Block

1

OVERVIEW OF GLOBAL FINANCIAL MARKETS

Ref. No. GFM-SLM-IFHE – 102022 B1

For any clarification regarding this book, the students may please write to The ICFAI Foundation for Higher Education (IFHE), Hyderabad specifying the unit and page number.

While every possible care has been taken in type-setting and printing this book, The ICFAI Foundation for Higher Education (IFHE), Hyderabad welcomes suggestions from students for improvement in future editions.

Our E-mail id: cwfeedback@icfaiuniversity.in

Centre for Distance and Online Education (CDOE)
The ICFAI Foundation for Higher Education
(Deemed-to-be-University Under Section 3 of UGC Act, 1956)
Donthanapally, Shankarapalli Road, Hyderabad- 501203

COURSE INTRODUCTION

The Financial Markets across the globe witnessed several upheavals over time. The subprime mortgages in US (2007), collapse of Lehman Brothers (2008), the euro zone crisis (2010), decision of UK to exit from Euro Zone, Brexit (2016), Covid pandemic and related lockdowns across the world (2020-21), Ukraine War in 2022, etc., are the most important events that shook the world financial markets. The collapse of financial institutions and lock down of economies due to pandemic as such raised many questions on the operations and strengths of the economies and the financial institutions. To prevent and curtail crises, many changes were initiated by the regulatory authorities which were meant to bring stability in the banking system and economy as a whole.

There are changes with respect to macroeconomic policy, financial stability, financial regulation and supervision, corporate governance, risk management, etc. A comprehensive and well-structured banking and financial framework is strongly recommended to encounter any similar financial crisis that has occurred in the past.

The course on Global Financial Markets intends to educate the students about the financial sector in very clear and easy to understand terms by providing them a broad and balanced introduction to financial markets across the world.

This course also gives an in-depth analysis of valuation of global bond and equity markets.~~,~~ The global financial markets are very dynamic; and this course provides a comprehensive and up to date coverage about issues that impact the global markets. This course also gives an overall idea about various global market functions like global money markets, international banking, etc.

The course Global Financial Markets mainly deals with

- Various issues and challenges in global financial market
- Global Bond Markets and valuation of bonds
- Global Stock Markets
- Global Perspective of Money Markets, Commodities Markets & Derivatives Market.
- Banking in International Perspective
- The impact of subprime lending and its resultant global crisis in 2007 and the impact of Brexit 2016 and the repercussions of Pandemic Covid19 that shattered world economy in 2020 and 2021
- Regulatory aspects and Corporate Governance in Global Financial Markets

The course contains four blocks and nineteen units.

This edition has brought in updations in content, including addition of contemporary, relevant examples.

BLOCK 1: OVERVIEW OF GLOBAL FINANCIAL MARKETS

This is the introductory block for Global Financial Markets. This block introduces the basic concepts of Global Financial Market such as globalization, global financial markets, foreign direct investments, risk management aspects in financial markets, WTO, GATT, etc. This block consists of three units.

Unit 1: *Introduction to Global Financial Markets* discusses the various issues and challenges in global financial markets. Globalization has influenced all the economies. The integration of financial markets necessitated business managers to understand the nuances of global markets. This unit also discusses globalization and its impact on the global financial markets and also evaluates global bond markets with special reference to corporate bond market. This unit deliberates on topics like FDI, FII, and FDI by Indian Companies Abroad, Private Equity, Venture Capital, Hedging and Forfaiting. The impact of Covid 19 on global economy was briefly touched.

Unit 2: *Macro issues impacting Global Markets* deals with macro factors which have an impact on day-to-day operational issues in the markets. Global markets consist of various components/market players. The seamless market integration gives scope for contagion effect on the global markets. Hence the business managers have to understand the issues that impact the markets. This unit makes an attempt to discuss macro factors briefly. The impact of Pandemic Covid 19 on the world economy and subsequent changes are discussed briefly. The main function of a financial market is facilitating capital formation and distribution of capital. The prevailing political scenario in the respective economies is the first and foremost factor to influence such activities. This unit also triggers some discussions on political scenarios, analysis on price setting, evaluating yield, etc.

Unit 3: This unit on *Multilateral Institutions* discusses the genesis and the role of WTO, BIS, WB, IMF and their impact on Global markets. Each multilateral institution has taken birth because of a compelling economic reason and with a clear objective of providing a framework for development/protection/regulating the member countries. Understanding functional aspects of these multilateral institutions will help the managers. This unit also discusses the development of new financial instruments, liberalization in financial market regulations and increasing cross penetration of foreign ownership in various economies. This unit also discusses the relevance of IMF in shaping the global economy, identifying the role of World Bank, understanding the contribution of WTO and the relevance of Bank for International Settlements (BIS) in global banking and role of Asian Development Banks in uplifting of Asian Economy.

Unit 1

Introduction to Global Financial Markets

Structure

"Our financial markets work best when they are competitive, fair, and transparent."

- Kenneth C. Griffin

1.1 Introduction

Let's study how global financial markets evolved and how they function.

In this unit you will learn about global financial markets. Global financial markets consist of financial institutions, instruments and regulatory system and business players operating across various international markets.

In financial markets investment is the lifeline – investment for expansion of business, investments in financial instruments, investment in other countries. Hence while introducing the global financial markets, issues related to foreign direct investment in India, global bond market, corporate bond market, private and venture capital, strategies of investments by private equity firms, hedge funds, external commercial borrowings and trade credit, and trade finance are discussed.

This unit also discusses the various issues and challenges in global financial markets. The beginning of 1990s heralded globalization process across all emerging economies. The financial markets have started picking up trading volumes and introduction of new-products in all parts of market segments has gained momentum. Globalization has influenced all the economies. The main features of globalization are integration of financial markets, large capital flows across the economies through FDIs, private equity, venture capital, foreign portfolio and other modes of funding.

1.2 Objectives

After reading this unit, you will be able to:

- Define the meaning of globalization and its impact on global economy
- List global financial markets and various segments of the markets
- Recall various sources of finance available to market players
- List the features and impact of the products like foreign direct investments, instruments like bonds on global markets
- Distinguish features of private equity and venture capital
- Discuss the purpose of PE firms and their investment strategies
- Evaluate the avenues available in Global Markets with respect to external commercial borrowings and trade finance.

1.3 Globalization

Globalization makes the world a global village as the geographical boundaries for trade literally vanish. Globalization facilitates increased trade and business with the rest of the world. The globalization process opens free movement of capital among the different countries and helps the economies to take speedy path for the growth.

Globalization is a process of interaction and integration among the people, companies and governments of different nations, a process driven by international trade and investment and aided by information technology. Globalization is not restricted to finance, banking, trade and production alone. It includes cultural confluence as well, though the popular definitions generally do not consider this aspect.

"Globalization" in particular related to financial sector is movement of people, goods, services, technology and finance (long, medium and short term) across countries and continents, with minimal restrictions in the form of taxes or tariffs or embargoes. In a sense, every country enjoys financial globalization without isolation. It is a question of difference in degree of globalization.

The term 'globalization' has multiple definitions. Globalization is the concept of inter-connected economies, interlinked technological, cultural, environmental, and political processes across the countries.

The intention of capitalists of advanced nations in the early 1980s was to expand into greener pastures, and this started the globalization process. Multinational Companies (MNCs) started expansion of their market share in the respective markets and became dominant players in various economies.

Perspective of IMF on Globalization

"Globalization" is a historical process, the result of human innovation and technological progress. It refers to the increasing integration of economies around the world, particularly through the movement of goods, services, and capital across borders. The term sometimes also refers to the movement of people (labour) and knowledge (technology) across international borders. There are also broader cultural, political, and environmental dimensions of globalization.

The globalization concept provided the impetus and facilitated different economies to introduce various structural reforms in the rules and regulations of international trade, domestic economic policies of countries, financial sector, industrial policy, equity and bond markets, foreign direct investments, and capital markets. These steps facilitated free flow of capital, technology and profit across national boundaries. Multilateral institutions like the World Bank, the International Monetary Fund and the World Trade Organization are also advocating various structural processes to be implemented.

Interconnectivity in Lifestyles

Globalization has connected developed and developing economies much closer. In fact, it made these countries inter-dependent. The developed countries depended on developing countries for their natural resources whereas, developing countries depended on developed countries for oil, technology, raw materials, industrial products, etc. Furthermore, increase in communication between the individuals and the trading companies of one country with those of other countries paved the way for free trade between the countries. It has led to economic growth.

However, many countries have profited from globalization but some countries have lagged behind. Political system, bureaucracy and literacy could be responsible for this. For example, India and China have grown faster than other wealthy nations whereas some African countries still reel under poverty, civil wars, diseases, etc.

MNCs originating from the developed countries set up factories in developing countries to exploit the local resources. Many polluted the environment due to poor regulation. However, increased awareness amongst the developing countries resulted in stricter regulatory policies on the environmental front.

Globalization has many benefits but can be detrimental to the culture in developing countries. Post-globalization, many developing countries have understood the culture of developed countries like USA, Europe and Australia. Globalization has brought about changes in the lifestyles, eating habits and conveniences.

International Trade

A core element of globalization is the expansion of world trade through the elimination or reduction of trade barriers, such as import tariffs. More imports offer consumers a wider variety of goods at lower prices but providing more incentives for domestic industries becomes necessary to remain competitive. Exports, often a source of economic growth for developing nations, stimulate job creation as industries sell beyond their national frontiers. Generally, trade enhances national competitiveness by driving workers to focus on those vocations where they and their country, have a competitive advantage. Trade promotes economic resilience and flexibility as higher imports help to offset adverse domestic supply shocks. Greater openness can also stimulate foreign investment, which would be a source of employment for the local workforce and could bring along new technologies—thus promoting higher productivity.

World Trade in 2019[1]

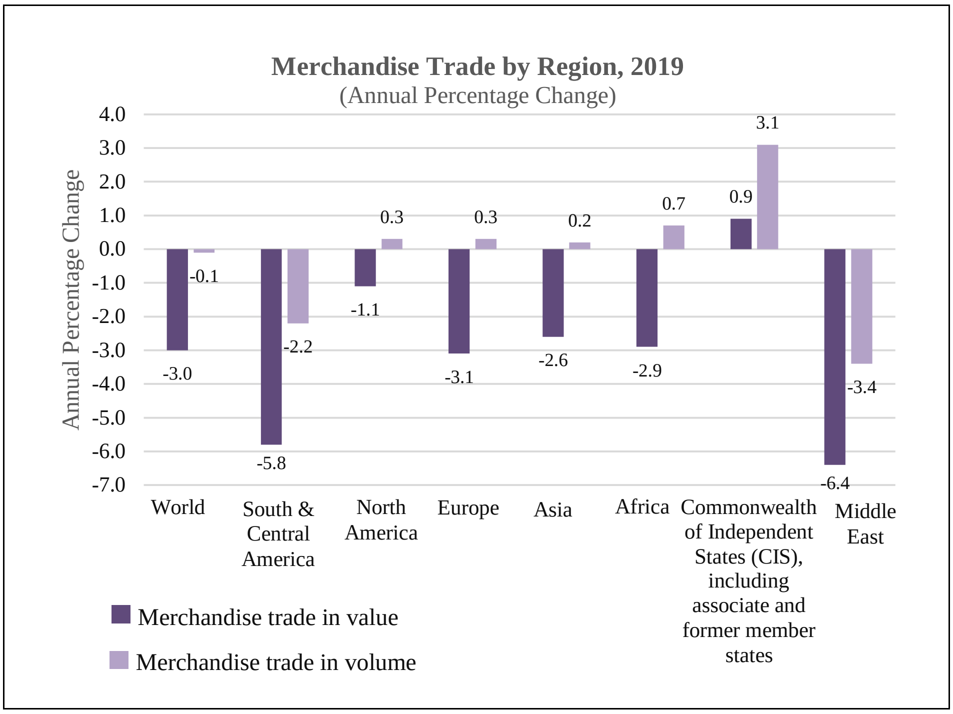
World merchandise trade in volume terms recorded a slight decline of 0.1 per cent in 2019 after rising by 2.9 per cent in the previous year. Merchandise trade is measured as the average of exports and imports. In value terms, trade declined by 3.0 per cent compared with a 10.2 per cent increase in 2018. World trade in commercial services increased by 2.1 per cent in 2019, slowing substantially from its 8.4 per cent rise in 2018. Transport exports declined by 0.8 per cent as merchandise trade faltered. Other commercial services recorded the highest export growth (3.3 per cent) among services sectors in 2019, buoyed by slowing, but continued, growth in the telecommunications, computer and information services sector.

Merchandise trade of the European Union accounted for 30 per cent of world trade in 2019, totaling US$ 5,670 billion. 54.2 per cent of global exports in 2019 in commercial services was contributed by top 10 countries USA, UK, Germany, France, China, Netherlands, Ireland, India, Singapore and Japan in that order. The rest was contributed by other countries

Trade in manufactured goods represents 70 per cent of world merchandise exports.

[1] Source: https://www.wto.org/english/res_e/statis_e/wts2020_e/wts20_toc_e.htm

Figure 1.1: Merchandise Trade by Region, 2019



Adapted from WTO Secretariat

All regions recorded a decline in merchandise trade in terms of volume and value in 2019. The largest decline was in South and Central America and the Caribbean. The 3.0 per cent decline in the value of world merchandise trade was mostly driven by Europe and Asia, which represent almost two-thirds of merchandise trade.

Globalization provided access to corporates across Less Developed Countries (LDCs), Developing countries and Developed countries. These corporate entities will compete to gain world market share. Hence, various perspectives of global markets are to be understood.

1.3.1 Global Marketing

With increasing globalization, the companies operating in international markets face fierce competition. In this dynamic corporate environment, the multinational companies must adapt to change and manage themselves to bring continuous change into their organizational structures.

Global marketing is marketing in a global environment where the world is becoming increasingly inter-dependent for its economic progress. In the process, radical social transformation is taking place. Globalization, in general, has resulted in what we now call the entire world a global village.

Global marketing is concerned with resources and competencies on global market opportunities and challenges. It needs to comprehend new ways of managing the marketing mix, in different and diversified economic, financial, political and cultural environment of each target nation. Global marketing opportunities have become more profitable under the conditions of globalization and willingness of various economies to enhance the degree of globalization by removing / reducing trade barriers and by promoting bilateral and or multilateral trade arrangements.

The organizations that wish to go global need to possess adequate knowledge of fiscal, monetary, legal, forex and cultural practices and policies of the different nations and display willingness to customize their marketing strategies in tune with these diversities. This list should also include GDP growth rates, savings and investment growth rates, inflation and unemployment rates, FDI patterns, etc.

The need to understand bilateral/multilateral agreements and the specific features of certain regional economies is essential for global markets. Agreements between nations deal with free trade areas, customs unions, common market, economic unions, etc.

In global marketing, cultural environments do differ radically from nation to nation. This calls for market adaptations. While similarities encourage standardization, differences call for adaptations. Balancing these two on a global plane is the key to success.

Following is the broad classification of global markets on the basis of geographical/ historical considerations:

a. Asia Pacific region

b. European Union

c. North and South America

India and China have been added to this list r because of the sheer size of these two markets. Let us study the specifics of these classifications:

Asia Pacific Region: South Korea, Taiwan, Hong Kong, Singapore are the high value added competitors. Malaysia, Thailand and Philippines are entering high value added markets. Trade in this region is fueled by increasing domestic demand, expanding business environment *overseas* and growing competitiveness of firms based in the region.

European Union: Twenty-eight countries of Europe have joined European Union for economic cooperation, with a view to create a trade perception that this union is just like one country with regard to trade/tariff barriers, labor movements, etc. Euro is their common currency. With over 75 crore population, European Union is a sizable market. There is competition between EU companies and Non-EU firms. With Brexit in 2016, UK opted out of European Union.

North America Free Trade Zone (NAFTA): This region consists of the US, Canada and Mexico. It aims to enhance the North American market and reduce trade barriers within. It increases competition among member firms. The US is a very attractive destination, being the wealthiest nation in the world, but cannot accommodate unhindered growth.

India: Very large market - fast growing economy. Ease of doing business is improving. Demographic dividend is a favorable factor. It is a stable political system but judicial system is mired in delays. Bankruptcy laws are not of global standards, so are patents, intellectual property and copyright laws.

China: Very large market - till recently the fastest growing nation. Demographic dividend, presently, is not considered favorable. Unsatisfactory legal system is a challenge. Intellectual property rights like copyright, patents, etc., are quite unsatisfactory. Low technology, low wages but known for mass marketing of low end products on a global plane.

Global marketing is boundary-less marketing: It aims to eliminate communication barriers between marketing and other business functional areas. Successful value creation efforts are achieved by integrating and leveraging operations on a worldwide scale.

An industry is global to the extent that a company's industry position in one country is interdependent with its industry position in another country. Global companies adopt focus as a strategy. Here, focus refers to concentration and attention on core business and competence: the way Nestle is exclusively focused on food and beverages.

Global marketing is instrumental in Coca Cola, a US based company, generating 90% of its operating income outside the US. Likewise, Japan, an export driven economy, has 85% of its market outside Japan. For German and EU companies, 94% of potential is outside Germany.

There are many global companies which adapted to local environments and expanded their market share in the segment they were operating. Some such companies are: Johnson & Johnson, Cadbury, DuPont, Ogilvy and Mather, Whirlpool, Samsung, Unilever and many more.

Example: World Economic Forum 2022: Is Globalization under Threat?

The leaders that met during June 2022 at Davos felt an urgent sense of the need to reboot and redefine 'globalization'. The open market framework that shaped the last three decades of commerce became increasingly wobbly. The pandemic exposed the fragility of global supply networks. But again, it was globalization that made vaccines available to many countries that couldn't produce them. Companies have yet to recover from the global supply chain disruptions and the war in Europe raised fears about further disruptions, with everything from energy supplies to auto parts to exports of wheat and raw materials under threat.

Sources: i) https://www.business-standard.com/article/economy-policy/wef-2022-globalisation-s-cheerleaders-grasp-for-new-buzzwords-at-davos-122052601366_1.html, dated May 26, 2022. (Accessed on June 7, 2022)

ii) https://www.ndtv.com/world-news/new-world-order-one-two-punch-of-covid-and-war-rattle-globalisation-2845636, dated March 27, 2022. (Accessed on June 7, 2022)

1.4 Global Financial Markets

Global financial markets promote economic growth by various financial instruments and other financial products. Global markets facilitate risk management in the market operations and provide access to capital globally. It is the provider of valuable information as well with respect to products, services, relative costs of capital, liquidity status, suitability of instruments, etc.

Global financial markets function in highly inter-connected markets. It is generally banking intermediated and banking dependent. However, systems like trade credit function principally outside the banking system.

It is only through the availability of various financial instruments like bonds, private equity, venture capital, equity, term loans, carry trade, trade finance, external commercial borrowing, etc., that different stake-holders in project finance, with different risk perceptions are able to participate. In general, global financial markets are efficiently regulated and bank dominated. However, shadow banking (consisting of mutual funds, hedge funds, investment banks, etc.) is also gaining prominence.

Example: How Connected Are Global Markets?

Global markets became highly inter connected. Change in oil price impacted the whole world.

Asian stock markets declined on June 2, 2022, as a result of high inflation and the possibility of a recession. Following news of Saudi Arabia's promises regarding supply, oil prices fell. Global benchmark Brent crude fell by more than 2% a barrel reaching $ 113.86 while the U.S. crude to $ 112.55 a barrel ahead of a summit of oil-producing nations later in the day, as it was expected to clear the way for the output hike.

Source: https://economictimes.indiatimes.com/markets/stocks/news/asian-shares-fall-on-inflation-recession-concerns-oil-skids/articleshow/91952317.cms, dated: June 02, 2022. (Accessed on June 7, 2022)

1.5 Foreign Direct Investment in India

In the liberalized business environment, Indian Regulatory System (the Government, the RBI, SEBI, IRDA and other related regulatory bodies) allowed foreign fund flows into various industries. These capital flows have long term impact on the economy. This topic deals with investments by foreign entities.

Overseas corporates invest in the equities of Indian companies with a view to earn higher returns and take advantage of the access to a very huge Indian domestic market. Low cost of labor and recent investor-friendly policies of the government encouraged such investments.

Further, overseas companies from the European Union, Japan and the US have realized that it is very challenging to expand further in their respective domestic economies due to stiff competition and near saturation stage of demand. Lax pollution control regulations in India are also a factor for them to converge into India.

The Indian government considers Foreign Direct Investment (FDI) as a long-term investment, which is very much needed for the economic growth of India. FDI is a good source for employment generation, modern management skills, large capital, technology and possibilities of exports from India. On the flip side, lack of adequate infrastructure, bureaucratic hassles and unsatisfactory legal system restrict FDI inflow into India.

