effect on current account deficit variables will not be able to correct a trade deficit.
- 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.
- A movement in the reserves position of a country can also provide some indications as to the possible movement of the exchange rates of its currency.

4.14 Glossary

Assets are bought or created to increase a firm's value or benefit the firm's operations.

Balance of Payments is the account showing movements of goods, services and capital between a country and the rest of the world.

Capital Account Balance is a part of the BoP which reflects the net inflow of public and private capital.

Current Account Balance is a part of the BoP which reflects the net inflow on account of trade in goods, services and transfer payments.

International Monetary Fund (IMF) is the supranational body, created to help countries in maintaining exchange rate stability which came into existence along with World Bank.

Liabilities are defined as a company's legal financial debts or obligations that arise during the course of business operations.

Official Reserves refers to the central bank's holdings of foreign currencies, gold and SDRs.

Sterilization refers to the intervention by a central bank to prevent the BoP situation affecting the domestic money supply.

Terms of Trade is the ratio of the prices at which a country exports its products to the prices at which it imports products from other countries.

Trade Deficit is the difference between the values of exports and imports of a country where the cost of imports exceeds the value of country's exports.

4.15 Self-Assessment Test

1. Explain the concept of economic transactions, resident and non-resident entities.
2. State the principles for valuation of transactions in BoP account.

3. Enumerate on the underlying factors that affect the BoP components of accounting.
4. How would you compile the BoP accounts? Illustrate.
5. "The BoP statement is usually divided into three major groups". Explain in detail the various components to BoP statement.
6. State the limitations of BoP.
7. Discuss in detail the relationship between BoP and other economic variables.

4.16 Suggested Readings/Reference Materials

1. Francis Cherunilam, International Business - Text and Cases, 6th Edition, PHI Learning.
2. P G Apte (2020), International Financial Management, McGraw Hill Education (India) Private Limited.
3. Madhu Vij (2021). International Financial Management – Text and Cases. 4th edition. Taxmann.
4. Charles W. L. Hill, G. Tomas M. Hult (2021). International Business. 12th edition. McGraw Hill Education (India) Private Limited.
5. Choel S. Eun & Bruce G. Resnick (2022). International Financial Management. 8th edition. McGraw Hill Education (India) Private Limited.
6. K. Aswathappa (2020). International Business. 7th edition. McGraw Hill Education (India) Private Limited.

4.17 Answers to Check Your Progress Questions

1. (b) Balance of trade

The 'Balance of Trade' refers to merchandise imports and exports (visible trade) whereas BoP refers to all economic transactions – including 'invisible transactions' like banking, insurance, transport services, etc., with the rest of the world.

2. (b) Decrease in external purchasing power of a country

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, merchandise imports and invisible imports; a capital outflow or lending abroad and increase in foreign exchange reserves and gold reserves of the monetary authority.

3. (e) Investment income

All others being classified under the head capital, investment income represents the servicing of capital transactions in the nature of both debt and non-debt, in the form of interest, dividend and profit for servicing of capital transactions.

4. (b) Foreign Portfolio Investment (FPI)

When a foreign country portfolio investor directly purchases financial assets in the Indian securities market, it is termed as 'Foreign Portfolio Investment'.

5. (c) Monetary movements

The monetary movements keep record of India's transactions with the International Monetary Fund (IMF), and India's foreign exchange reserves which basically consist of Reserve Bank of India (RBI) holdings of gold and foreign currency assets.

6. (b) 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. The higher the inflation, the lower the competitiveness and the lower the demand for domestic goods.

7. (b) Higher international pricing gets translated to a higher domestic price

The international demand and supply positions determine the international prices of a commodity. A higher international price would get translated into a higher domestic price.

8. (c) Transfer payments

Four major factors affect international capital transactions. The foremost is the rate of return which can be earned on the investments. Another factor is the additional risk that accompanies these returns. Diversification across countries may offer some extra benefits in addition to the returns offered by a particular investment. One more factor which has a very significant effect on these transactions is the expected movements in the exchange rates.

9. (b) C.I.F value

The second significant deviation from the IMF principles of valuation on recording transactions 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).

10. (e) Average

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.

International Finance

Course Structure

Block 1: Fundamentals of International Finance	
Unit 1	Introduction to International Finance
Unit 2	Theories of International Trade
Unit 3	International Trade Finance in India
Unit 4	Balance of Payments
Block 2: Foreign Exchange Transactions	
Unit 5	International Monetary System
Unit 6	The Foreign Exchange Market
Unit 7	Exchange Rate Determination
Unit 8	Exchange Rate Forecasting
Block 3: Exchange Risk Management	
Unit 9	Introduction to Exchange Risk
Unit 10	Management of Exchange Risk
Unit 11	International Project Appraisal
Block 4: International Financial Management	
Unit 12	International Financial Markets and Instruments
Unit 13	International Equity Investments
Unit 14	Short Term Financial Management
Unit 15	International Accounting and Taxation
Block 5: International Trade	
Unit 16	Trade Blocks
Unit 17	Foreign Trade Policy
Unit 18	Documentary Credits
Unit 19	Export Finance and Exchange Control Regulations Governing Exports
Unit 20	Import Finance and Exchange Control Regulations Relating to Import Finance