[2]According to the Department for Promotion of Industry and Internal Trade (DPIIT), FDI equity inflow in India stood at US$ 15.59 billion between January and March, 2022

In September 2021, the Union Cabinet announced to allow 100% foreign direct investment (FDI) via the automatic route, from the previous 49% in the telecom sector in India, to boost the sector.

In August 2021, the government amended the Foreign Exchange Management (non-debt instruments) Rules, 2019, to allow the 74% increase in foreign direct investment limit in the insurance sector.

In May 2021, the Finance Ministry notified the final rules for foreign investment limit (74%) in the insurance sector. This is expected to benefit 23 private life insurers, 21 private non-life insurers and seven specialized private health insurance firms.

According to a press release[3] by Government of India on 24th May 2021, India attracted the highest ever total FDI inflow of US$ 81.72 billion during 2020-21, 10% more than the financial year 2019-20.

FDI equity inflow in India stood at US$ 17.56 billion between April 2021 and June 2021. Data between April 2021 and June 2021 indicates that the automobile sector attracted the highest FDI equity inflow of US$ 4.66 billion, followed by computer software & hardware sector (US$ 3.06 billion), services sector (US$ 1.89 billion) and metallurgical industries (US$ 1.26 billion).

The following are the details of the developments recorded in the area of Foreign Direct Investment (FDI) during FY 2020-21.

- India has attracted highest ever total FDI inflow of US$ 81.72 billion during the financial year 2020-21 and it is 10% higher as compared to the financial year 2019-20 (US$ 74.39 billion).
- FDI equity inflow grew by 19% in the F.Y. 2020-21 (US$ 59.64 billion) compared to the previous year F.Y. 2019-20 (US$ 49.98 billion).

[2] https://www.ibef.org/economy/foreign-direct-investment.aspx
[3] https://pib.gov.in/PressReleseDetail.aspx?PRID=1721268 press release on 24th May2021 by PIB

- In terms of top investor countries, 'Singapore' is at the apex with 29%, followed by the U.S.A (23%) and Mauritius (9%) for the F.Y. 2020-21.
- 'Computer Software & Hardware' has emerged as the top sector during F.Y. 2020-21 with around 44% share of the total FDI Equity inflow followed by Construction (Infrastructure) Activities (13%) and Services Sector (8%) respectively.
- Under the sector 'Computer Software & Hardware', the major recipient states are Gujarat (78%), Karnataka (9%) and Delhi (5%) in F.Y. 2020-21.
- Gujarat is the top recipient state during the F.Y. 2020-21 with 37% share of the total FDI Equity inflows followed by Maharashtra (27%) and Karnataka (13%).
- Majority of the equity inflow of Gujarat has been reported in the sectors 'Computer Software & Hardware' (94%) and 'Construction (Infrastructure) Activities' (2%) during the F.Y. 2020-21.
- The major sectors, namely Construction (Infrastructure) Activities, Computer Software & Hardware, Rubber Goods, Retail Trading, Drugs & Pharmaceuticals and Electrical Equipment have recorded more than 100% jump in equity during the F.Y. 2020-21 as compared to the previous year.
- Out of top 10 countries, Saudi Arabia is the top investor in terms of percentage increase during F.Y. 2020-21. It invested US$ 2816.08 million in comparison to US$ 89.93 million reported in the previous financial year.
- 227% and 44% increase recorded in FDI equity inflow from the USA & the UK respectively, during the F.Y. 2020-21 compared to F.Y.2019-20.

Example: FDIs in India – Recent Trends

For the FY 2021-2022, India reported an FDI (Foreign Direct Investment) inflow of $83.57 billion which eventually was the highest recorded FDI, in any FY till then. This increase was 20 times compared to the FDI of $ 4.3 billion recorded during the FY 2003-04. Despite the Covid-19 pandemic and the war in Ukraine, FDI for 2021-22 was more than the previous FY by $ 1.60 billion. FDIs in the manufacturing sector increased YOY by 76%. FDIs from Singapore topped the list accounting for 27%, followed by the FDIs originating from the United States which was 18%, and Mauritius which was 16%. The computer software and hardware sector received 25% of total inflows, topping the list followed by the services sector and the automobile sector, which received 12% each.

Sources: i) https://www.hindustantimes.com/india-news/india-reported-highest-fdi-inflow-worth-83-billion-in-2021-2022-centre-101653049532939.html, dated July 19, 2022. (Accessed on June 8, 2022)

ii) https://www.fdi.finance/news/in-2021-2022-india-reported-the-highest-fdi-inflow-of-83-billion-centre, dated June 01, 2022. (Accessed on June 8, 2022)

Activity 1.1

You are required to list out major FDI's in Telecommunication industry in India.

Foreign Institutional Investors (FIIs)

Foreign Institutional Investor is an investor or investment fund that is from a country outside India. Hedge funds, private equity and venture capital funds with overseas origin fall into this category. Pension funds, provident funds, etc., on a global level also constitute FII funds. However, FIIs are known for the following distinct features:

- FIIs obtain mandate from such investors and organize for them a fee-based service in the form of global investments into equity and debt markets, with a view to earn higher rate of return.
- They are perceived by the host economies as hot money funds that chase interest rates.
- They are also called fair weather friends as they quickly shift their investments from one country to another in no time for better returns or to book losses and exit temporarily.
- They are essentially short-term investors in equities and bonds.

FII - The Big Debate

Many economies consider FII investments into their nations as unproductive and in some cases even undesirable because of the very short-term nature of these funds and the possible volatility they could create in the forex markets when they enter or exit. FIIs are not like FDI players who have long-term goals and who are perceived as investors on mutually rewarding terms. Those in favor of FII investments point out that these investments create a vibrant secondary market in equities and bonds with international standards. They also add to the liquidity in the secondary market. But for their participation, economies like India cannot boast of a stock market of global standards with substantial depth. This debate continues and lot can be said on either side.

Direct Investment by Indian Companies Overseas[4]:

Outward Foreign Direct Investments (OFDI) or direct investment abroad means the net FDI outflows made by the residents of a reporting country in all host

[4] http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=1555
http://www.business-standard.com/article/economy-policy/fdi-outflows-mauritius-is-india-s-largest-overseas-investment-destination-117043000425_1.html
https://www.ibef.org/economy/indian-investments-abroad
https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=40189
http://statisticstimes.com/economy/countries-by-projected-gdp.php

economies. Such investments are generally made either under the automatic route or the approval route, by way of contribution to the capital or subscription to the memorandum of a foreign entity.

The outbound direct investment includes Equity, Loans, and Guarantee Invoked.

Table 1.1: Outbound FDI for the Period from April, 2000 to August, 2021

Equity	US$ 61792.96 million
Loans	US$ 81328.93 million
Guarantees Invoked	US$ 6443.84 million
Total	US$ 249565.73 million

Source: RBI Monthly Fact Sheet Overseas Direct Investment Data from April 2000 to August 2021 as on August 2021.

Outbound investments from India have undergone a considerable change not only in terms of magnitude but also in terms of geographical spread and sectorial composition. Analysis of the trends in direct investments over the last decade reveals that while investment flows, both inward and outward, were rather muted during the early part of the decade, they gained momentum during the latter half.

Due to global economic slowdown, India does not rank amongst the top 10 outward FDI nations in the world (refer Table 1.2 below).

Table 1.2: Outward FDI of Major Nations and Regions for the Period 2019 to 2021 August in USD Millions

Rank	Country	2019-20	2020-21	2021-22 upto Aug'21	US$ millions	*As % of Total FDI
1	Singapore	3730.03	2655.51	2526.86	8912.40	27.75%
2	Mauritius	1052.35	1411.78	516.35	2980.48	9.28%
3	United States of America	2017.14	2639.22	705.36	5361.72	16.69%
4	Netherlands	1222.36	1232.12	549.20	3003.68	9.35%
5	United Kingdom	1322.05	886.22	491.97	2700.24	8.41%
6	United Arab Emirates	441.08	662.98	142.77	1246.83	3.88%
7	British Virgin Islands	181.64	358.09	147.13	686.86	2.14%
8	Russia	590.46	397.75	230.97	1219.18	3.80%
9	Switzerland	637.49	102.08	172.77	912.34	2.84%
10	Sri Lanka	87.99	104.32	37.75	230.06	0.72%

Source: https://www.oecd.org/investment/statistics.htm

Table 1.3: Summary of Overseas Direct Investment Outflows for 3 Years

Month	Actual ODI Outflow (In US$ Million)		
	2019	2020	2021
April	737.48	853.92	1995.63
May	1183.99	311.87	1360.21
June	735.16	744.25	2022.23
July	766.70	707.62	916.65
August	684.77	481.89	669.04
Total	**4108.10**	**3099.55**	**6963.76**

Source: RBI Monthly Fact Sheet Overseas Direct Investment Data from April 2019 to August 2021 as on August 2021

While the status of India's OFDI in 2021 is as above, it is observed that there has been a perceptible shift in Overseas Investment Destination (OID) during 2020 and 2021. During the referred period, the impact of pandemic Covid19 was there in 2020 while during 2021 the situation was eased out.

India’s overseas investments were channeled towards countries such as British Virgin Islands, Mauritius, Netherlands, and Singapore as they provide higher tax benefits. Interestingly, Indian companies invested offshore primarily through the inorganic route of Mergers and Acquisitions (M&A). The driving force for burgeoning M&A activity amongst Indian companies is the greater access to modern markets and state-of-art technologies that would facilitate them to enhance their customer base and attain a global scale of operations.

A slew of reforms applicable to joint ventures and wholly-owned subsidiaries were rolled out that included: doing away with the ceiling for raising funds through pledge of shares and domestic and overseas assets. Subsequently, such concessions were also extended to even a step-down subsidiary.

Table 1.4: FDI Outflows Nations for 4 Year Period 2017 to 2020 USD Millions

Country	2017	2018	2019	2020
China	136293	143027	136210	109922
India	110901	11418	13141	11569
Brazil	19040	-16336	19031	-25808
Russia	34153	35820	22024	6311.00
South Africa	7366	4074	3147	-1973.00

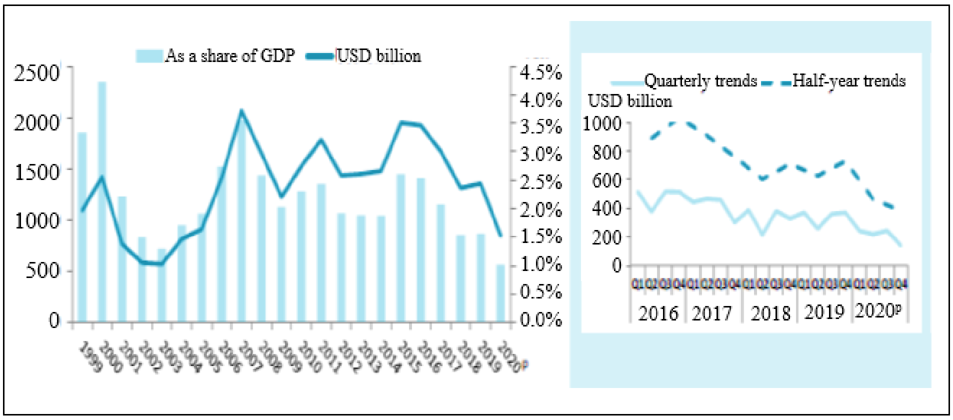
Source: OECD FDI in Figures April 2021

While the general trend of FDI outflows across all the BRICS nations seem to be on the rise, only in case of Brazil there seems to be a negative trend.

Covid-19 pandemic hit the outflows of FDI in the year 2020. In 2020, global FDI flows plummeted to USD 846 billion, a 38% decrease compared to 2019. The pandemic accelerated a steady decline and contributed to sinking global FDI flows to their lowest levels since 2005. In 2020, global FDI flows represented only 1% of world GDP

Figure 1.2 shows annual global FDI flows from 1999 to 2020 as well as quarterly and half-year trends from 2016 to 2020. Looking at half-year values, FDI flows dropped by 37% in the first half of 2020 to the lowest half-year level recorded since 2013, before dropping by a further 17% in the second half of the year. Looking at quarterly values, global FDI flows declined throughout 2020, except in the third quarter where they rebounded by 11%, before dropping again by 42% in the last quarter.

Figure 1.2: Global FDI Flows 2019-2020



Source: OECD International Direct Investment Statistics database

FDI inflows to non-OECD G20 economies only decreased by 9%, due to rebounds in China and India later in the year 2020. FDI outflows across a number of non-OECD G20 economies dropped by 49%.

China overtook the United States as the top destination for FDI worldwide. India and Luxembourg (excluding resident Special Purpose Entities (SPEs)) trailed them as large FDI recipients.

[5]An associated factor was the relatively slow growth of emerging markets as a whole, which dampened investment activity. Among BRICS economies, which represented roughly a third of FDI flows to developing and transition economies, Brazil and the Russian Federation were in recession. Brazil was badly hit by recession and political unrest, whereas Russia was able to withstand the recession by its economic and political stability. Indian growth was stable due to its structured economic reforms and strong government. However, growth slowed during the referred period in South Africa and in China. In turn, depreciating

[5] http://unctad.org/en/PublicationChapters/wir2016ch1_en.pdf

national currencies weighed on profits when expressed in dollars, which put downward pressure on reinvested earnings.

The only trillion-dollar club member in the BRICS category is China which had an accumulated FDI stock of USD 1.32 trillion (refer Table above) as of 2016 December.

During 2016-17, the RBI had further rationalized/liberalized guidelines for outward FDI by Indian companies by raising the annual overseas investment ceiling from US$ 75,000 to US$ 125000 for establishing joint ventures and wholly owned subsidiaries. Going forward, these initiatives taken by the central government buttressed by experimental outlook of Corporate India should witness an upward trend in OFDI. Moreover, the RBI has relaxed norms for direct foreign investment abroad by enhancing the borrowing limit of Indian corporates. The financial commitment to be undertaken by an Indian party will be restricted to within 400% (as against 100%) of the company's net worth. Even Limited Liability Partnership (LLP) firms were allowed by the RBI to undertake financial commitment to/on behalf of joint ventures or wholly owned subsidiaries of Indian corporates overseas.

1.6 Global Bond Market

The bond market basically consists of government and corporate bond securities. The market facilitates investment in government or corporate companies with a fixed rate of interest. The bond market occupies a pivotal role for corporate and government funding and major investment vehicle across all global markets.

The government usually invests such money borrowed in various projects like construction of roads, buildings, hospitals, etc.; whereas the corporate invests such money borrowed in expansion or diversification programs, purchase of plant and machinery, etc.

Some of the examples of bonds issued by foreign borrowers in the currency in which it is sold are Yankee Bonds issued by foreign borrowers in U.S, Samurai Bonds issued in Japan and denominated in Yen and Bulldog bonds issued in U.K. pounds.

International Debt Securities (IDS) are issued outside the local market of the country where the borrower resides. They capture issues conventionally known as euro-bonds and foreign bonds and exclude negotiable loans. The IDS statistics are compiled from a security-by-security database built by the BIS using information from commercial data providers. Amounts are presented at face value.

The IDS statistics are presented by currency, maturity and interest rate type of the issue, and nationality and residence of the issuer. The residence of the issuer is the country where the issuer is incorporated, whereas the nationality of the issuer is the country where the issuer's parent is headquartered.

Concretely, to include an issue in the IDS statistics, the [6]BIS assesses

(i) The residence of the immediate issuer;

(ii) The location of the issue's registration

(iii) The governing law; and

(iv) The listing location

When all four Characteristics refer to the same country, the issue is classified as a domestic debt security (DDS) when atleast one points to a different country, the security is classified as international. For example, if a resident of the United Kingdom issues a security governed by English law and listed on the London Stock Exchange but registered in the United States, then this is an IDS. The security would also be considered international if, say, the UK resident issued it under New York law or listed it on the New York Stock Exchange.

Some of the observations as per BIS Quarterly Review June 2021:

The market for NFC (Non-financial corporations) international debt securities has grown substantially in recent decades, expanding further during the pandemic. As regards EME (emerging markets economies) corporates, a salient finding of the analysis is that their IDS issuance – much of which is in US dollars and conducted through offshore affiliates – responds strongly to global financial conditions. Nevertheless, while these conditions deteriorated with the pandemic, forceful policy measures supported strong debt issuance by both EME and AE (advanced economies) corporates efficiently allocated across sectors and firms, whether the increased borrowing has generated pockets of excessive indebtedness and whether credit risk has been properly priced. As regards monitoring the funding needs of corporates, especially those from EMEs. The analysis suggests that it is important to pay close attention to their offshore activity. Such activity may be particularly sensitive to potential changes in global financial conditions as support measures are phased out.

Example: Size of the Global Bond Market

According to the estimates of ICMA (International Capital Market Association) as of August 2020, the overall size of the global bond markets was approximately $ 128.3 tn. This consisted of $ 87.5 tn Sovereigns, Supranational and Agencies (SSA) bonds (68%), and $ 40.9 tn corporate bonds (32%). The US with $ 22.4 tn, China with $ 19.8 tn, and Japan with $ 12.4 tn were leading the global SSA bond markets. In the global SSA market, they collectively held 62% of it. 73% i.e. $ 63.7 tn, of the total outstanding SSA market were sovereign bonds.

Contd….

[6] Source : BIS Quarterly Review June 2021 International banking and financial market developments

In the global corporate bond markets, US corporates accounted for $ 10.9 tn while those of China accounted for $ 7.4 tn. Together, they accounted for 45% of the total global corporate bond market. Of the total outstanding corporate bonds, 53% ($ 21.5 tn) were issued by financial institutions.

Source: https://www.icmagroup.org/market-practice-and-regulatory-policy/secondary-markets/bond-market-size/, dated August 2020. (Accessed on June 8, 2022)

The following Tables 1.5 and 1.6 provide the size of the bond market across globe in the international scenario. The data is compiled from the Bank for International Settlement. The size of the market gives the depth of the bond market.

Table 1.5: Global Bond Market Quarter 1 2021 (Amount in Billion $)

(All Countries Excluding Residents)

Q1 2021	Amount	Net flows	Amount outstanding	Gross issuance	Net flows	Total	Of which: Up to and including
	Q3 20	**Q4 20**	**Q4 20**	**Q121**	**Q1 21**	**Q1 21**	**Q1 21**
Resident issuers							
International debt securities	26190	51.5	26962.1	1988	554.1	26978.3	3633.2
Banks	7040.1	-131	7114	735.3	81.5	7040.9	1543.1
Other financial corporations	10952.7	48.6	11287.6	647.6	201.1	11289	1142.4
Non-financial corporations	4237.1	13.4	4371.3	248.2	80.2	4356.9	437.3
General government	2183.2	63.5	2290.6	166.9	101	2349.4	208.6
National issuers							
International debt securities	26190	51.5	26962,1	1988	554.1	26978.3	3633.2
Banks	8172.1	-123.7	8291.6	734.8	93.4	8205.7	1546.9
Other financial corporations	6559.5	55.7	6780.7	463.5	150.7	6812.8	768.2
Non-financial corporations	7498.3	-1	7700.7	432.8	118	7668.3	807.7

(1) Total debt securities (TDS) and domestic debt securities (DDS) are reported by national authorities, while international debt securities (IDS) are defined and compiled by the BIS from commercial data sources.

Source: http://stats.bis.org:8089/statx/srs/table/c3?c=3P&p=20211&f=xlsx

Table 1.6: Global Bond Market Q2 2021 (Amount in billion $)

Q1 2021	Amount outstanding	Net flows	Amount outstanding	Gross issuance	Net flows	Total	Of which: Up to and including
	Q3 20	Q4 20	Q4 20	Q121	Q1 21	Q1 21	Q1 21
All countries	26,962.10	554.10	26,978.30	1,941.50	463.80	27,608.80	3,546.60
Offshore	3,534.90	105.20	3,628.60	283.00	122.90	3,754.10	443.40
Developed countries	18,566.10	296.10	18,408.90	1,343.10	216.00	18,767.20	2,530.50
Developing Africa & ME	646.20	33.40	676.40	40.30	16.50	693.90	56.50
Developing Asia & Pacific	913.90	19.60	927.20	61.30	25.10	953.90	134.60
Developed Europe	499.40	-6.60	482.80	20.30	5.70	491.30	51.70
Developing Latin America & Carrebian	905.20	15.90	914.40	26.20	2.50	918.60	53.00
Emerging market and developing economies	2,964.60	62.40	3,000.80	148.00	49.90	3,057.80	295.70

Source: http://stats.bis.org:8089/statx/srs/table/03?c=5R&p=&f=xlsx

These are the international securities issued by the different countries.

Global bonds are those bonds which can be traded in both domestic and European markets. This bond is issued and traded outside the country in required denominated currency. This type of bond can be issued and traded by non-European companies also. For example, a U.S company can issue a bond in Europe. These bonds are sold in various maturities and credit qualities. The following Table 1.7 illustrates the outstanding US bond market debt in billion dollars.

[7]Table 1.7: Outstanding U.S. Bond Market Debt in $ Billion

	Municipal	Treasury	Mortgage-Related	Corporate Debt	Federal Agency Securities	Asset-Backed	Money Market	Total
2016	3,891.9	13,908.2	9,023.4	8,024.7	1,971.7	1,391.8	884.9	39,096.5
2017	3,906.6	14.468.8	9,304.5	8,372.6	1,934.7	1,457.9	965.9	40,411.1
2018	3,860.5	15,608.0	9,732.3	8,566.8	1,841.6	1,615.6	996.0	42,220.8
2019	3,869.5	16,673.3	10.227.6	8,865.8	1,726.2	1,663.2	1,045.2	44,070.9
2020	3,952.9	20,973.1	11.214.0	9,756.4	1,693.6	1,535.8	986.9	50,112.8

Source: https://www.sifma.org/resources/research/us-fixed-income-securities-statistics/us-fixed-income-securities-statistics-sifma/

[7] http://www.sifma.org/research/statistics.aspx

The investment in municipal bonds showed a near steady levels from 2016 to 2020 However, in 2020 the bonds have shown an upward trend. It implies that investors have shown a great deal of interest in municipal bonds.

The investment in Treasury showed an upward trend from 2016 to 2020 due to increase in the yield for these bonds.

The mortgage related bonds have shown a marginal increase from 2016 to 2020 in absolute figures. However, there was a slight increase in 2020.

There is consistent increase in the investment of corporate debt from 2016 to 2020. The corporate bond market has imbibed the confidence of the investors.

Overall, the investments in bond market are increasing as they are seen as safe investments. Table 1.8 captures the trading volumes in US Bond market during 2020 and 2021.

Table 1.8: US Bond Markets Average Monthly Trading Volumes

(USD billions)

	Municipal	Treasury	Agency MBS	Non-Agency MBS	Corporate Debt	Federal Agency Securities	Asset-Backed	Total
Mar-20	23.4	915.5	335.6	3.4	49.9	6.8	3.6	1,338.2
Apr-20	13.3	721.9	279.5	2.9	48.9	6.9	2.0	1,075.3
May-20	11.7	627.8	269.6	2.0	46.3	5.4	1.8	964.6
Jun-20	11.1	626.4	249.4	2.0	43.0	5.9	2.0	940.0
Jul-20	11.1	492.5	277.8	1.4	32.7	5.8	1.6	822.9
Aug-20	96	517.0	294.6	1.5	31.1	5.1	1.7	860.5
Sep-20	10.4	554.6	282.7	1.6	34.5	4.7	1.6	890.0
Oct-20	11.4	498.8	300.6	1.6	34.6	4.4	1.6	853.0
Nov-20	7.9	624.6	308.6	1.2	38.3	3.9	1.6	986.1
Dec-20	8.8	525.9	274.0	1.5	29.9	3.0	1.4	844.4
Jan-21	9.1	651.4	367.6	1.6	45.2	4.0	1.8	1,080.6
Feb-21	10.1	681.1	344.0	1.7	43.9	4.3	1.7	1,086.9
Mar-21	9.7	703.6	295.5	1.6	44.7	3.4	1.7	1.060.1
Apr-21	9.4	524.3	271.7	1.4	38.5	3.0	1.4	849.7
May-21	8.7	591.2	283.4	1.4	37.8	3.0	1.5	927,1
Jun-21	9.0	653.7	263.7	1.4	37.6	2.5	1.2	969.3
Jul-21	7.7	543.3	271.0	1.2	32.0	2.2	1.0	858.3
Aug-21	7.0	579.1	252.1	1.0	28.8	2.1	1.0	871.1
Sep-21	8.7	582.1	265.7	2.2	36.8	2.4	1.6	899.4

Source: https://www.sifma.org/resources/research/us-fixed-income-securities-statistics/us-fixed-income-securities-statistics-sifma/

The features of a bond are explained in the following paras:

A bond is a debt instrument having a specified face value (at which it is initially sold by the issuer to the investor), coupon (interest rate) and maturity. The buyer of a bond gets cash inflows in the form of periodic interest receipts and capital appreciation/ depreciation, if any, on sale/ or on redemption on the maturity date[8]. Bonds can be traded in secondary market. They are interest rate sensitive instruments. When the basic interest rate rises, bond value in the secondary market falls and the yield rises. When the basic interest rate falls, bond value rises and the yield falls.

Why does this happen?

Imagine a bond with face value of ₹ 1000 was issued two years ago with a coupon rate of interest of 7.5% p.a. with a maturity period of 10 years. After two years the rate of interest in the economy has gone up to 8%. p.a. When the bond holder wants to sell in the secondary market, the bond will be sold for a lower price; a prospective buyer has two options – either to invest in the open market at 8% or invest in this bond which gives 7.5% interest. If he wants to invest in this bond, he therefore offers a price much less than ₹ 1000 (face value) so that he gets compensated. It should be remembered that although a bond is sold for less than the face value, the coupon rate of interest is calculated on the face value itself.

$$X = 75^{*}\ \text{PVIFA}_{(8\%,\ 8\text{yrs})} + 1000^{*}\ \text{PVIF}_{(8\%, 8\text{yrs})} = 971$$

Another way of putting the fact is that when all the investors are interested in investing in other securities which yield 8%p.a., in order to sell the bond, the bond holder has to reduce the price, so that the investors will get a similar return, had they opted for other avenues. Since no investor looks at this bond, the demand falls, and the price reduces.

Generally, bonds are of two types:

1. Debentures, issued by corporates
2. Bonds issued by Government and Government undertakings.

Corporate bonds are considered as riskier than the Government bonds. Corporate bonds usually carry a higher interest rate than the Government bonds. Investment in bonds/debentures is beset with two types of risks:

1. Credit risk or default risk and
2. Interest rate risk / reinvestment risk.

The credit risk is generally estimated based on the ratings given by credit rating agencies like CARE, CRISIL, ICRA, FITCH, S& P etc.

The rating depends on the fundamental strength of the issuing company, the tax position regarding interest income and capital gains, its ability to service bond debt through adequate cash flows, the purpose of issuance of the bond, the economic strength of the future cash flows, etc. While highly rated bonds offer lower interest rates, low rated bonds have to necessarily offer higher interest rates.

---

[8] The study material on Financial Management, Block 2- Corporate Financial Management pages 3 to 13 explains in detail.

Bonds are generally issued for periods, say 5-10 years. However, globally there are corporates who issue bonds for even 30 years. With regard to government bonds, default risk is perceived to be zero, even though there are nations which defaulted on repayment of bonds or interest thereon.

The following Exhibit 1.1 provides further detail on what each rating letter grade means for the issuing entity. These are the letter grades used by S&P.

Exhibit 1.1: Ratings Scale for Long-Term Bonds

Letter Grade	Grade	Capacity to Repay
AAA	Investment	Extremely strong
AA+, AA, AA-	Investment	Very strong
A+, A, A-	Investment	Strong
BBB+, BBB, BBB-	Investment	Adequate
BB+, BB	Speculative	Faces major future uncertainties
B	Speculative	Faces major uncertainties
CCC	Speculative	Currently vulnerable
CC	Speculative	Currently highly vulnerable
C	Speculative	Has filed bankruptcy petition
D	Speculative	In default

Source: https://www.thebalance.com/what-are-sandp-credit-ratings-and-scales-3305886

This is a descending order of rating, while AAA bonds are the highest rated, CCC bonds are the rated low. CCC means the bonds are vulnerable on capacity to repay parameter. Column indicating Capacity to repay shows the risk involved in the respective instrument.

Having understood the features of bonds let us see what type of debt securities are popular in international markets. Bank for International Settlements, Basel, and the bank for all central banks of the world compiles the data related to debt capital markets.[9]The BIS compiles and publishes three sets of statistics on borrowing activity in debt capital markets.

International Debt Securities (IDS)

IDS are debt securities issued in a market other than the local market of the country where the borrower resides. They capture issues conventionally known as Eurobonds and Foreign bonds. IDS are compiled from a security-by-security database built by the BIS using information from commercial data providers.

Domestic Debt Securities (DDS)

Every economy will have debt market and equity market. Debt market securities include bonds, debentures, fixed deposits and other money market instruments

[9] http://www.bis.org/statistics/about_securities_stats.htm

like CDs and CPs, Treasury Bills. All these instruments are denominated in the currency of that economy. Indian debt market is denominated in INR and Japanese market in Japanese Yen and so on.

DDS are domestic debt securities issued in the local market of the country where the borrower resides, regardless of the currency in which the security is denominated. Bank for International Settlements BIS collect the data from respective central bank of the country. The data of Domestic Debt Securities is compiled from various statistical data reported to the BIS by central banks, except for a few countries in which the BIS collects data via publicly available sources. The BIS calculates exchange rate adjusted changes in stocks by assuming that amounts outstanding are denominated in the currency of the local market.

Total Debt Securities (TDS)

TDS are debt securities issued by residents in all markets (the sum of international and domestic debt securities). The BIS does not calculate TDS. This is due to potential overlaps between IDS and DDS statistics. TDS statistics are published only for countries whose central banks report the relevant data to the BIS (some central banks report only DDS or TDS, while others report both).

1.7 Corporate Bond Market

Corporates issue bonds to garner long term funds as a supplement to their equity base. Bonds are one of the major sources of long term funds for the corporate entities. Therefore, it is necessary to understand the issues involved in bond operations.

[10]By the end of 2019, the global outstanding stock of non-financial corporate bonds reached an all-time high of USD 13.5 trillion in real terms. This record amount is the result of an unprecedented build-up in corporate bond debt since 2008 and a further USD 2.1 trillion in borrowing by non-financial companies during 2019. The global outstanding stock of non-financial corporate bonds at the end of 2019 reached an all-time high of USD 13.5 trillion.

According to OECD Corporate Bond Market Trends, Emerging Risks and Monetary Policy the annual global issuance of corporate bonds has averaged USD 1.8 trillion since 2008 till 2019.

The portfolio allocation of all major bondholders, such as pension funds, Insurance corporations and investment funds is influenced by external credit ratings. This influence is either through regulations that use rating grades as a reference for establishing quantitative limits and capital requirements or through self-imposed rating-based investment strategies that are reflected in their investment mandates and policies. For example, corporate bond holdings by exchange traded funds (ETFs) who typically use passive rating-based strategies

[10] Çelik, S., G. Demirtaş and M. Isaksson (2020), "Corporate Bond Market Trends, Emerging Risks and Monetary Policy", OECD Capital Market Series, Paris,

increased 13-fold from USD 32 billion in 2008 to USD 420 billion in 2018.Non-financial companies have become significant owners of corporate bonds. Between 2009 and 2018, the combined value of corporate bond holdings by 25 large non-financial US companies tripled from USD 119 billion to USD 356 billion. The company with the largest portfolio alone held USD 124 billion in corporate debt securities. This equals the combined holdings of the world's 6 largest corporate bond ETFs.

Secondary markets are also transforming to adapt to a new economic and regulatory environment. Understanding the nature and reasons for this transformation is the key in identifying future potential systemic risk issues and opportunities for market development.

Example: RBI Report in April 2022 calls for a Guarantee Mechanism to Boost the Bond Market in India

A credit enhancement mechanism that provided a partial or complete guarantee on corporate bonds, according to a report written by the research team at the RBI, might assist reduce risk perception and revitalise the Indian bond market, which was largely thin and lacking in liquidity. This approach may also assist in reducing the perceived risk of infrastructure projects to levels appropriate for investors' risk tolerance and increase fund inflows.

Source: https://economictimes.indiatimes.com/markets/bonds/rbi-report-calls-for-guarantee-mechanism-to-boost-bond-market/articleshow/91185110.cms?from=mdr, dated April 29, 2022. (Accessed on June 8, 2022)

1.8 Private Equity and Venture Capital

For their expansion plans many startup firms and existing companies look for funds of long-term in nature either as equity or debt. Many types of long-term sources of funds are available for corporate entities. Private Equity and Venture Capital are two of the avenues available to entrepreneurs as their long-term sources of funds.

Private Equity is an asset class consisting of equity securities and debt in operating companies that are not publicly traded on a stock exchange. A private equity investment will generally be made by a private equity firm, a venture capital firm or an angel investor (a high net-worth individual prepared to investing in new firms and a venture capital firm also does the same but it is a group of individuals). Each of these categories of investors has its own set of goals, preferences and investment strategies. Venture capitalist for example, seeks a very high return on capital and insists on management control as well. Venture capitalists are global experts in the industry they invest. However, all of them provide term capital and working capital to a target company to nurture expansion, new product development, restructuring of the company's operations, management or ownership.

Example: Private Equity and Venture Capital Investments in India

In April 2022, the venture capital and private equity investments in India across 117 deals amounted to $ 5.5 billion. 16 huge deals among them accounted for $ 4 billion. The total fund raised during the month, across 16 funds, amounted to $ 1.5 billion. Compared to the funds raised for the same month last year which was $ 569 million this was a substantial rise. Elevation Capital raised $ 670 million, which was its eighth fund dedicated to the Indian market, its largest corpus ever, and the biggest fund raise in India in April. During the month, there were 13 exit deals at ₹ 1.3 billion.

Source: https://www.business-standard.com/article/specials/private-equity-vs-venture-capital-investment-for-april-2022-declines-27-yoy-to-5-5-bn-ivca-ey-report-122051800786_1.html, dated May 18, 2022. (Accessed on June 8, 2022)

Check Your Progress - 1

1. Which of the following is not a feature of China bond market?
   a. China is the fastest growing nation
   b. Demographic dividend is not considered in China’s economy
   c. Low wages and low technology
   d. Global standards in intellectual property rights
   e. Unsatisfactory legal system is a challenge
2. Which of the following is not a feature of Indian market?
   a. A very large market
   b. Adequate bankruptcy laws
   c. Favorable demographic dividend
   d. Indian government fixes sectoral caps on FDI
   e. Indian government considers foreign direct investment as a long-term investment which is very much needed for the economic growth of India
3. Which of the following is true?
   a. Global financial system functions in highly inter-connected markets under conditions of financial globalization
   b. It is neither banking intermediated nor bank dependent
   c. Systems like trade credit functions principally inside the banking system
   d. Global financial market is not regulated and bank dominated
   e. Global financial market is basically controlled by developing countries

4. Which of the following is a feature of Foreign Institutional Investors (FIIs)?
   a. FIIs do not create volatility in the forex markets while entering and exiting
   b. They invest in government bonds and equities in the primary market
   c. They do not chase interest rates
   d. They invest in debt and equity market for the purpose of earning high return
   e. They have restrictions to invest only in specified sectors
5. Which of the following is not a feature of a bond?
   a. It is a debt instrument
   b. It has a face value
   c. Maturity period is not fixed
   d. They are interest rate sensitive
   e. Bonds are traded in secondary market

1.9 Strategies of Investments by Private Equity Firms

Private equity is one of the long-term funding sources for unlisted corporate entities who look for an equity stake. PE firms are different from venture capital which provides funding for early stage and younger companies. PE Firms look for various types of investments like management buyouts and managing buy-ins in mature companies.

The funding by PE firms is done in different models. The following are some of the models:

a. **Leveraged Buyout (LBO):** The first strategy is LBO which is the most important one. Leveraged buyout is a strategy of making equity investments as part of transaction in which a company, a business unit or business assets is / are acquired from the current shareholders principally with the use of financial leverage. The companies involved in LBO transactions are typically mature and generate operating cash flows. Private equity firms view target companies as either platform companies which have sufficient scale and successful business model to act as a standalone entity, or as an add on or tuck in acquisitions which would include companies with insufficient scale or other deficits.

   Leveraged buyout involves a financial sponsor agreeing to acquisition without itself committing all the capital required for the acquisition. To do this, the financial sponsor will raise acquisition debt which ultimately looks to the cash flows of the acquisition target for servicing the debt. Acquisition debt in an LBO is often on non-recourse terms to the financial sponsor and has no claim on other investments managed by the financial sponsor. Therefore, an LBO transaction's financial structure is particularly attractive to a fund's limited partners, allowing them the benefits of leverage but greatly limiting the degree of recourse of that leverage. This kind of financial structure leverage benefits an LBO's financial sponsor in two ways: the investor only needs to provide a fraction of the capital for the acquisition and the returns to the investor will be enhanced, if the return on assets exceeds the cost of the debt. With the eventual retirement of the debt through enhanced cash flows, the company becomes debt-free with good valuation prospects.

Example: Private Equity in Asda

In February 2021, The Issa Brothers and TDR Capital acquired a majority ownership stake in Asda, which was reportedly the biggest leveraged takeover in UK's history for more than 10 years. Walmart retained an equity investment in the business, with an ongoing commercial relationship and a seat on the Board. For Asda, which was earlier valued at £6.8 billion, the TDR Capital and Issa Brothers were said to have paid just £780 million all in cash. This payment was expected to be funded through asset disposals and debt deals. It was claimed that Asda's private equity value of its investment in the supermarket chain soared by nearly 20 times by April 2022.

Source: https://corporate.walmart.com/newsroom/2021/02/16/issa-brothers-and-tdr-capital-complete-the-acquisition-of-asda-from-walmart, dated February 16, 2021. (Accessed on June 8, 2022)

b. **Growth Capital:** Growth Capital refers to equity investments, most often minority investments, in relatively mature companies that are looking for capital to expand or restructure operations, enter new markets or finance a major acquisition without a change of control of the business.

c. **Mezzanine Capital:** Mezzanine capital refers to subordinated debt or a preferred equity security that often represents a claim on company's asset which is senior only to that of the common stock represent. This form of financing is often used by private equity investors to reduce the amount of equity capital required to finance a leveraged buyout or major expansion. Mezzanine capital, which is often used by smaller companies that are unable to access the high yield market, allows such companies to borrow additional capital beyond the levels that traditional lenders are willing to provide through bank loans. In compensation for the increased risks, mezzanine debt holders require a higher return for their investment than secured or other more senior lenders. Mezzanine securities are often structured with a current income coupon.

d. **Venture Capital:** Venture capital is a broad subcategory of private equity that refers to equity investments made typically in less mature companies, for the launch of a seed or Startup Company, early-stage development, or expansion of a business. Venture investment is most often found in the application of new technology, new marketing concepts and new products that do not have a proven track record or stable revenue streams.

Venture capital is often sub-divided by the stage of development of the company ranging from early-stage capital used for the launch of start-up companies to late stage and growth capital that is often used to fund expansion of existing business that are generating revenue, but may not yet be profitable or generating cash flow to fund future growth.

Entrepreneurs often develop products and ideas that require substantial capital during the formative stages of their companies’ life cycles. Many entrepreneurs do not have sufficient funds to finance projects themselves and they must therefore seek outside financing. The venture capitalists’ need to deliver high returns to compensate for the risk of these investments. This makes venture funding an expensive capital source for companies. Being able to secure financing is critical to any business, whether it is a start-up seeking venture capital or a mid-sized firm that needs more cash to grow. Venture capital is most suitable for businesses with large up front capital requirements which cannot be financed by cheaper alternatives such as debt. Although venture capital is often most closely associated with fast-growing technology, healthcare and biotechnology fields, venture funding has been used for other more traditional businesses.

Investors generally commit to venture capital funds not only as part of a wider diversified private equity portfolio, but also to pursue the larger returns the strategy has the potential to offer. However, venture capital funds have produced lower returns for investors over recent years compared to the other equity fund types, particularly buyout.

The Exit Strategy: Private equity funds have an investment strategy with a time horizon of three to seven years, during which period they wish to exit with targeted profits and scout for new investment opportunities. Their return on equity (ROE) is much higher than the ordinary investors. Following are the exit strategies:

Initial Public Offering (IPO):

The private equity investors arrange for the initial public offer of equity shares of the target company, when they feel that the valuations are comfortable and then sell their shares in the secondary market. This is a very commonly employed exit strategy for private equity firms and the following are the different exit strategies adopted by PEs.

Trade Sale:

Under the trade sale, the PEs sell their private equity component entirely to a trade buyer. This way, the exit is smooth and avoids the hassles of organizing a successful IPO.

Secondary Buyout:

Under this strategy, the target company is sold to another PE firm. This could happen because PE players generally operate on both sides of the deal.

Leveraged Recapitalization:

This strategy involves substitution of equity for debt in the target company.

1.9.1 Private Equity - Global Scenario

Let us understand the global scenario of private equity.

Global buyout deal value was around US$800 billion striking around 5000 deals in the year 2020. During that year (2020) the exits counted around 1500 amounting to US$ 600 billion whereas fund raising was around US$600 billion for about 500 deals.

PE funding activity picked up in 4th quarter of 2020 after decimal performance in 2nd quarter of 2020. The global PE industry sprinted to the finish in 2020, generating $ 592 billion in buyout deal value. The industry recorded an 8% jump from 2019's performance and 7% higher than the five-year average of $555 billion. A full $410 billion of that total came in the third and fourth quarters of 2020 as global private equity industry raced to put money to work. Confidence reigned that central bank stimulus would prop up the global economy long enough for the worst of the Covid-19 pandemic to pass.

Covid-19 had a pronounced negative impact on global deal count, as the number of buyouts fell 24% to around 3,100 in 2020, from 4,100 in 2019. While the performance of the technology and telecom sectors was good the number of deals in retail, consumer, and media and entertainment sectors were among those taking the biggest hits. The average deal size was $776 million in 2020.

As per the Bain's India private equity report 2021, the broad technology sector attracted the most PE investment in 2020 (29% of total buyout deal count globally, 32% including fintech). Funds gravitated toward SaaS-based businesses with particularly sticky business models, like vertical software. Gaming got a big boost from a single deal, a $1.5 billion funding round for Epic Games led by KKR, Baillie Gifford and BlackRock

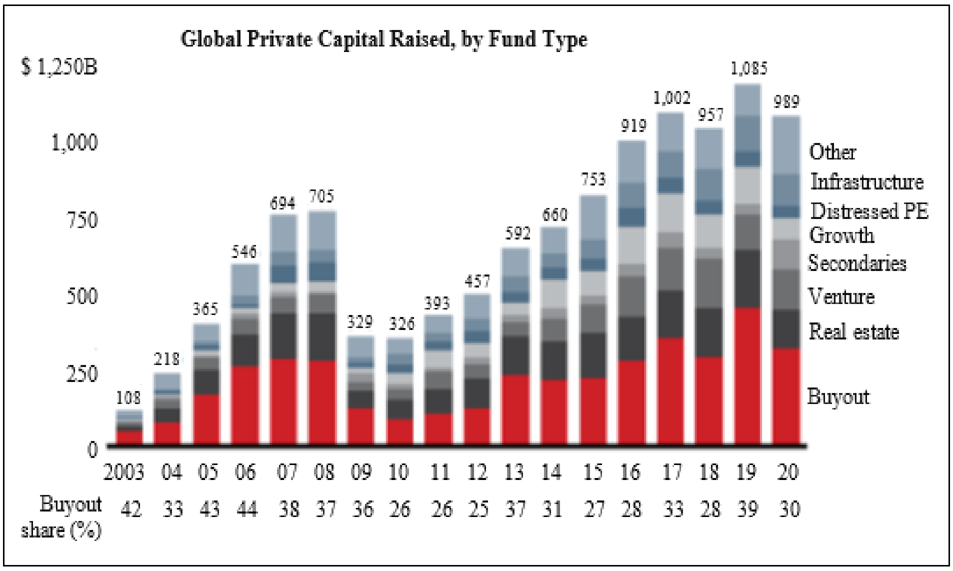
The financial sector also drew significant private equity interest despite the slumping economy during 2020 due to Covid-19. But some of the sub-sectors have recorded significant growth. Insurance didn't see much activity, while the payments sector was on fast-track. The secular shift to digital payments that was already well underway got a Covid-19 boost when retailers and consumers alike backed away from cash in favor of cards and other forms of online payment. Deals involving payments companies made up 24% of total financial services/fintech investment value in 2020, up from 16% the year before in 2019.

Given that still the world is battling the Covid pandemic in 2021, the expected strong deal activity in 2021 will likely follow these same patterns discussed above.

Exits

Exit activity in 2020 followed the same pattern as investments. Both buyers and sellers hunkered down when the Covid-19 pandemic hit in first quarter of 2020 and second-quarter activity was very low. But exit value picked up in the second half of 2020 as revived price multiples and the threat of a tax-law change in the US gave sellers ample incentive to put companies on the market—particularly big ones. The number of exits trailed 2019's total, but owing to an increase in deal size, global exit value hit $427 billion in 2020, on par with 2019 and in line with the five-year average. The strategic buyers provided the largest exit channel. Sponsor-to-sponsor deals held up well, and initial public offerings increased by 121% to $81 billion as public equity markets soared. Firms also leaned heavily on partial exits, as Global private equities sought to keep a stake in attractive assets rather than have to hunt down new prospects in a highly competitive deal market. Overall, the median holding period for companies exited in 2020 was 4.5 years, slightly higher than in 2019 but in line with the five-year average.

Figure 1.3: Fund Raising by PEs



Source: https://www.bain.com/insights/india-private-equity-report-2021/ June 2021

Global fund-raising of $989 billion of 2020 was a decline from 2019's all-time record of $1.09 trillion. But it was still the third-highest total in history, and if you add in the $83 billion raised for SPACs, it was the second highest. All told, the industry has raised almost $5 trillion in capital over the past five years.

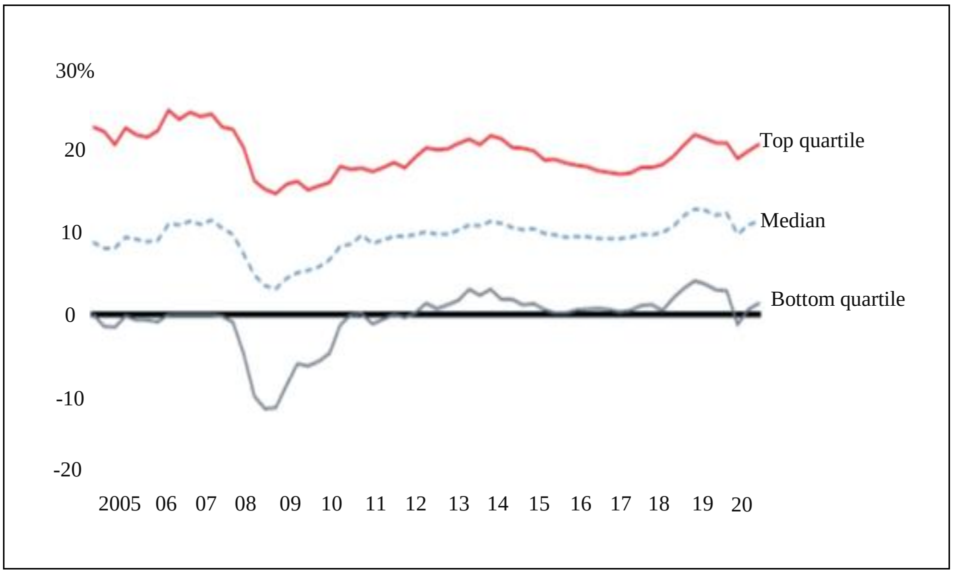
Buyout funds alone raised about $300 billion in 2020, or $340 billion if you include SPAC (special purpose acquisition company) capital aimed at buyout-type targets, estimated at $41 billion It's clear that LPs (limited partners) continue to view private equity as a haven in the storm. Institutions did take a pause in April 2020 during the first peak of the Covid-19 crisis but quickly got back to business during the 2nd quarter 0f 2020.

According to Private Equity International's December 2020 LP (limited partner) Perspectives Study, around 80% of LPs are confident that private equity will continue to perform in 2021, and close to 40% say that they are under allocated to the asset class. The vast majority plan to either increase or maintain their commitments in 2021.

Return on investments in PEs

Private equity returns on investment during Covid 19 affected 2020 had very limited impact or no impact. Looking at 10-year annualized IRR, funds have so far avoided the kind of damage suffered in the global financial crisis.

Figure 1.4: 10-Year Annualized IRR for Global Buyouts



Source: https://www.bain.com/insights/india-private-equity-report-2021/ June 2021

[11]Private Equity in India during 2020

The economic impact of the coronavirus pandemic in India has been significant, causing GDP contraction of more than 10% and leading to the highest-ever annual fiscal deficit at 9.5% for fiscal year 2021. Imposition of a nationwide lockdown in late March 2020 halted over 65% of the Indian economy.

[11] Source https://www.bain.com/insights/india-private-equity-report-2021/ June 2021

Despite Covid-19 in the year 2020, the deal volume flow continued with a 5% year-over-year (YOY) increase despite a slowdown in the total value of investments. The exception was for Reliance Group companies Reliance Jio and Reliance Retail. Growth equity momentum was sustained with $10 billion in investments, more than in all previous years and nearly at par with 2019. Strong momentum continued in consumer tech and IT/IT-enabled services (ITES). Additionally, India-focused investments remained resilient at $8 billion, with the share of oversubscribed and at-target funds increasing further.

In terms of sector activity, healthcare witnessed a surge with big-ticket deals in pharmaceuticals manufacturing and distribution and active pharmaceutical ingredient (API) development. However, banking, financial services, and insurance (BFSI) investment value fell by 60% due to uncertainty over nonperforming assets (NPAs), the Reserve Bank of India (RBI)-imposed bank moratorium, and the impact of Covid-19 on lending. From an exit perspective, multiples rose by 1.4 times even as exit value dipped by 30% in 2020 vs. 2019.

In 2020, the Indian Private Equity (PE) Landscape witnessed strong investment momentum with $62 billion in deal value and 40% from Jio Platforms and Reliance Retail deals. Investment activity was muted from March to May in the year 2020 due to Covid-19-led uncertainty, but it recovered strongly in the second half year in 2020 to pre–Covid-19 levels with late-stage and buyout deals witnessing increased traction.

The pandemic also led to a shift in the type of deals made, with investors focusing on alternate investment strategies such as distressed opportunistic sales and qualified institutional placements (QIPs).

1.10 Hedge Funds

One of the major investment vehicles in the global markets is Hedge Funds. These are the investment vehicles that control a mix of equity and borrowed money, with a corporate structure, not exactly mutual funds, not a much-regulated investment company set up. They operate in high-risk zone also.

A hedge fund is an investment fund that can undertake wider range of investment and trading activities than other funds, but which is generally open to certain types of investors specified by regulators. These investors are typically institutions such as pension funds, university endowments, high net worth individuals, etc., who are considered to have the knowledge or resources to understand the nature of the funds.

Hedge funds focus on absolute returns. Many hedge funds do not even use hedging.

A typical fee structure for hedge funds includes both a management fee and a performance fee. Hedge funds frequently borrow with leverage in order to increase their investment portfolio and thereby increase returns.

The growth in hedge funds globally is driven by the following factors:

a. Favorable market environment.

b. Human capital growth.

c. Financial innovation in executing increasingly complex and high volume trading strategies with the help of technology and by reduction of transaction costs.

d. Electronic trading platforms.

Example: Performance of Hedge Funds in the US

As per the data provided by Hedge Fund Research Inc. (HFR) on June 6, 2022, hedge funds in the US reported poor performance in May 2022, bringing their losses for the FY to around 3%. This was attributed to the recession fears in the investor's minds. The hedge fund weighted composite index decreased by 0.58% in May amid heightened turbulence in stocks, bonds, and commodities. From January to May, equity hedge funds posted a loss of 8% but outperformed the S&P 500, which was down 12.76%. The top decile of hedge funds posted an average positive performance of 33.9% in the first five months of the year, and the bottom was down by 25.7%.

Source: https://www.reuters.com/markets/funds/hedge-funds-struggle-may-amid-recession-fears-2022-06-07/, dated June 8, 2022. (Accessed on June 9, 2022)

1.11 External Commercial Borrowings and Trade Credit

Corporate entities can borrow from the domestic markets in which they are operating or from overseas markets. Borrowing from external (to the economy they are operating) sources by corporate entities is regulated within the laws of the land. Buyer's Credit, supplier's credit, raising bonds in the international markets, availing lines of credit from financial institutions are some of the avenues available to the corporate entities in global financial markets. ECB cab be accessed through two routes namely (a) automatic route and (b) approved route[12]. The external commercial borrowings, in Indian scenario offer, innovative hybrid products also. The different type of products available are discussed below:

External Commercial Borrowings (ECBs)

[13]The ECB Framework enables permitted resident entities to borrow from recognized non-resident entities in the following forms:

i. Loans including bank loans

ii. Securitized instruments (e.g. floating rate notes and fixed rate bonds, non-convertible, optionally convertible or partially convertible preference shares / debentures

[12] https://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=5786#L1

[13] RBI/FED/2015-16/15FED Master Direction No.5/2015-16 Master Direction - External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorized Dealers and Persons other than Authorized Dealers (Updated as on May 09, 2018)

iii. Buyers' credit

iv. Suppliers' credit

v. Foreign Currency Convertible Bonds (FCCBs)

vi. Financial Lease

vii. Foreign Currency Exchangeable Bonds (FCEBs)

Now, let us discuss about the foreign currency convertible bonds, preference shares and foreign currency exchangeable bonds which can be converted/exchangeable into equity shares.

a. Foreign Currency Convertible Bonds (FCCBs)

FCCB means a bond issued by an Indian company expressed in foreign currency, the principal and interest in respect of which is payable in foreign currency. A convertible bond is a bond (debt) initially and can be converted into equity shares at predetermined conversion rate. Issuance of FCCBs shall conform to the Foreign Direct Investment guidelines including sectoral cap. The other requirements are (i) minimum maturity of 5 years, (ii) the call & put option[14], if any, shall not be exercisable prior to 5 years, (iii) issuance without any warrants attached, (iv) the issue related expenses not exceeding 4 per cent of issue size and in case of private placement, not exceeding 2 per cent of the issue size, etc. The other guidelines should abide terms of provisions contained in Regulation 21 of the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, and FEMA.

Example: External Commercial Borrowing of Reliance Industries Ltd.

In Jan 2022, Reliance Industries Ltd., the telecom-to-oil conglomerate, raised $4 billion in debt through the largest ever issue of foreign currency bond by an Indian entity. The issue was oversubscribed by nearly 3 times. Reliance Industries Ltd. raised in a 10-year issue, $1.5 billion at an interest rate of 2.875%, in a 30-year deal $1.75 billion at an interest rate of 3.625%, and in a 40-year deal $750 million at an interest rate of 3.75%. This was the first 40-year dollar bond issued by an Asian corporation with a BBB rating outside of Japan.

Source: https://economictimes.indiatimes.com/markets/bonds/reliance-raises-4b-in-largest-ever-foreign-currency-bonds-issue/articleshow/88745022.cms, dated January 7, 2022. (Accessed on June 9, 2022)

[14] A call option is a right that a buyer of call option gets to buy a security at a future date at a price agreed upon; he will exercise the right only if it is profitable to buy on the due date as compared to its price in the spot market. A put option is a right that buyer of a put option gets to sell a security at a predetermined price, called exercise price, on the due date; he will exercise the option only if the spot selling rate is less that the exercise price.

b. Preference Shares

Government of India, Ministry of Finance vide Press Note dated April 30, 2007 (Annex), has notified the revised guidelines for foreign investment in preference shares. With effect from May 1, 2007, only preference shares which are fully and mandatorily convertible into equity within a specified time would be reckoned as part of share capital and eligible to be issued to persons resident outside India under the Foreign Direct Investment Scheme in terms of Regulation 5 (1) of Foreign Exchange Management (Transfer and Issue of shares by a Person Resident outside India) Foreign investments in other types of preference shares (i.e. non-convertible, optionally convertible or partially convertible) for issue of which, funds have been received on or after May 1, 2007 would be considered as debt and shall conform to External Commercial Borrowings (ECB) guidelines / caps. Accordingly, all the norms applicable for ECBs, viz. eligible borrowers, recognized lenders, amount and maturity, end use stipulations, etc. would apply. Since these instruments would be denominated in rupees, the rupee interest rate will be based on the swap equivalent of LIBOR plus the spread as permissible for ECBs of corresponding maturity.

c. Foreign Currency Exchangeable Bonds (FCEBs)

FCEB means a bond by an Indian company expressed in foreign currency, the principal and interest in respect of which are payable in foreign currency. It is issued by a company which requires approvals from RBI/Government and subscribed to by a person who is resident outside India, in foreign currency and exchangeable into equity shares of another company, to be called the offered company, in any manner, either wholly or partly or based on any equity related warrants attached to debt instruments.

ECB can be accessed under two routes: automatic route and the approval route.

There are slight changes in ECB guidelines for different sectors.

ECB for investment in real estate sector (companies can use proceeds from external commercial borrowings to invest in the real-estate of other domestic companies.

However, the funds cannot be used to acquire stakes in those companies. industrial sector, infrastructure sector and specified services sectors in India are under the automatic route and do not require RBI/Government of India approval for eligible borrowers. The lender should be an internationally recognized source. There are monetary ceilings and maturity restrictions as well, depending on the purpose. There are LIBOR (London Inter-Bank Offer Rate) linked interest rate ceilings. ECB funds should be utilized only for the purpose they are borrowed. This is called end-use principle. ECBs should not be backed by guarantees from any Indian entity, while provision of security to the lender is left to the borrower.

Borrowers are permitted either to keep ECB proceeds abroad or remit these funds to India, pending utilization for permissible end uses.

Indian corporates resort to ECB borrowing for the following reasons:

1. Lower interest rates which are LIBOR linked. However, while servicing these loans in forex currency, the borrower must have a natural hedge in the form of forex inflows (through exports) or get his rupee funds converted into forex involving foreign exchange risk.
2. Borrowers generally evaluate the merit of ECB, vis-a-vis domestic borrowing, after factoring for exchange rate risk.

Trade Credits (TC)

Trade Credits (TC) such as suppliers' credit or buyers' credit refer to credits extended for imports directly by the overseas supplier, bank, and financial institution for maturity of less than three years. They are:

- Suppliers' credit refers to credit extended by the overseas supplier for imports into India whereas the buyers' credit refers to loans for payment of imports into India arranged by the importer from a bank or financial institution outside India for maturity of less than 3 years.
- Suppliers' credit and buyers' credit for 3 years and above come under the category of ECB and governed by ECB guidelines.

1.12 Trade Finance

In global financial markets international trade is a major financial activity. International trade is funded by various sources like financial institutions / banks / private funding agencies etc. International trade takes place in two different modes. (i) Transactions through letter of credit (ii) Transactions without letter of credit.

Letters of credit will be initiated by the buyer, seller as beneficiary, through the banking system. Letter of credit provides security to the seller of the goods/services in the trade finance. Understanding the operational issues in trade finance that is dependent on letters of credit transactions is an important learning in global financial market operations.

Trade finance is short-term working capital finance extended by banks to exporters in foreign trade, generally in association with the Letter of Credit (L/C) mechanism. A letter of credit is an irrevocable, without recourse to the exporter undertaking by the credit opening bank (called the importer's bank, or issuing bank), to pay the exporter the pre-defined value of the export, on tender of the requisite export documents, strictly in conformity with the terms of L/C, at its counter.

In an L/C transaction, banks deal in documents while settling the transaction and not in the underlying goods, though they are under charge to the issuing bank.

L/C mechanism eliminates payment risk for the exporter. While L/Cs could cover capital goods and raw material, trade finance is discussed only in conjunction with working capital finance (trade in raw materials).

In view of its global appeal and the reputation of the banks involved and more importantly, the need to eliminate payment risk, trade finance has been a very popular and reliable means of payment in global trade.

L/C is generally an off-balance sheet obligation. However, in case of usance[15] term LCs, the issuing bank hands over the documents to the importer without payment, but against his acceptance to pay and recovers the bill amount with interest later from him as per the terms of usance. This way, an L/C transaction becomes an on-balance sheet item as well. Of course, there could be devolution: while the credit opening bank pays the bill amount to the exporter through his bank, obviously it has to recover the same from the importer as per its tenor (demand/usance). At times, there could be delay/default on the part of the importer in retiring the bill, resulting in devolution on the issuing bank. This is yet another situation of L/C transaction turning into an on-balance sheet obligation.

Example: The Partnership of Supply Chain Platform Olea Global Pvt. Ltd. and trade finance platform Vayana Network

In May 2022, a partnership between trade finance platform Vayana Network and the digitized supply chain platform Olea Global Pvt. Ltd. was reached with the purpose to give Indian exporters and importers quick access to alternative cash. In April 2022, as part of its Series C funding, Vayana Network raised ₹ 114 crore from PayU, IFC (International Finance Corporation), the fintech business of Prosus NV (the Dutch Conglomerate), and the payments. This was done to aid MSMEs in improved working capital management and loan readiness. The company closed its latest fundraising of ₹ 397 crore for making export finance readily available for small and mid-sized exporters.

Source: https://economictimes.indiatimes.com/tech/funding/trade-finance-startup-vayana-network-raises-15-million-in-funding/articleshow/90954901.cms, dated April 20, 2022. (Accessed on June 9, 2022)

1.12.1 Recent Innovations in Trade Finance

L/C mechanism apart, trade finance is undergoing innovation. There is a new method now called “bank payment obligation” (BPO), a payment method that offers a similar level of payment security to the exporter, without the bank’s physical handling of documentary evidence.

[15] Means simply a specified time period of credit.

A BPO is an irrevocable undertaking given by a bank to another bank that payment will be made on a specified date after successful electronic matching of data according to an industry-wide set of rules.

One more innovation is supply chain finance, where banks automate documentary processing across entire supply chains, often linked to accelerating working capital loan opportunities, with products covering pre- and post-shipment finance like dealer and vendor finance, etc.

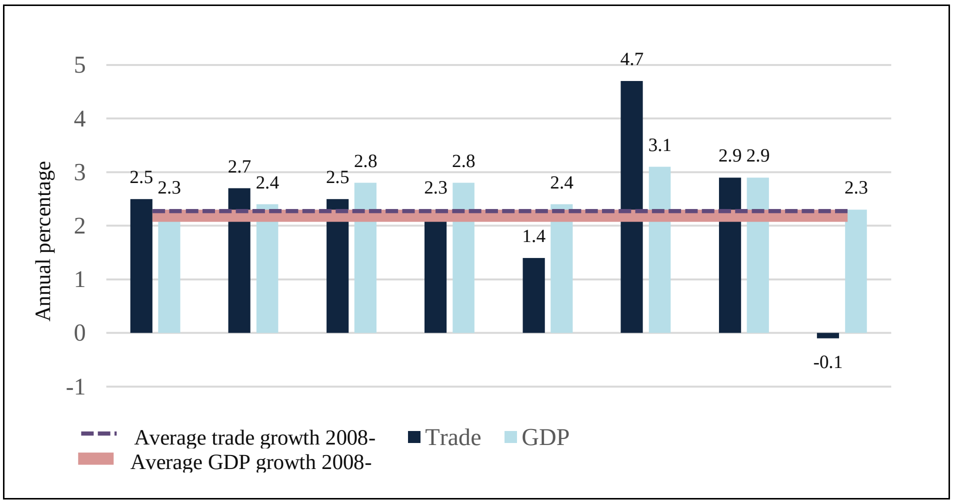
Sometimes exporters and importers resort to open account system, wherein importers make advance payment or exporters ship goods and await payment. This is called inter firm trade credit which involves lower fees and offers more flexibility. However, trade credit involves payment risk; also there is need for higher volume of working capital.

Trade credit is in vogue between firms that have well established conventional relations and among economies which have reliable legal framework for collection of receivables. Under trade credit, payment risk may be mitigated by purchasing what is called trade credit insurance.

Major Banks account nearly for one third of the global trade finance, while the regional and local banks provide the remainder.

The following Figure 1.5 depicts the ratio of merchandise to GDP demonstrates the trend in decade from 2012-2019.

Figure 1.5: Ratio of Merchandise to GDP from 2012 to 2019



Source: https://www.wto.org/english/res_e/statis_e/wts2020_e/wts2020chapter03_e.pdf World Trade Statistical Review 2020

Since the global financial crisis of 2008-09, for the first time World merchandise trade volume was declined by 0.1 per cent in 2019. Trade was weighed down by persistent trade tensions as well as by weaker global GDP growth, which slowed to 2.3 per cent in 2019 from 2.9 per cent in 2018. Trade declined in US dollar terms in 2019. World merchandise exports fell 3 per cent to US$ 18.89 trillion.

World commercial services exports increased by 2 per cent to US$ 6.07 trillion but the pace of growth was down sharply from the 9 per cent recorded in 2018.

Merchandise trade volume declined by 0.1 per cent in 2019, compared with 2.9 per cent growth in 2018. World GDP growth slowed to 2.3 per cent, down from 2.9 per cent the previous year 2018.

- The US dollar value of merchandise trade fell year-on-year, dropping 3 per cent to US$ 18.89 trillion in 2019. Trade declined more steeply in value terms than in volume terms due to falling export and import prices.
- Commercial services trade grew by 2 per cent in 2019, down from 9 per cent in 2018, as growth slowed and trade tensions escalated.
- The decline of 0.1 per cent for merchandise trade volume in 2019 was well below the average annual growth rate of 2.3 per cent since the financial crisis of 2008-09. GDP growth of 2.3 per cent last year was in line with its average rate over the past ten years.
- Although the first cases of COVID-19 were recorded in late 2019, the crisis did not contribute to the slowdown for the year. The pandemic is expected to lead to sharp declines in trade and GDP in 2020.

The COVID-19 pandemic is likely to produce a significant contraction of world trade in 2020. New export orders for manufacturing and services shown in purchasing managers' indices (PMIs) fell sharply in the first and second quarters of 2020. GDP growth turned negative in the first quarter of 2020 for the United States (-1.2 per cent), the euro area (-3.8 per cent) and China (-9.8 per cent). Further declines are expected in the second quarter and beyond.

1.12.2 Pricing

Trade finance pricing is not all that transparent. Major banks appear to decide the price based on their perceptions of demand and the movement in the hurdle rates[16], considering the cost of capital and the overall cost of funds.

Following the Lehman Bank failure, bank intermediated trade finance has drastically fallen in volumes during 2008-2009. Generally, bank intermediated trade finance is a very safe and stable mechanism and it is not influenced in terms of quantity by the volatilities in global trade.

1.12.3 Settlement Process in Trade Finance

The monetary settlement of trade finance is done through foreign exchange markets. Let us understand few of the basic features of the foreign exchange market.

[16] The discounting rate used which would factor into the risk element in the financing

Foreign currency has characteristics of a currency and a commodity. On a day-to-day basis, the value of dollar (a foreign currency in India) depends on the supply and demand of dollars in the forex market which is considered as an example of a near perfect market. When the demand for dollars is more, its price against the rupee (the local currency) rises. When the supply of dollars is more, its price falls.

The demand for dollars is generated by importers (who need to buy foreign currency to retire their import bills), outbound tourists from India, borrowers who wish to service their foreign debt, FIIs who wish to shift a part of their India portfolio funds to other overseas markets, FDIs who wish to repatriate dividends to overseas equity investors, etc.

Likewise supply of dollars (or any foreign currency) is created by exporters who tender their export bills to banks for collection, purchase or discount, borrowers who convert loan funds from abroad into rupees, inbound tourists who surrender foreign denominated traveler’s cheques to banks in exchange of Indian rupees, foreign banks operating in India who source forex funds for lending or investing in India, the government which receives forex denominated loans from IMF/multilateral agencies, etc. Even non-resident Indians who deposit their foreign currency funds add to the supply of dollars in India.

Forex market generates globally a huge trading volume which is the largest asset class leading to high liquidity. It is a 24/7 model market except for the two weekend holidays. Forex trade is screen based fully automated trade with low margin and high volumes. Margin here refers to the difference between selling and buying price of any currency by the banker who is called an authorized dealer. All forex transactions have to be mandatorily routed through an authorized dealer, who gets his license from the Reserve Bank of India. An authorized dealer is a market maker as he buys and sells any foreign currency from/to the clients. The daily turnover in the forex market is very huge, about $ 6 trillion, consisting of spot transactions, outright forwards, forex swaps, currency swaps and options and other products. Each bank considers its forex trade department as a good profit center.

Foreign currencies like the US dollar, pound sterling, euro, Japanese yen and Swiss francs are regarded as exotic currencies as they possess characteristics like reliable payment currency, reserve currency with long term stability of their domestic economies.

Global trade settles its financial transactions, principally in these currencies. The major trading centers are London, New York, Tokyo, Hong Kong and Singapore. Volume percentage of all individual currencies should add up to 200% as each transaction involves two currencies.

Many economies the world over are in a floating exchange rate model, where the value of the foreign currency against the domestic currency is allowed to be determined on a daily basis on the law of demand/supply. However, central banks have right of intervention into the market to arrest extreme volatility conditions during any day. That is why floating exchange rates are called dirty floats. India also follows this dirty float system. Under fixed exchange rate regime, rates are decided by the government. While spot rates, as already stated, depend on supply/demand situation, forward rates are a function of international parity conditions.

The players in the forex market take positions in the forward segment for the purposes of hedging, speculation, or arbitrage. International parity conditions are derived from the theories of relative purchasing power parity, interest rate parity, Fisher effect theory[17], balance of payment situation, etc. While these theories are mathematical in nature, their underlying assumptions (like free flow of goods, services, and capital, etc.,) are often questioned. Hence, currency rate forecast is not a perfect mathematics, but embraces behavioral finance[18] issues as well. In fact, these rates also depend on economic, political and market psychology.

Spot Market & Swap Market - General Perspective

[19]The spot market is a commodity or security market where goods, both perishable and non-perishable are sold for money and delivered immediately or within a short span of time. Contracts traded on a spot market are also in effect instantly. The spot market is also recognized as the cash market or physical market. The purchases are settled in cash at the current prices fixed by the market as opposed to the price at the time of distribution. An example of a spot market commodity that is often sold is crude oil. It is sold at the existing prices and physically supplied later.

A commodity is a basic material or good used in commerce which is interchangeable with other commodities of similar type. They are often used as input in the production of goods and services, some examples of commodities are grains, gold, oil, electricity and natural gas. Technology has provided new dimension to marketing of the commodities and services sector. The market information on commodities & services is available from authentic sources from internet services. Market size of commodities are standardized and are essential to meet the specific standards to be traded on the spot market.

---

[17] The Fisher effect is an economic theory created by economist Irving Fisher that describes the relationship between inflation and both real and nominal interest rates. The Fisher effect states that the real interest rate equals the nominal interest rate minus the expected inflation rate… https://www.investopedia.com/terms/f/fishereffect.asp

[18] Behavioral finance, a sub-field of behavioral economics, proposes psychology-based theories to explain stock market anomalies, such as severe rises or falls in stock price. The purpose is to identify and understand why people make certain financial choices. URL: https://www.investopedia.com/terms/b/behavioralfinance.asp

[19] www.readyratios.com

Types of Spot Market

The spot market which is also called the cash market is a financial market, in which the financial commodities and instruments are transacted for instantaneous delivery. It contrasts with a futures market in which distribution or delivery is owed at a later date. A spot market can be:

1. **Exchange -** It is also called an organized market where the security or commodity is traded on an exchange using and changing the current market price.
2. **Over The Counter (OTC) -** In OTC, the trades are based on contracts which are done openly between two parties and not subject to the guidelines of an exchange. The contract terms are approved between the parties and might be non-standard.

Spot Market v/s Futures Market

The spot market is different from the futures market in that the value in the futures market is affected by the price of storage and future price movements. In the spot market, prices are affected by the existing supply and demand, which inclines to make the prices more volatile. Another aspect that affects spot market prices is whether the commodity is perishable or non-perishable.

The term ‘swap’ has two different meanings in the financial markets. In one definition, it refers to the simultaneous purchase and sale of currency for different maturities or vice versa. The other definition states that it is the agreed exchange of future cash flows with or without any exchange of cash flows at present. The base on which the cash flows are exchanged may be different and it gives rise to different types of swaps.

Financial swaps are broadly classified into –

i. Interest rate swaps
ii. Currency swaps

Swaps have been defined variously as:

- A transaction in which two parties agree to exchange a predetermined series of payments over time.
- An agreement between two parties to exchange interest payment for specific maturity on an agreed upon notional amount.
- An arrangement whereby one party exchanges one set of interest payments for another, example fixed for floating rate.

An agreement between two parties to exchange a series of payments, the terms of which are predetermined can be regarded as a financial swap. If the terms provide for exchange of interest payments without involving exchange of principal payments it is normally referred to as an interest rate swap. If the terms of agreement also provide for exchange of principal, which normally happens when two currencies are involved, it is called a currency swap.

Swaps can be used to convert liabilities or assets to the benefit of the owner. With the help of a swap, a floating rate liability (loan) can be converted into a fixed rate liability (loan), thus ensuring that the volatility in the interest rates does not increase the burden of payments or else, vice versa convert a fixed rate liability (loan) into a floating rate liability (loan) when the interest rates fall steeply in the market.

1.12.4 Forfaiting

Forfaiting is a financial transaction involving the purchase of receivables from exporters by a forfaiter. (This is similar to factoring, which is used in domestic transactions.) The forfaiter takes all the risks associated with the receivables but earns a margin. The forfaiter may also be immunized from certain risks if the transaction involves payment by negotiable instrument.

Following are the features of a forfaiting transaction:

a. Credit is extended to the importer for a period of 180 days to 7 years.
b. Generally, it covers trading in capital goods.
c. The minimum bill size is $ 1,00,000.
d. The payment is normally receivable in any major convertible currency.
e. A letter of credit or a guarantee is made by a bank, usually in the importer's company.

The pricing depends on a LIBOR linked discount rate and a commitment fee. Forfaiting transactions are now covered under "Uniform rules for forfaiting (URF)" 800 of ICC (International Chamber of Commerce), 2013.

Activity 1.2

Assume that Great India Company is a manufacturer of component XYZ4028. This component is used in manufacturing of mobile phones. The company received an order from Belgium for 1,00,000 units. The manufacturing cost of the component is € 100/. The company needs working capital to manufacture such components for export. The Company had approached a nationalized bank for trade finance. List out the general formalities of trade finance.

Answer:

Check Your Progress - 2

6. Which of the following in not a feature of private equity?
   a. Private equity is an asset class consisting of equity securities and debt
   b. They are highly regulated
   c. Venture capital is a form of private equity
   d. The target return on equity is very high for them
   e. A private equity investment will generally be made by a private equity firm, a venture capital firm or an angel investor
7. Which of the following is false about venture capital?
   a. It is a broad sub-category of private equity
   b. Venture investment is generally found in the application of new technology, new marketing concepts and new products that do not have a proven track record of stable revenue streams
   c. Venture capitalists insist on a dominant role in the management of the target company
   d. Venture capitalists are considered to be global experts in the industry they invest
   e. Venture capitalist has restriction in investing in government sectors
8. Which of the following is not an exit route for private equity investments?
   a. IPO
   b. Trade Sale
   c. Secondary Buyout
   d. Leveraged Recapitalization.
   e. Leveraged Buyout
9. Which of the following is not true about forfaiting?
   a. It is a financial transaction involving the purchase of receivables from exporters
   b. The forfaiter takes on all the risks
   c. The forfaiter is not entitled for any margin or profit and merely undertakes the transaction as a service
   d. Forfaiting transactions are for sales with receivable period of 180 days to seven years
   e. The payment is normally receivable in any major convertible currency

10. Which of the following is not a feature of ECB?
    a. This involves borrowing by Indian corporates only from external sources
    b. Debt servicing FC loans should be in foreign currency
    c. End use principle has to be complied with
    d. Credit availed by Indian entities from non-resident lenders, with a minimum average maturity of three years.
    e. ECB can be accessed in multiple routes

1.13 Summary

- Global financial markets are highly interlinked in an environment of liberalization, privatization and globalization.
- Thanks to technology, there are very innovative financial instruments and financial strategies in global financial markets.
- We are practically living in a global financial village because the happenings in one part of the globe have its repercussions in another part.
- If the US faces sub-prime crisis, the entire globe could be enveloped in an unprecedented financial crisis.
- If the US decides to resort to tight money policy with gradual increase in interest rates, many stock markets across the globe could substantially fall.
- If China's growth rate retards, there could be competitive devaluation of many Asian currencies. Hence the need for global cooperation, coordination and a high degree of financial regulation.

1.14 Glossary

Bond: A bond is a debt investment in which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate.

Demographic dividend: Demographic dividend refers to the growth in an economy that is the resultant effect of a change in the age structure of a country's population. The change in age structure is typically brought on by a decline in fertility and mortality rates.

Equity: In accounting and finance, equity is the difference between the value of the assets/interest and the cost of the liabilities of something owned. For example, if someone owns a car worth $ 15,000 but owes $ 5,000 on that car, the car represents $ 10,000 equity.

Foreign Institutional Investor: Foreign Institutional Investor (FII) means an institution established or incorporated outside India which proposes to make investment in securities in India. They are registered as FIIs in accordance with Section 2 (f) of the SEBI (FII) Regulations 1995 Sep 27, 2012.

Gross Domestic Product: Gross Domestic Product (GDP) is the broadest quantitative measure of a nation's total economic activity. More specifically, GDP represents the monetary value of all goods and services produced within a nation's geographic borders over a specified period of time.

IPO: Initial Public Offer. When a public limited company goes for a public issue for the first time, then it is known as Initial Public Offer.

Leveraged Recapitalization: This strategy involves substitution of equity for debt in the target company.

Marketing Mix: Marketing mix is a business tool used in marketing by marketers. Marketing mix is often crucial when determining a product or brand's offer and is often associated with the four Ps: price, product, promotion and place.

Secondary Buyout: Under this strategy, the target company is sold to another PE firm. This could happen because PE players generally operate on both sides of the deal.

Trade Sale: Under the trade sale, the PEs sell their private equity component entirely to a trade buyer. This way, the exit is smooth and avoids the hassles of organizing a successful IPO.

Unemployment Rate: Unemployment rate is a measure of the prevalence of unemployment and it is calculated as a percentage by dividing the number of unemployed individuals by all individuals currently in the labour force. During periods of recession, an economy usually experiences a relatively high unemployment rate.

Venture Capital: Venture capital (VC) is money provided to seed early-stage, emerging and emerging growth companies. Venture capital funds invest in companies in exchange for equity in the companies they invest in, which usually have a novel technology or business model in high technology industries, such as biotechnology and IT.

1.15 Self-Assessment Test

1. What do you understand by globalization?
2. Why is global marketing important?
3. What is Foreign Direct Investment?
4. What do you understand by Global Bond Market?
5. What is meant by Carry Trade and explain the Theory of Convergence?
6. Briefly explain about Trade Finance.

1.16 Suggested Readings/Reference Material

1. Anthony Saunders, Marcia Cornett, Anshul Jain (2021). Financial Markets and Institutions. McGraw-Hill. 7th edition
2. I.M. Pandey, Financial Management (2021). 12th edition, Vikas Publishing House.
3. Jeff Madura (2020). Financial Markets and Institutions – Asia Edition, 13th edition; Cengage Learning.
4. P. G. Apte (2020). International Financial Management; Tata McGraw-Hill Education Private Limited; 8th edition
5. Prasanna Chandra (2019). Financial Management – Theory and Practice, 10th edition, New Delhi: Tata McGraw-Hill
6. Frank J. Fabozzi, Frank J. Jones (2019). Foundations of Global Financial Markets and Institutions. Mit Press. 5th edition
7. Brealey Myers (2018). Principles of Corporate Finance, 12th edition, USA: McGraw-Hill Companies Inc.

1.17 Answers to Check Your Progress Questions

1. (d) Global standards in intellectual property rights

Global Standards in intellectual property rights is not the feature of China market.

2. (b) Adequate bankruptcy laws

Adequate bankruptcy law is not the feature of Indian market.

3. (a) Global financial system functions in highly inter-connected markets under conditions of financial globalization

Global financial markets are inter-connected with bank intermediaries and trade credit functions.

4. (d) They invest in debt and equity market for the purpose of earning high return

FII create volatile forex markets, invest in Government equity and bonds, chase high interest rates with motive of high income.

5. (c) Maturity period is not fixed

Bonds have no fixed maturity period.

6. (b) They are highly regulated

Private equity is highly regulated is not its feature.

7. (e) **Venture capitalist have restriction in investing government sectors**

Venture capital are broadly sub categorized, they are found in new technology, new market, etc., they form dominate role in the management and they are global experts in doing business.

8. (e) **Leveraged buyout**

IPO, trade sale, secondary buyout and leveraged capitalization are exit route for private equity investment.

9. (c) **The Forfaiter is not entitled for any margin or profit and merely undertakes the transaction as a service**

The forfaiter takes all the risks for the financial transactions involving purchase of receivables from exporters with a receivable period of 180 days to seven years. He will be paid a margin on the transaction for the services rendered by him.

10. (e) **ECB can be accessed in multiple routes**

Accessing multiple routes by ECB is not a feature. However, ECB can be accessed in two routes namely automatic route and approved route as per RBI circular (see page 28 of this unit).

Unit 2

Macro Issues Impacting Global Markets

Structure

"There's no locality on the web - *every market is a global market."*

- Ethan Zuckerman

2.1 Introduction

Let's study the macro issues that impact the global market.

In the previous unit, we studied about basic instruments in global financial markets, global bond market, corporate bond market, private equity and venture capital, strategies of investment by private equity firms, hedge funds, external commercial borrowings, and trade credit, carry trade and trade finance.

In this unit we will be discussing some of the important issues like the impact of the political scenario on financial and commodities markets, the market dynamics in price setting in various markets and how the carry trade is playing an important role in global trade. We will also be studying how the yield curve reacts, the quantitative easing introduced by various economies to smoothen the market sentiment and risk management in global markets.

Financial markets will create a strong base in all economies – whether it is developed economy or developing economy. Financial markets are impacted by many macro factors or issues day in and day out. This unit will try to bring out all these macro aspects, briefly discussing each of them.

The main function of a financial market is facilitating capital formation*)*. The prevailing political scenario is the first and foremost factor to influence such activities. At any point of time the political scenarios *stable or unstable* - will decide investment pattern. Capital flows between countries are triggered by such evolving political scenario. Since additional cash flows lead asset creation and consequent wealth creation, asset valuation techniques are very important for capital formation and investment decisions. Large scale participation in investment activity in any economy by the investing community will trigger strong capital formation in that economy. Hence let us understand some of the important aspects in the markets which will impact the decision making by the investing community.

What is the price discovery method applicable or available and how is the price set? In the same breadth, what is the level of prevailing interest rates and how it is going to change during the course of the investment?

The level of development of local financial marketplace can be ascertained by looking at arbitrage opportunities present for the financial assets. The factors like yield curve, liquidity of the market, inflation in the country and the effective capital gains etc. will enable evaluation and ascertaining the future direction of the marketplace.

The financial markets get impacted by the factors like:

- The size of the market
- Measures taken for cross border capital flows
- Quantitative easing monitor by central bank
- Transparency in the financial markets
- Investor protection measures and related regulatory framework
- Lower transaction costs in the market

Aspects like risk management, technology, deregulation, liberalization, consolidation and globalization are the factors widely used and compared to choose, discard and leave by global players in the financial markets.

Example: Effects of RBI's Interest Rate Hike

On May 4, 2022, as the RBI increased the key interest rate by 40 basis points, to tame inflation, the Sensex plunged more than 1,400 points, in the intra-day trade, to close at 55,669.03, while the NSE Nifty recorded a fall of 391 points and settled below 16,700.

Contd….

Again, on June 8, 2022, in response to RBI's decision to hike key rates by 50 bps, benchmark indices declined with the Sensex falling 180 points in early trade. The raise of the repo rate to 4.9 per cent, up from 4.4 per cent made Sensex fall 215 points and Nifty lose 60 points by day's close.

The stock market index and the interest rates have an inverse relationship. A hike in the repo rate prompts companies to also cut back on the spending on the expansion. This leads to a dip in growth and affects the profit and future cash flows of companies, resulting in a fall in stock prices. When many follow this suit, it eventually leads to a fall in markets.

Source: https://www.hindustantimes.com/business/how-change-in-repo-rate-affects-stock-markets-101651668114172.html, dated 19th July, 2022 (Accessed on June 10, 2022)

2.2 Objectives

After studying this unit, you will be able to:

- Discuss how the political scenario influences trade activities
- Explain the concepts of price setting in the markets to understand their impact on trade activities
- Define the impact of carry trade on global market to evaluate how this multiplier effect disturbs the economic scenario
- Apply the concept of the quantitative easing to assess the vibrant monetary policies of the central bank
- Analyze the concept of risk management to interpret how the risk management process is implemented in the markets

2.3 Political Scenario

The prevailing political scenario may lead to political risks in a country for an investor – both domestic and foreign.

Political risk is the risk faced by corporations, investors and governments due to changes in the political scenarios. It is the risk an investment's returns could suffer as a result of political changes or instability in a country. Instability affecting investment returns could stem from a change in government, legislative bodies, other foreign policy makers, or military control. It is a risk that can be better understood and managed with reasoned foresight and flexible strategies.

For multinational companies, political risk refers to the risk that a host country might make political decisions which will prove to have adverse effects on the multinational's earnings and/or profits. Unfavorable political actions can vary from very damaging, such as widespread destruction due to revolution, to those of a more economic nature, such as the enactment of laws that prevent the movement of capital. The political turmoil in a nation will force the MNCs to look for alternative geographical places. For example, the turmoil in Turkey, Afghanistan, and Iraq and some of the erstwhile USSR countries forced the MNCs look for alternative places for their manufacturing units.

Two types of political risks are common – micro risk and macro risk.

Macro risk refers to unfavorable actions that will impact all foreign firms, such as expropriation or insurrection, whereas micro risk refers to the adverse conditions affecting only a specific industrial sector or a particular business, such as corruption charges or prejudicial actions against foreign companies.

All in all, regardless of the kind of political risk that a multinational company faces, if companies are not adequately prepared, they end up losing a lot of money.

Sometimes, political risk in these countries may force investors to withdraw large volume of funds. The outflow of money often goes to the tax haven countries, US banks and subsidiaries of banks in the Cayman Islands and the Bahamas. These countries are having very stringent bank secrecy rules regarding maintenance of secrecy on the accounts of the client. Because of the secrecy, the client may resort to money laundering and financing of terrorist activities. The US government enacted the US Patriot Act in 2001. This Act prohibits the US banks from providing banking services to foreign banks that have no physical presence in any country (so called shell banks). The bill also added foreign corruption offences to the list of crimes that can trigger a US money laundering prosecution.

Some of the political decisions of the respective governments which have impacted international trade are given below:

Greece, a small country in Europe ran into debt crisis in 2015. To bail out Greece from the debt crisis European Commission (EC), the International Monetary Fund (IMF) and the European Central Bank (ECB) put some conditions and suggested a referendum. The bailout conditions were rejected by people of Greece in July 2015. The then government took a decision to accept the bailout conditions of EC, ECB and IMF. This entire transaction had wide ramifications on Greece and other EU countries.

The US administration imposed sanctions on Iran in May 2018 to curtail Iran's actions on certain military actions and develop atomic weapons. The sanctions by US restrict international trade activities by Iran with US and the other countries and identified entities. The U.S. moves have already contributed to a run on the Iranian Rial, Iran currency and triple-digit inflation as Iranians scramble for the safety of U.S. dollars and gold.

Some of the policy decisions taken by the US Government on issuing H-1B work visas to individuals impacted Indian Software Companies as they are the biggest users of this visa.

The US administration during 2018 increased taxes on imports from China, Mexico, Canada and the EU, to encourage consumers to buy American products.

All of these countries have retaliated. As a consequence, the trade wars have started among major trading countries.

These above events are a very few to state how the political scenarios impact the global markets. This type of political decisions by various economies keep the business entities to face risks from different dimensions. The dynamic nature of political scenarios impact investments, cash flows and valuation of assets dealt in the financial markets – financial assets and physical assets.

2.4 Impact of Covid-19 Pandemic on Economy

Covid-19 is the disease caused by a new coronavirus called SARS-CoV-2. WHO first learned of this new virus on 31 December 2019, following a report of a cluster of cases of 'viral pneumonia' in Wuhan, People's Republic of China?

As on October 2021 Covid-19 was still a threat across many counties. Covid vaccine manufactured by different companies under different brand names was being administered to fight the Virus. Globally, as on 22nd October 2021, there were 242,348,657 confirmed cases of Covid-19, including 4,927,723 deaths, reported to WHO.

In 2020, global gross domestic product declined by 6.7 percent as a result of the coronavirus (Covid-19) pandemic outbreak. In Latin America, overall GDP loss amounted to 8.5 percent.

[20]The Covid-19 pandemic has triggered the deepest economic recession in nearly a century, threatening health, disrupting economic activity, and hurting well-being and jobs. Extraordinary policies are required to walk the tightrope towards recovery, which will shape the economic and social prospects of the coming decade.

[21]Brief overview of the impact of Covid-19 on world economy from IMF Perspective

According to IMF annual report 2020, the world faced a crisis like no other crisis. IMF observed that all National governments took bold steps to save lives and put a floor under the world economy, with nearly $12 trillion in fiscal actions and about $7.5 trillion in monetary actions.

[22]According to World Bank over the 12 months (March 2020 to April2021, the pandemic has harmed the poor and vulnerable the most, and it is threatening to push millions more into poverty.

[23]According to OECD observation published in October 2021, the ramifications of Covid-19 continue to ripple across the world, with the health pandemic

[20] https://www.oecd.org/coronavirus/en/themes/global-economy

[21] https://www.imf.org/external/pubs/ft/ar/2020/eng/downloads/imf-annual-report-2020.pdf

[22] https://blogs.worldbank.org/voices/2020-year-review-impact-covid-19-12-charts

[23] https://www.unido.org/stories/coronavirus-economic-impact-21-october-2020

triggering the greatest global economic crisis since the 1930s (see July UNIDO Covid-19 bulletin). Countries remain focused on how to respond to the devastating social and economic impacts of the pandemic, which look set to be both profound and protracted. The IMF's latest World Economic Outlook suggests that the Covid-19 pandemic will cost the world economy $28 trillion in lost output over the next five years while the ILO predicts severe disruption of labour markets for the foreseeable future.

OECD had taken a sample of 62 countries' IIP and observed that on average, IIP continued to fall compared to December 2019. The average IIP percentage decrease across countries in March 2020 compared to December 2019 was 5.6 per cent, while the average percentage decrease across countries between March 2020 and June 2020 was 2.5 per cent.

OECD grouped the 62 countries' sample into four different categories:

Recovery: countries whose IIP score fell in March 2020 (compared to December 2019), but increased in June 2020 (compared to March 2020);

Protracted Economic Downturn: countries whose IIP score decreased in March 2020 (compared to December 2019) and continued to fall in June 2020 (compared to March 2020);

Lagged Crisis Effects: countries whose IIP score increased in March 2020 (compared to December 2019), but decreased in June 2020 (compared to March 2020);

Weak Impacts: countries whose IIP score climbed in March 2020 (compared to December 2019) and continued to rise in June 2020 (compared to March 2020).

[24]According to RBI Financial Stability Report July 2021, the global economic performance improved in the first half of 2021, but in a manner so widely divergent across countries that unequal participation in the recovery could emerge as a downside risk going forward. A supportive financial environment and continued policy support have contributed to nurturing the recovery; the game changer has, however, been the speed and scale of vaccination and the consequent unlocking of advanced economies and some EMEs, including contact-intensive activities. In many EMEs, lack of access to vaccines, the slow pace of vaccine deployment, new surges of infections and associated containment measures are operating as drags on the recovery, with a disproportionately high toll on the poorest and most vulnerable.

Turning to the second quarter of 2021, global mobility stalled in April 2021, but improved in May, especially in respect of recreation and retail in the advanced economies where containment is being eased. In contrast, there were declines in

[24] https://m.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1179 Financial Stability Report July 2021

mobility in parts of Europe, Latin America and India where infections had recorded renewed surges. The global composite purchasing managers' index (PMI) rose to an 11-year high in April, with services expanding at a higher pace than manufacturing for the first time since July 2020. In May 2021, the composite PMI increased to its highest level in over 15 years, with the services PMI at a 181-month high and above the manufacturing PMI for the second successive month.

Against this backdrop, as per the International Monetary Fund (IMF), after an estimated contraction of –3.3 percent in 2020, the global economy is projected to grow at 6 percent in 2021 before moderating to 4.4 percent in 2022 and 3.3 per cent over the medium-term. In advanced economies, the strong pace of vaccination is expected to boost contact-intensive services as pent-up demand is released and funded by accumulated savings. Output is expected to emerge out of the decline of (-) 4.7 per cent in 2020 and grow by 5.1 per cent in 2021 and by 3.6 per cent in 2022. In emerging and developing countries, effective vaccine protection is likely to become available for most of the population only by late 2021 and hence containment measures may be needed in 2021 and 2022. Accordingly, GDP growth is projected to recover from (-) 2.2 per cent in 2020 to 6.7 per cent in 2021 and 5.0 per cent in 2022. As the recovery strengthens in 2021, global trade growth is projected to accelerate to 8.4 percent, mainly because of the rebound in merchandise volumes. Cross-border services trade is expected to remain subdued until the pandemic is brought under control everywhere. Although commodity prices (particularly for oil) are expected to firm up further in the months ahead, the increase is widely regarded as transitory. Hence, inflation is expected to revert to its long-term average – remaining below target in advanced economies and averaging below 5 per cent in emerging and developing economies in 2021 and 2022.

Yet another disruption in 2022 was the War in Ukraine.

Example: The War in Ukraine – Effect on Global Market

In reaction to the news when Russia invaded Ukraine on 24th February, 2022, the global financial markets responded by selling off stocks and surging commodity prices. Though markets rebounded later, stability didn't return.

Volatility remained elevated, and both the political and economic situations were in flux. The oil prices peaked, and inflation became a common phenomenon across the countries. In the U.S., bond markets started increasingly pricing the potential for stagflation, a scenario of higher inflation and lower economic growth.

Source: https://www.morganstanley.com/ideas/ukraine-crisis-market-potential-headwinds, dated 1st March 2022. (Accessed on June 10, 2022)

2.4.1 Capital and Investments

The stock, bond and money markets offer a possibility to build up assets to provide income in future. They provide a means to earn income from funds not required immediately.

Firms often require funds to build new facilities, replace equipment or increase their business in other ways. Shares, bonds and other types of financial instruments make this achievable. Some of the institutions in the financial markets like banks, non-banking financial companies and similar institutions provide funding to individuals and business entities for their investments in movable and immovable assets. The Credit Card issuers enhance the purchasing power of the individuals by extending credit card facilities liberally. The efficacy of such capital and investment is evaluated by various measures such as return on capital employed, return on net capital employed, return on average capital employed, return on total assets and net operating assets.

Generating a superior return means to achieve a return on investment that is greater than the rate of return achieved by similar business operations.

A sustainable superior return or producing a superior rate of return on a continuous basis, is perhaps the most difficult objective to achieve.

A business may do well when its products or services are in trend. However, the downfall can be speedy when its services or products become old and outdated and the business slips from making superior returns to producing inferior ones.

To be sustainable is to develop and plan the business in a way that customers keep buying the company's services/products in preference to those of its competitors. Innovation, technology and cost minimization are the activities that can help preserve a sustainable return.

2.4.2 Capital Flows

- 'Capital flow' means the movement of money for investment, production and trade or business. Capital flows in the companies are in the form of investment of capital and expenses on research and development and operations. In any economy, the government sets the direction of capital flow into the selected sectors by allocating higher capital budgets to these sectors. For example, Indian Government allocated huge capital in infrastructure projects (power sector, roads, railways and telecom etc.,) in its budget, 2021-22 ₹ 1.97 lakh crore (US$ 27.02 billion) in next 5 years for Production Linked Incentive scheme (PLI) in 13 Sectors ; huge capital flows can be expected into these sectors by overseas investors.

Individual investors channelize their investment capital and savings into securities like stocks, bonds and mutual funds.

Different sets of capital flows exist:

- Asset class movements – measured as capital flows between cash, stocks, bonds, etc.
- Venture capital – investments in start-up businesses
- Mutual fund flows – net cash additions or withdrawals from broad classes of funds
- Capital spending budgets – examined at corporations as a sign of growth plans
- Government budget – government spending budgets

Investors are interested in the growth rate of capital flows, like venture capital and capital spending, to find any trend that might point to prospective investment opportunities or risks.

International capital flows are a part of international trade. When one imports goods or services, the buyer (the importer) gives the seller (the exporter) a monetary compensation, just as in domestic transactions. If total exports are equal to overall imports, these dealings balance at zero and citizens of that country receive as much in monetary inflows as they payout in cash outflows. The trade balance however is never zero. The general report of a country's balance of payments, including its trade in goods and services, income receipts and transfers, is known as current account balance. If the nation has a surplus or deficit on its current account, there is an off-setting financial flow of currency, securities, or other claims. This is called its capital account balance. It is basically the net financial flow.

Composition of Capital and Financial Flows: Trade imbalances are financed by offsetting capital and monetary flows, which cause changes in net foreign assets. These payments can be any mixture of the following: portfolio investments, direct investment in domestic firms (FDI) including start-ups and changes in international reserves and capital investments (in debt or equity).

The above discussion concludes that political issues impact the cash flows and investments.

Activity 2.1 You are working for ZEBA Investment company as portfolio manager. An NRI approaches you for investment into various assets in India. How do you explain to him about the prevailing political scenarios that may lead to political risk in India? **Answer:**

2.4.3 Asset Valuation

Asset valuation is a technique of evaluating the value of real property, a company, security, antique objects or other items. Asset valuation is normally performed before the sale of an asset or prior to purchasing insurance for an asset.

Asset valuation may consist of subjective as well as objective measurements. For example, the valuation of the company takes the brand name of the company also. Subjectivity in valuing a company, is about how much its brand name is worth. This aspect of asset valuation must be subjective. In contrast, net profit based on the company's income and expense figures is an objective measurement.

Common methods for finding an asset's value comprise of comparing similar assets and evaluating its cash flow potential. Replacement cost, acquisition cost and deprival value are also methods of asset valuation.

Market prices are the best technique to decide on the value of a firm or of the firm's assets, or property. This is important not only to those selling and buying businesses, but to regulators as well. An insurer, for example, may appear strong if it values the securities owned at the prices paid for them years ago, but the relevant question for judging its solvency is at what prices those securities could be sold if it needed cash to pay claims today.

Check Your Progress - 1

1. Which of the following factors have no influence on financial markets?
   a. Micro factors
   b. Volatile exchange rate fluctuations of the domestic currency
   c. Inflation factor
   d. Government policies
   e. Macro-economic factors
2. What risk does the Political scenario may lead to in a country for an investor, both domestic and foreign?
   a. Political risk
   b. Economical risk
   c. Financial risk
   d. Foreign exchange risk
   e. Credit risk
3. Political risk refers to the risk that a host country will make political decisions that will prove to have ___________ effects on the multinationals' profits and/or goals.
   a. Favorable
   b. Unique
   c. Futile

   d. Adverse
   e. No effects

4. Which of the following is reward for the investment in stocks?
   a. Interest
   b. Return on capital
   c. Profit
   d. Dividend
   e. Return on funds

5. The efficacy of capital and investments are evaluated by various measures such as return on capital employed, return on net capital employed, return on average capital employed, and return on total assets. Identify another parameter which will help in evaluating capital and investments.
   a. Net revenue
   b. Net non-operating assets
   c. Net operating assets
   d. Net profit
   e. Net income

2.5 Price Setting

Pricing is an important aspect in marketing scenario whether it is domestic market or international market, whether it is tangible commodities or services. What should be the price of a product? Is it cost plus some per cent of profit, or cost offered by competitor minus some discount? There are many ways to arrive at pricing of a product / services.

Price discovery and setting are different from valuation. The value of an ounce of gold or a share of stock is no more and no less than what someone is keen to pay to possess it. Markets offer price discovery, a way to determine the relative values of different items, based on the prices which individuals are ready to buy and sell them.

The process of price discovery is a summation of the market's emotions at a particular point of time - a comprehensive, aggregate view on the future. It is how every price in every marketplace is determined.

The process of price discovery involves buyers and sellers arriving at a 'deal price' for a specific item at a specified time. It involves:

- Buyers and sellers (number, size, location and valuation perceptions)
- Market mechanism (bidding and settlement process, liquidity)
- Available information (amount, timeliness, significance and reliability)
- Risk management choices

In the above, the word ‘market’ is a broad term that covers sellers, buyers, expectations and emotions. The execution venue is where trade is carried out. It could be a physical infrastructure providing online trading facility. Instances of virtual or electronic execution venues include National Stock Exchange in India, NASDAQ, the London Metal Exchange, NYSE, and London Stock Exchange. “Market” is an extensive term that includes buyers, sellers and even sentiment. These electronic markets are also called virtual markets.

Post Enron scandal in 2001, the United States tightened the accounting rules through the [25]Sarbanes Oxley Act regarding the mark to market method, necessitating freshly or most recently discovered prices to be used. The intention of this change was to prevent companies from overvaluing the assets held. Each night (or reporting period) they would have to take a freshly discovered market price acquired from two or more market observers.

Price discovery is sensitive to many factors such as:

- Number of buyers
- Number of sellers
- Number of items for sale in that trading period
- Number of recent sales or purchase price (this is the price at which items are traded)
- Current bid price
- Current offer price
- Availability of funding
- Obligations of participants (e.g., regulation, exchange rules, fund policy)
- Cost of execution (market fees and tax)
- Cost, availability and transparency of pricing information in current and other execution venues

The cost of execution applies to all markets. This is not cost of production, but a cost incurred to access the execution venue.

Market rules set the duration and time for settlement and trade. A few markets may not have many participants as the assets being traded do not have much appeal. Such markets are often called illiquid. Discovery might take place at auction time, which is predefined or whenever the participant desires to trade in such illiquid markets. In such cases, there may be no executions for months; no price discovery takes place for long periods and the last traded price is used.

[25] https://www.sarbanes-oxley-101.com/sarbanes-oxley-compliance.htm

This can have major risk as the marketplace for the illiquid may have moved. An added characteristic of such illiquid markets is that the cost of trading can be higher and the spread between bid and offer may be very wide due to lack of competition.

In a vibrant marketplace, price discovery happens continuously while items are bought and sold. The price will be lower than the duration average sometimes and sometimes exceeds the average due to uncertainties and temporary changes in supply resulting from trading activity.

A closed marketplace has no price discovery. The previous and the last trade price is all that is known. It is common in some markets not to use the actual last price but some kind of average / weighted mean. This is to prevent price manipulation by the execution of outliers at market close. One side outcome of this practice is that market close prices are not always available at market close. Even after the official market close is available in print, it is possible to make "alterations" to be issued at a later date.

Derivative contracts are also based on "fixing" price snaps at a point in time when the market is open. London fixing for precious metals including gold and silver is very popular.

Usually, price discovery helps find the exact price for a commodity or a share of a company. The price discovery is used in speculative markets which affect traders, manufacturers, exporters, farmers, oil well owners, refineries, governments, consumers, and speculators.

2.5.1 Interest Rates

An interest rate represents cost of borrowed funds. Alternatively, it is the compensation for the service and risk of giving loans. Without interest, people would not be keen to lend or even save their cash, both of which require deferring the chance to spend in the present. But existing interest rates are always changing and different category of loans offer different interest rates. It is important for both the lender and borrower to recognize and comprehend the reasons for these differences.

Interest rates setting are mainly of two types. At the macro level, interest rates have been set by national governments or central banks. At the micro level, interest rates have been set by the commercial banks for their different borrowers or deposit customers.

Although the commercial banks are normally free to determine the micro level interest rate, they will pay for deposits made by the customers. They will take into account the customer specific details (background, purpose, security, risk credit rating etc.), the competition in the market as well as forecast and also prevailing macro level interest rates.

How are interest rates determined?

Supply and Demand: Changes in the interest rates are a result of variations in the supply and demand of credit. An increase in demand for credit will increase interest rates, while a decrease in the demand for credit will decrease the interest rates. On the other hand, a rise in the supply of credit will decrease interest rates, while a decline in the supply of credit will boost them.

The supply of credit increases by a rise in the amount of money accessible to borrowers. For example, when you open a bank account, you are in fact giving or lending money to the bank. Depending on the type of account you have (a certificate of deposit will provide a higher interest rate than a checking account, which gives you access to the funds at all times), the bank can employ that fund for its investment activities. The bank can lend the money to other clients. The more the banks lend, the more credit is available to the nation. And with the increasing supply of credit, the price of borrowing (interest) reduces. Further when RBI changes the SLR and CRR requirements, the lendable funds with the banks also increase or decrease. This also results in increasing /decreasing the rates of interest.

The credit accessible to the nation is reduced as lenders choose to postpone their loan repayment. For example, when you decide to delay paying credit card bill for one month, you are not only escalating the quantity of interest you will have to shell out, but also reducing the total credit available in the market leading to a rise in the interest rates.

Inflation: Inflation will also influence interest rates. The higher the inflation rate, the more is the likelihood of interest rates rising. This is because lenders will demand increased interest rates as compensation for the cut in purchasing power of the money.

The following discussion covers the perspectives from US economy angle and Indian scenario.

The rate that institutions charge each other for very short-term loans or US federal funds rate influences the interest rate that banks set on the money lent. The rate then finally spreads down into all other short-term lending rates.

The Fed monitors these rates through ‘open market transactions’, which is fundamentally the buying or selling of previously issued US stocks. If the government buys securities, banks have more money than they can use for lending and the interest rates decline. When the government sells securities, money from the banks get exhausted, rendering less funds at the banks’ disposal for lending, leading to a forced rise in interest rates.

In India the RBI monitors interest rates through Bank Rate, Repo Rate and Reverse Repo rate. Changes in any of these rates provide direction to rate changes in the economy.

Similar to US markets, in India also, the RBI monitors money supply [26]M3 through sale/ purchase of Government dated securities/Treasury bills with different maturity periods.

Example: Raising Interest Rates to Tackle Inflation

To temper soaring inflation in the US, the US Federal Reserve on May 4, 2022, raised its benchmark interest rate by half a percentage point, the biggest jump in 22 years. With the US inflation at a 40-year high, further hikes were expected. The Economist Intelligence Unit expected the Fed to raise rates seven times in 2022, reaching 2.9% in early 2023 to achieve a hold on inflation.

Annual U.K. inflation hit a 30-year high of 7% in March 2022. On May 5, 2022, the Bank of England raised interest rates to their highest level in 13 years in a bid to tackle soaring inflation which it expected to rise to roughly 10% in 2022.

Source: https://www.wsj.com/livecoverage/federal-reserve-meeting-inflation-rate-may-2022, dated 4th May, 2022. (Accessed on June 10, 2022)

Type of loans: The foregoing discussion points out that, supply and demand are the principal forces behind interest rate levels. The rate of interest on different type of loans, however, depends on the credit risk, time and convertibility of the particular loan.

Risk refers to the probability of the loan not being repaid. A bigger chance that the loan will not be repaid, leads to higher levels of interest rate. However, if the loan is secured, by collateral which the lender will acquire in case of loan not being paid back (i.e. such as a car or a house) the rate of interest will be lower. This is because the risk factor is taken care of by the collateral offered as security.

For government securities, there is obviously very little or no risk at all because the borrower is the government. They are also known as risk-free securities and offer low rates of interest.

Time is also a risk factor. There is a bigger chance of long-term loans not being paid back because there is an increased time period for any likely adversity to occur, that leads to non-payment. In addition, the face value of a long-term loan when compared to that of a short-term is more vulnerable to the effects of inflation.

According the monetary policy released on 5th December 2018, the RBI modified computation of lending rate by commercial banks as follows.

[26] M1+ Time deposits with the banking system = Net bank credit to the Government + Bank credit to the commercial sector + Net foreign exchange assets of the banking sector + Government's currency liabilities to the public– Net non-monetary liabilities of the banking sector
source; https://m.rbi.org.in/scripts/PublicationsView.aspx?id=9455

In the monetary policy dated 5th December 2018. the RBI proposed that from April 1, 2019, banks to use external benchmarks instead of the existing system of internal benchmarks i.e. Prime Lending Rate, Benchmark Prime Lending Rate, Base Rate and Marginal Cost of Funds based Lending Rate (MCLR) to ascertain the lending rates.

According to the proposal, the loans can be benchmarked to any one of the following:

a) Reserve Bank of India policy repo rate, or

b) Government of India 91 days Treasury Bill yield produced by the Financial Benchmarks India Private Ltd (FBIL), or

c) Government of India 182 days Treasury Bill yield produced by the FBIL, or

d) Any other benchmark market interest rate produced by the FBIL.

A few loans that can be changed back into money quickly will have little if any loss on the principal amount loaned out. These loans usually carry relatively lower interest rates.

2.5.2 Arbitrage

Another important aspect that plays a crucial role in price setting is Arbitrage price theory.

Arbitrage pricing theory is basically an extension of capital asset pricing model. The return from an investment is assumed to depend on numerous factors. These factors involve variables such as the domestic interest rate, gross national product, the inflation rate and other macro-economic factors. By exploring the means with which investors can shape portfolios that eliminate their exposure to these factors, arbitrage pricing theory demonstrates that the expected return of an investment is linearly dependent on many factors. An investor can leverage deviations in returns from the linear pattern using the arbitrage strategy. Arbitrage is a practice of the simultaneous purchase and sale of an asset, taking advantage of slight pricing discrepancies to lock in a risk-free profit for the trade.

In arbitrage pricing theory, there are a number of factors impacting the investment returns. Every factor is a separate source of systemic risk. In arbitrage pricing theory, unsystematic (i.e. diversifiable) risk is the risk that is unrelated to all the factors.

In countries with less developed financial markets, currencies and commodities trade at different prices at different locations. Brokers and dealers in markets make an effort to profit from these differences in prices, till such time the differential price becomes negligible.

Activity 2.2 As a portfolio manager identify factors that determine the return on investment **Answer:**

2.6 Carry Trade: Impact on Global Trade

In global financial markets, carry trade has been gaining popularity in view of the significant interest rate differential between developed economies (like Japan and the US) and developing nations (like India and China).

[27]A currency carry trade is usually defined as a leveraged cross-currency position designed to take advantage of interest rate differentials and low volatility. The strategy involves borrowing funds at a low interest rate in one currency (the funding currency) and buying a higher-yielding asset in another (the target currency). Ex ante, the strategy is only profitable as long as the gains from interest rate differentials are not expected to be overwhelmed by exchange rate movements in the short to medium term. That is, Uncovered Interest Parity (UIP) is not expected to hold. The use of leverage – borrowing large amounts with small own equity base - makes these positions particularly sensitive to changes in exchange rates or interest differentials.

The big trade outfits or brokers do this leverage of 1: 100 to 1: 300 ratios. As high ratio of leverage is being applied, carry trade is always in big bulk which has impact on trillions of dollars on various central banks across the world.

How does carry trade take place?

Carry trade involves borrowing from low interest rate economies in their home currency, say Japanese yen from Japan and investing in high interest rate nations like India. The process obviously involves converting Japanese yen into rupees in the forex spot market, invest the rupee proceeds in India, say in bonds, sell the bonds on maturity or even before (when the price is found favorable), use the rupee maturity proceeds to buy back spot yen and extinguish the yen borrowing and be left with a net profit, usually representing the interest rate differential.

However, the profit could be even higher or lower, depending on the movement of rupee against the yen during the period. If rupee gains against the yen, the net profit could be higher due to capital gains. If rupee depreciates, the net profit could be lower, even it could be loss if the depreciation overshoots interest rate differentials. Carry trade is generally considered a safe bet with huge volumes.

[27] http://www.bis.org/publ/qtrpdf/r_qt0709e.pdf

Another form of carry trade is in the derivative market. This strategy involves going short in a low interest rate currency market and simultaneously taking a long position on a high interest rate currency market. On settlement, the profit could be the interest rate differential, if the currency remains stable. Even in this derivative strategy, the profit could be higher/lower than initially estimated, or there could be eventual loss, as in the earlier example.

In the derivative based carry trade, as leverage is employed, the profits could be very much higher by as much as 8-12 times on the initial investment.

The practice of carry trade is further extended to the strategy of shifting investment out of low interest assets into high interest rate yielding or profit yielding assets like debt, equities, real estate, commodities, etc. Carry trade these days is generally conducted for short to medium periods, but rarely for a long period. The currency fluctuations and the interest rate movement pay a significant role in avoiding long term trades.

A classical case in point is the story of long-term carry trade of the US, which has become great history in global finance and economics. During early part of this century, the US real estate practised carry trade of gigantic dimension. It was financed by dollar funds that converged into the US, literally from all parts of the globe, in high volumes and at low interest rate, under what is called the phenomenon of "global imbalances". This worked nicely initially, but with interest rate cycle turning upwards in the US and real estate prices falling simultaneously, the delinquencies on home loans rose to unusual percentage. This process was further abetted by mortgage bankers' misplaced enthusiasm to absorb the entire loanable funds into the home loan segment, even at the expense of diluting the credit standards, under the false notion that home loans in the US can never go bad. The "originate and distribute" model only added to the complacency of the bankers. The consequences were disastrous. The entire globe plunged into a financial crisis called "sub-prime crisis", affecting many industries, major banks and economies very severely. The US in particular was pushed into recessionary conditions, layoffs, closure of industries and bankruptcies. It took a good 5 years for the US to get back to normalcy.

Carry Trade and the Theory of Convergence:

Is carry trade always a successful bet? In theory, yes. But in reality, not necessarily. The theory of convergence argues that arbitrage should nullify the carry trade advantage over a period of time. Illustratively, if global investors borrow from Japan at low interest rate to invest in any Asian nation with high interest rate, the initial interest rate differential should gradually come down. The Japanese banks, in theory should raise their interest rates on discovering that the demand for borrowing in the yen for carry trade has gone up. Likewise, the Asian nation which experiences inflow of Japanese funds, say into bonds, or fixed deposits, will invariably decrease the coupon/interest on them due to the excessive supply of funds.

This process has to result in nullifying the advantage of interest rate differential. This is in fact the essence of the “uncovered interest parity theory”, which argues that the interest rate differential should be offset by the forward rate. That is, if the Japanese interest rate is lower than Australian interest rate - say by 5% points - then Australian dollar should depreciate by the same percentage against the yen.

This theory of “uncovered interest parity” does not prove true in many practical situations. The Japanese interest rates may not go up because of the higher demand for loans, as the monetary policy objective of the Central Bank of Japan is to keep interest rates low. So, instead of rising, the interest rates in Japan may even fall. For similar reasons, Australian interest rates could rise further instead of falling, due to anti-inflationary monetary policy of the Central Bank of Australia. The monetary policy, it appears, is designed among economies without considering its effects on carry trade.

Paradoxically, carry trade defeats “uncovered interest parity” theory but rewards the investor with capital appreciation gains as well at times. However, carry trade could end up in losses as had been proved in the US sub-prime crises. Often, new information about economic fundamentals and unforeseen events could cause the reversal. Major banks, however, have the advantage of additional information of the size of the deal flows.

Carry trade annual volumes were a whopping $ 9 trillion[28], in the beginning of 2015. With low interest rates, the US is the destination to borrow apart from Japan and various Asian economies are the targets for carrying the investments. The US interest rates, however, started increasing from December 2015, following return to normal economic conditions that no longer require easy money policy.

Carry trade may receive severe jolt if the rise in the interest rates is too steep over a period of time in which case, certain analysts predict yet other financial crises. Maybe their fears are unfounded and the rise in interest rates in the US could be in small doses and with gradualism.

[29]*The trends in 2020 and 2021*

The hedge funds and other players accumulated massive bets on carry trades in 2021. These investments involve borrowing currencies with significantly lower interest rates, like the Japanese yen and to a lesser extent the euro, and floating the money into currencies where there is a prediction of interest rates to rise, such as the dollar. The Bank of Japan left its key short-term interest rate unchanged at -0.1% and that for 10-year bond yields around 0% during 2020 and 2021. The interest rate structure is one of the reasons for heave carry trade in Japanese Yen over the years.

---

28 http://www.zerohedge.com/news/2015-01-23/9-trillion-us-dollar-carry-trade-blowing

29 https://www.wsj.com/articles/falling-dollar-shows-resurgence-of-infamous-carry-trade-11638268315

Investors have been drawn back to carry trades in 2021 due to low volatility in currency markets. The dollar had slowly appreciated 11% against the yen since the beginning of the year 2021, the most of any developed-markets currency pair. The net short positioning of yen was very huge as on November 2021 indicating huge increase in carry trade.

Example: Japan's Inflation and Carry Trade

Japan was popular for very low inflation. While every other country declared war on inflation in 2022, Japan spent on redoubling its efforts to fight deflation. Years before the global financial crisis, the popular idea was to borrow in yen, at very low interest rates, park in a currency with higher rates, and pocket the difference, or "carry." As the Bank of Japan was still deliberately holding down 10-year yields (through "yield curve control") the currency tanked, and the yen hit a 20-year low against the dollar. The yen's decline came even as it has maintained its domestic buying power better than any other currency on the planet.

Source: https://www.bloomberg.com/opinion/articles/2022-06-08/yen-weakness-carry-trade-depend-on-mrs-watanabe-more-than-boj#xj4y7vzkg, dated 8th June 2022. (Accessed on June 10, 2022)

2.7 Yield

An investor expects returns on his investment whether it is equity or debt, whether the asset may be gold or real estate or a security. The debt earns interest, the equity earns dividend and capital appreciation, the asset earns (gold, precious stones, real estate) capital appreciation (sometimes depreciation). All these earnings (interest, dividend, capital appreciation) come under yield category. Yield or return can be simply understood as the income received for one rupee of investment; i.e. compute the net income received and divide by the amount invested. (An investor must understand what goes into the numerator and the denominator.)

Investment can be in equity or debt instruments. If you invest in equity your income on the investment will be dividend (if paid) plus the net capital appreciation/depreciation after a year which the amount in the numerator and divide it by the amount invested at the beginning of the year. The same is represented as

$$\frac{\text{Return}}{\text{Yield}} = \frac{Dt + (Pt - Pt\text{-}1)}{P_{t-1}}$$

Where,

t is the present time period

t-1 represents last year. (t could be expressed in years or months or days depending on our requirement).

The value comes out in decimal. To express it for ₹ 100 of investment, you need to multiply by 100 and express it as %.

Current yield for a bond is the effective interest rate at its current market price. It is calculated by a simple formula – annual coupon interest divided by current price. If the price has gone down since the bond was issued, the current yield will be more than the coupon. If the price has increased, the yield will be less than the coupon. Suppose a bond was issued with a par value at ₹ 100 and a 6% coupon. Interest rates have decreased and the bond now trades at ₹ 105. The current yield is 6/105 = 0.0571 which is expressed as 5.71%.

Yield to maturity, though considered as a long-term bond yield, is generally expressed as an annual rate. It is the internal rate of return of an investment in a bond if the investor holds the bond till maturity and if all the payments are made as scheduled. Thus, Yield to Maturity (YTM) is the annual rate the bondholder will receive if the bond is held till maturity. YTM takes into consideration the value of any capital loss or gain the bondholder will enjoy when the bond is redeemed. This is the most widely used measure for comparing returns on different bonds.

Dividend yield is a financial ratio and it indicates how much a company pays in dividends every year relative to its share price. Dividend yield is represented as a percentage on each share and can be calculated by dividing the rupee value of the dividends paid in a given year by the rupee value of one share in a stock current market price.

Another important feature in any discussion on yield is yield curve. Yield curve is a line that plots the interest rates of bonds with equal credit quality but differing maturity dates at a particular point of time. The most often reported yield curve for effective comparison is plotted for three-month, two-year, five-year and thirty-year US Treasury debt. This yield curve is used as a yardstick for other debt in the market, such as mortgage rate or prime lending rates. In addition, the curve is used to forecast changes in economic growth and output.

Example: Inverted Yield Curve - A Signal of Recession?

In the last week of March 2022, for the first time since 2019, the 2-year and 10-year treasury yields inverted, sending a possible warning signal that a recession could be on the horizon. (An inverted yield curve occurs when short-term debt instruments have higher yields than long-term instruments of the same credit risk profile.) Again, in the second week of June, the 30-year, treasury yield fell below its five-year counterpart. This was attributed to the Federal Reserve's quickly raising rates to combat inflation.

Source: https://www.cnbc.com/2022/03/31/2-year-treasury-yield-tops-10-year-rate-a-yield-curve-inversion-that-could-signal-a-recession.html, dated 31st March, 2022. (Accessed on June 11, 2022)

2.7.1 Liquidity

Liquidity refers to the ability of the company or financial institution to make cash payments as they become due. Financial institutions that are solvent also can fail because of liquidity problems. Liquidity is therefore a very important macro issue and greatest threat to the financial system and economy of any country.

2.7.2 Inflation

The most important factor to affect interest rate is the actual or the expected inflation rate in the economy. Specifically, the higher the level of inflation (actual or expected), the higher will be the level of interest rates. The intuition behind the positive relationship between inflation and interest rates is that an investor should earn a superior interest rate on the securities purchased with increasing inflation, to compensate for the increased cost of forgoing consumption of real goods and services today. In other words, the higher the rate of inflation, the more expensive the same basket of goods and services will be in the future.

Inflation of the general price index of goods and services is defined as the percentage increase in the price of standardized basket of goods and services over a given period of time.

Inflation erodes the value of financial assets and increases the value of physical assets, such as houses and machines, which will cost far more to replace than they are worth today.

A real interest rate is the interest rate that would fetch interest income on a financial asset if no inflation were expected over the holding period (e.g. a year) of the financial asset. As such it measures society's relative time preference for consuming today instead of tomorrow. The higher the society's preference to consume today (higher the time value of money), the higher the real interest rate will be.

2.7.3 Capital Gain

Capital gains are increases in the value of the investments itself and are often not available to the owner until the investment is sold.

A capital gain may be short-term (usually one year or less) or long-term (more than one year). Capital gains computed in any financial year will have to be shown in the tax return for the corresponding assessment year. Compared to short-term capital gains, long-term capital gains attract favorable treatment in the hands of tax authorities in many countries. This huge difference is to enable or facilitate long-term investment in projects which generate employment and add to the growth and development as a whole. As an investor's portfolio grows, she/he would increasingly keep track of capital gains, including making adjustments near the end of the calendar year/financial year as the case may be, to reduce capital gains taxes as much as possible.

As against capital gains, capital loss can also occur when there is a decrease in the capital asset value compared to an asset's purchase price.

2.8 Quantitative Easing

The Central Bank of the country regulates money supply in an economy through its monetary policy. The government of the country meets the budgetary deficit through its fiscal policy and meets the government expenditure for its management and developmental activities. The budgetary deficit will be met by the government through issue of T Bills, dated securities, issuance of bonds and money market instruments. When the economy is slowing down, financial markets are on the downturn, industry is not picking up, investment sentiment is low on the economy, the central bank of the country in consultation with government takes measures to stimulate the economy. One such step is quantitative easing.

Quantitative Easing (QE) is a type of monetary policy used by central banks to stimulate the economy and financial system when normal monetary policy has failed to give the preferred results.

The central bank may acquire government securities as well as other securities from the marketplace to reduce interest rates and boost supply of money. Quantitative easing boosts the money supply by flooding financial institutions with capital in an attempt to encourage lending and improve liquidity. Quantitative easing as a measure is thought of, commonly when short-term rates of interest are zero or nearing zero and do not involve in the printing of new bank notes.

Central bank of the country controls the supply of money through open market operations, i.e., selling/buying government bonds / securities / treasury bills in the market. Banks seek to promote economic growth by buying government bonds, which in turn decreases short-term interest rates and raises the money supply. However, the strategy may fail when rates of interest move towards zero and banks have to compulsorily try out other strategies in order to stimulate the economy.

Quantitative easing targets commercial banks and private sector assets instead and attempts to spur economic activity and growth by encouraging banks to lend out money. But quantitative easing can lead to higher inflation rates if the money supply increases rapidly, as there is still a fixed amount of goods for sale, but more money is available now in the economy. In addition, banks may decide to keep funds generated by quantitative easing in reserve instead of lending those funds to businesses or individuals.

QE adopted by various central banks was dependent on the actions taken by the financial systems/governments across the countries to give impetus to the economic activity and growth by introducing measures related to financial market size, cross-border trades, transparency in the financial markets, action of regulatory authorities to improve the investor protection and lower transaction costs due to technological developments in the financial markets. These aspects have been covered in the following paragraphs briefly.

Example: Quantitative Easing of US

The US Fed began using QE (quantitative easing) to combat the Great Recession in 2008. In three different rounds, the central bank purchased more than $ 4 trillion worth of assets between 2009 and 2014. QE was relaunched by the US Fed in response to the economic crisis caused by the Covid-19 pandemic in 2020. The plans for QE in March 2020 did not disclose the dollar or time limit. The safety net of QE was claimed to be the prime reason for the 68% surge of the S&P 500 in Jan 2022 from its March 2020 lows.

The champion of QE was the Bank of Japan which deployed this policy for more than a decade. QE was also deployed by the European Central Bank and the Bank of England in the wake of the global financial crisis that began in 2007.

Source: https://www.forbes.com/advisor/investing/quantitative-easing-qe/, dated 19th January, 2022. (Accessed on June 11, 2022)

2.8.1 Cross-Border Measures

There is one more measure to find out the growth of finance by looking at the value of cross-border transactions and financing. Cross-border financing is by no means new, and at various times in the past it has been quite large relative to the size of the world economy. Looking strictly at securities provides an even more dramatic picture growth of financial markets. A quarter century ago, cross-border purchases and sales of securities amounted to only a tiny fraction of countries' economic output. But today, in a number of countries bond transactions and the annual cross-border share are several times larger than GDP. Such cross-border transactions also sometimes hinder the flow of money in financial markets and make the central bank to take measures such as quantitative easing.

2.8.2 Transparency

Transparency is the availability of complete and on time information on prices and trades. Usually, the people are not willing to trade in a less transparent market.

Yet, another definition of transparency in financial markets is as follows: the extent to which investors have ready access to any required financial information about a company such as audited financial reports price levels and the market depth. Transparency is classically defined as, when much is known by many and it is one of the most important prerequisites of any free and efficient marketplace.

Many financial markets have become subject to regulations requiring transparency. Such mandatory transparency requirements have vastly enabled the financial marketplace. However, this dissemination happened phase-wise. Aggressively traded, investment grade assets became transparent before thinly traded, high yield financial assets.

Transparency causes a significant decrease in price dispersion for all financial assets and as a result reduces speculation leading to decrease in trading activity of financial assets. Market experience indicates that transparency helps some investors through a decrease in price dispersion, while harming others through a reduction in trading activity. Thus, decrease in price and reduction of trading activity impact the money flow in the financial market. Thus, the central bank enters into financial market for quantitative easing.

Academic research has shown that transparency through high quality financial reporting can shrink the information asymmetry among management and investors, following a decrease in the cost of capital.

2.8.3 Investor Protection and Regulation

Excessive regulation can stifle a market. However, trading will also be deferred if investors lose confidence in the information available with respect to securities they want to trade in. Lack of investor protection and regulation will affect the financial markets adversely.

In US markets the U.S. Securities and Exchange Commission (SEC) protects investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

The European Securities and Markets Authority is a European Union financial regulatory (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by enhancing the protection of investors and promoting stable and orderly financial markets.

The Prudential Regulation Authority (PRA) will ensure the stability of financial services firms and it is part of the Bank of England.

The Securities and Exchange Board of India is the regulator for the securities market in ensuring protection of investors in India.

2.8.4 Low Transaction Costs

Many financial transactions are not attached to a definite geographic location. The participants will strive to complete them in locations where taxes, trading and regulatory costs are reasonable.

When the operations involve whole range of bonds, the sale price particularly is lower than the prevailing market price. The purchase price is higher than the measure which is known as the auction concession. Such operations affect the money supply, and hence the need for quantitative easing.

Exhibit 2.1 examines the economic and financial impact of COVID-19 and the policy measures taken by the Indian Government.

Exhibit 2.1: COVID-19 Pandemic and Policy Measures

As the COVID-19 pandemic has eased global meltdown with stock market crashing, manufacturing facilities closed, record unemployment levels and lockdowns, Governments around the world announced packages to stimulate the economies in the mid of March 2020.

Indian Government Stimulus Package

The following are some of the highlights of the $1.7 trillion package announced by Indian Government.

- Medical insurance cover of ₹ 50 lakh per person for those on the frontline of the fight against the deadly corona virus outbreak, including doctors, nurses and sanitation workers
- Direct cash transfers for eight categories of beneficiaries, including pensioners, women and the specially-abled was also announced as part of the relief package
- Farmers to get the first installment of ₹ 2,000 under the Kisan Samman Nidhi in the first week of April.
- The government increased the wages under the MNREGA scheme from the existing ₹ 182 to ₹ 202
- Women holding bank accounts under the financial inclusion scheme Jan Dhan will get an ex-gratia amount of ₹500 per month for next three months
- Supply of five kilograms of either rice or wheat and one kilogram of lentil of choice free of cost to poor households every month for a period of three months, in addition to the existing five kilograms of wheat/rice announced earlier
- Collateral-free loans worth up to ₹10 lakh for women self-help groups under the Deen Dayal Upadhyaya National Rural Mission scheme
- Doubled the limit applicable to the existing scheme to ₹ 20 lakh
- The government will pay EPF contribution on behalf of both the employee and the employer for a period of three months for certain small companies. The government said companies with up to 100 employees in which 90 per cent of the staff is paid less than ₹ 15,000 per month will be entitled to receive this benefit
- Withdrawals of up to 75 per cent of non-refundable advance or three months of wages from the EPF account, whichever is lower, a move likely to benefit 4.8 crore subscribers

Contd….

Reserve Bank of India package

Reserve Bank of India (RBI) Governor addressed the media through videoconference in view of extraordinary circumstances arising out of the coronavirus crisis. RBI advanced its meeting from March 31 and April 3, and held its meetings on March 24, 26 and 27. Monetary Policy Committee (MPC) has voted in favour of a sizeable reduction in repo rate.

- MPC has agreed to reduce the policy repo rate by 75 basis points to 4.4 per cent. "War effort has been mounted to revive the economy through both conventional and unconventional means. Tough times don't last, tough people and institutions do", said Das.
- According to the governor, the central bank has quarantined 150 members as part of a continuity plan. Rising probability that large parts of the global economy will slip into recession.
- India FY20 GDP growth forecast of 5 per cent is now at risk. If supply chain disruptions get accentuated due to the Covid-19 pandemic... the global slowdown could increase, the governor said.
- Inflation likely running 30 basis points above RBI expectations this quarter. Aggregate demand may weaken due to coronavirus and ease core inflation.
- No specific growth and inflation expectations from MPC this time as these would be contingent on the intensity of the coronavirus spread
- Macroeconomic risks, both on demand supply, due to the pandemic would be severe
- Banks and other financial institutions should do all that they can do to keep credit flow going
- Time for RBI to unleash an array of instruments to bolster the economy
- RBI to conduct auction of repo of 3-year papers to the tune of ₹ 1 trn at a floating rate
- Cash reserve ratio (CRR) reduced for all banks by 100 basis points to 3 per cent for one year
- Minimum daily CRR balance requirement reduced from 90 per cent to 80 per cent.
- Marginal standing facility reduced to 2 per cent of SLR. Policy rate corridor widened from 50 basis points to 65 bps
- Regulation and supervision:
  - Moratorium on term loans: All commercial banks permitted to allow a 3-month moratorium on repayment of term loan EMIs

Contd….

- Deferment of working capital interest repayment: Three-month deferment on payment of interest
- Net Stable Funding Ratio (NSFR) deferred to Oct 2020
- Capital buffers: Implementation of last tranche of Capital Conservation Buffer (CCB) deferred to Sep 30, 2020
- RBI injects ₹ 3.74 trn into the system as a result of all the announcements made today
- Depositors requested not to panic; their deposits are safe:
- Fundamentals of the Indian economy are more sound than they were in the aftermath of the previous global financial crisis

Source: ICFAI Research Center

2.9 Risk Management in Financial Markets: A Brief Account

Financial markets encounter various risks. Necessary steps are to be taken by the system to mitigate the risk. The following paragraphs deal with risk management aspects in financial markets.

There are new financial products in the market, such as asset-backed securities or derivatives, whose basic purpose is to reduce and restructure risk.

[30]The Centre for the Study of Financial Innovation in New York, together with PwC, conducted a survey of 672 of the world's top bankers, regulators and analysts across 52 countries to identify banking challenges for the year ahead as well as the risks they see facing the industry.

The report identified 25 risk factors faced by financial institutions/markets. We have taken five top risk factors out of 25. The identified risks are:

1	Macro-economic environment
2	Regulation
3	Technology risk
4	Political interference
5	Criminality

A brief description is given on each of the items.

Macro-economic Risk

Macro-economic risk is the top concern for financial markets. Uncertainties in the macro-economic environment with high levels of debt across sovereign, corporate and consumer sectors will lead to asset bubbles burst.

[30] http://zafin.com/peeling-banking-banana-top-banking-challenges-2016/; Zafin is a leading technology provider

Regulation

Tightening regulatory requirements are costly, excessive and ineffective. There is a need for tougher controls, but these are likely to cut into management time and overall industry margins.

Political Interference

In many places, governments intervene in banking operations for a multitude of reasons, including raising revenues in a time of budget stress, increase investor protection, and rebuild the national tax base.

Technology Risk

The outdated core IT systems were a significant concern for global bankers. Failure to invest appropriately in secure, agile systems that can enhance digital and mobile banking can result in significant loss while compounding the risk for cyber attacks.

Example: FinTechs and Cybersecurity

An increased onslaught of cyber threats compelled Fintechs to fortify their operations. According to a Juniper Research report, online sellers were estimated to lose $130 bn to online payment fraud between 2018 and 2023 in the US alone.

According to the research report by the think tank, Endpoint Ecosystem, poor employee practices, insufficient supply of cyber talent, and migration to the cloud had all compounded the problem. The study also revealed that poor password management, restrictive security policies, and inadequate security awareness training were the chief reasons for the vulnerability of Fintechs. According to Tom Thimot, CEO of authID.ai, a provider of secure, mobile, biometric identity verification software products, facial biometrics has already proved to be a better defense than OTPs and KBAs in preventing hackers from wreaking havoc.

Source: https://fintechmagazine.com/digital-payments/fintechs-prioritise-cybersecurity-as-global-threat-increases, dated 11th March, 2022. (Accessed on June 11, 2022)

Criminality

Financial systems are not currently equipped to prevent attacks from opportunistic hackers, organized criminals, or government-funded corporate (Intellectual Property) espionage. These are compounded by banks' increased embrace of newer (and potentially high risk) technologies including distributed ledgers, crypto currencies and real time payments.

These issues are to be addressed in risk management measures adopted by the market players. Some of these aspects are covered in the following paragraphs.

2.9.1 Technology

Almost everything about the markets has been reshaped by the forces of technology. Abundant computing power and cheap telecommunications have encouraged the growth of entirely new types of financial instruments and have dramatically changed the cost structure of every part of the financial industry thus reducing technology risk.

2.9.2 Deregulation

The trend towards deregulation has been worldwide. The authorities everywhere kept tight control on financial markets in the name of protecting consumers and preserving financial stability. But since 1975, when the United States prohibited stockbrokers from setting uniform commission for share trading, the restraints have been loosened in one country after another. Although there are immense differences, many national regulators agree on the principles that individual investors need protection and transactions, especially those involving institutional investors, require little regulation.

The deregulation facilitated rationalizing the laws of the land in all countries and some tax reforms also. The deregulation in a way mitigated operational risk, legal risk, and reputation risk.

2.9.3 Liberalization

Deregulation has been accompanied by a general liberalization of rules governing participation in the markets. Many of the barriers that once separated banks, investment banks, insurers, investment companies and other financial institutions have been lowered, allowing such firms to enter each other's businesses. The big market economies, most recently Japan and South Korea, have also allowed foreign firms to enter financial sectors that were formerly reserved for domestic companies. Such liberalization helped the MNCs, FIIs, etc. from managing the risk of uncertainties with the support of the government from both the countries.

2.9.4 Consolidation

Liberalization has led to consolidation, as firms merge to take advantage of economies of scale or to enter other areas of finance. For example, all of the UK's major brokerage houses and investment banks have been acquired by foreigners seeking a larger presence in London. A lot of the medium-sized investment banks in the United States were bought by commercial banks wishing to use new powers to expand share dealing and corporate finance. Such mergers help the merged company from the risk of financial loss.

2.9.5 Globalization

Consolidation and globalization go together. Leading financial firms are now highly international, with operations in all the major financial centers. Many companies and governments take advantage of these global networks to issue shares and bonds outside their home countries. Investors increasingly take a global approach as well, putting their money wherever they anticipate the maximum return for the risk taken, without worrying about geography. Thus globalization will mitigate financial and investment risk.

Check Your Progress - 2

6. Which of the following statements is true with respect to Capital flow?
   a. Movement of money within country
   b. Static state of money within country
   c. Movement of money into the country from outside economy
   d. Outward movement of money from one economy
   e. Movement of money from and to an economy
7. How capital flows occur within a corporation?
   a. Investment in capital
   b. Investment in foreign banks
   c. Investment in debentures
   d. Investment in bank
   e. Investment in mutual funds
8. Where the capital flows show the relative strength or weakness, especially in contained environments like the stock market or government budget?
   a. Foreign market
   b. Capital market
   c. Financial market
   d. Global market
   e. Gold market
9. What is an interest rate in the borrowing money?
   a. Miscellaneous Expenditure
   b. Recurring income
   c. Recurring expenditure
   d. Tax liability
   e. Cost
10. Which of the following is the base for Arbitrage pricing theory?
    a. Debt Capital of the company
    b. Asset base of the company
    c. Pricing of the commodities
    d. Capital Asset Pricing Model
    e. Share capital of the company

2.10 Summary

- Financial markets are the backbone of any economy, be it developed, undeveloped or underdeveloped. Financial markets are impacted by many macro factors or issues day in and day out.
- Political scenarios may lead to political risks in a country for an investor – both domestic and foreign.
- Political risk refers to the risk that a host country will make political decisions that will prove to have adverse effects on the multinational’s profits and/or goals.
- The stock, bond and money markets provide an opportunity to earn a return on funds that are not needed immediately and to accumulate assets that will provide an income in future.
- The efficacy of such capital and investments are evaluated by various measures such as return on capital employed, return on net capital employed, return on average capital employed, return on total assets and net operating assets.
- Capital flow means the movement of money for the purpose of investment, trade or business production. Capital flows occur within corporations in the form of investment capital and capital spending on operations and research and development.
- Capital flows can help to show the relative strength or weakness of capital markets, especially in contained environments like the stock market or government budget.
- Asset valuation is commonly performed prior to the sale of an asset or prior to purchasing insurance for an asset. It is a method of assessing the worth of a company, i.e., real property, security, antiques or other items of worth.
- Price discovery and setting is different from valuation.
- Markets provide price discovery, a way to determine the relative values of different items, based on the prices at which individuals are willing to buy and sell them.
- An interest rate is the cost of borrowing money. Interest rates setting is mainly of two types. At the macro level, interest rates have been variously set by national governments or central banks. At the micro level, interest rates have been set by the commercial banks for their different borrowers or deposit customers.
- Inflation of the general price index of goods and services is defined as the percentage increase in the price of standardized basket of goods and services over a given period of time.

- Inflation will affect interest rate levels. The higher the inflation rate, the more the interest rates are likely to rise.
- Arbitrage pricing theory can be viewed as an extension of the capital asset pricing model. The return from an investment is assumed to depend on several factors.
- Yield is the income the investor receives while owning an investment. This refers to the interest or dividend received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.
- Liquidity refers to the ability of the company or financial institution to make cash payments as they become due. Financial institutions that are solvent and sometimes do fail because of liquidity problems.
- Capital gains are increases in the value of the investments itself and are often not available to the owner until the investment is sold.
- A capital gain may be short-term (usually one year or less) or long-term (more than one year) and is required to be claimed on income tax.
- Quantitative Easing (QE) is a type of monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.
- QE increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity. QE is considered when short-term interest rates are at or approaching zero and does not involve the printing of new bank notes.
- Transparency is the availability of prompt and complete information about trades and prices. Generally, the less transparent the market, the less willing people are to trade there.
- Excessive regulation can stifle a market. However, trading will also be deterred if investors lack confidence in the available information about the securities they may wish to trade, the procedures for trading, the ability of trading partners and intermediaries to meet their commitments and the treatment they will receive as owners of a security or commodity once the trade has been completed.
- Low transaction costs, risk management, technology, deregulation, liberalization, consolidation and globalization are other important factors in facilitating or hindering global markets.

2.11 Glossary

Asset Valuation: A method of assessing the worth of a company, real property, security, antiques or other items of worth.

Capital Flow: Movement of money for the purpose of investment, trade or business production.

Capital Gains: Increases in the value of the investments itself, often not available to the owner until the investment is sold.

Inflation: The percentage increase in the price of standardized basket of goods and services over a given period of time.

Interest Rate: The cost of borrowing money.

Liquidity: The ability of the company or financial institution to make cash payments as they become due.

Price Discovery: A summation of the total market's sentiment at a point in time.

Political Risk: The risk that a host country will make political decisions that will prove to have adverse effects on the multinational's profits and/or goals.

Quantitative Easing (QE): A type of monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.

Transparency: Availability of prompt and complete information about trades and prices.

Yield: The income the investor receives while owning an investment.

2.12 Self-Assessment Test

1. What do you understand by arbitrage price theory?
2. What is yield on investment?
3. What do you understand by liquidity?
4. What is inflation?
5. What is capital gain?
6. Briefly explain Quantitative Easing.

2.13 Suggested Readings/Reference Material

1. Anthony Saunders, Marcia Cornett, Anshul Jain (2021). Financial Markets and Institutions. McGraw-Hill. 7th edition
2. I.M. Pandey, Financial Management (2021). 12th edition, Vikas Publishing House.
3. Jeff Madura (2020). Financial Markets and Institutions – Asia Edition, 13th edition; Cengage Learning
4. P. G. Apte (2020). International Financial Management; Tata McGraw-Hill Education Private Limited; 8th edition
5. Prasanna Chandra (2019). Financial Management – Theory and Practice, 10th edition, New Delhi: Tata McGraw-Hill

6. Frank J. Fabozzi, Frank J. Jones (2019). Foundations of Global Financial Markets and Institutions. Mit Press. 5th edition

7. Brealey Myers (2018). Principles of Corporate Finance, 12th edition, USA: McGraw-Hill Companies Inc.

2.14 Answers to Check Your Progress Questions

1. (a) Micro Factors

Financial markets are not impacted by micro factors.

2. (a) Political Risk

Political scenarios will lead to political risk to all financial implications.

3. (d) Adverse

Political risk in host country will have adverse effect on multinational companies.

4. (e) Return on funds

The financial market creates an opportunity for return on funds.

5. (c) Net operating assets

The efficacy of capital also measures net operating assets.

6. (e) Movement of money from and to an economy

Flow of capital means movement of funds from and to a country.

7. (a) Investment in capital

Capital flows occur when there is investment in capital.

8. (b) Capital market

Capital flow will show the strength of an organization in capital market.

9. (e) Cost

An interest rate is cost of borrowing money.

10. (d) Capital Asset Pricing

Arbitrage pricing theory can be viewed as an extension of the capital asset pricing model (CAPM). The return from an investment is assumed to depend on several factors. CAPM captures the relationship between the return on the asset as a function of various independent factors such as systematic risk.

Unit 3

Multilateral Institutions

Structure

"WTO is the only multilateral system in which developed and developing countries sit together at par."

- Nirmala Sitharaman

3.1 Introduction

Let's study the evolution and functions of various Multilateral Institutions in this unit.

In the previous unit, we studied the impact of political scenario on business, and the impact of carry trade on global financial markets and related topics.

In this unit, we will study Bretton Woods System, World Trade Organization and Bank for International Settlement.

By the end of the World War II, the economies of all countries that took part in the war, were in shambles and needed revival. An international conference was convened in Bretton Woods, New Hampshire, United States in July 1944. The goal of the conference was to establish a framework for economic cooperation and development that would lead to a more stable and prosperous global economy. The International Monetary Fund and the World Bank were created.

One of the recommendations of the Bretton Woods Conference (July 1944) was the establishment of an International Trade Organization (ITO). After various rounds of discussions between the major economies, the final Act of the General Agreement on Tariffs and Trade (GATT) was signed by its 23 members on 30th

October 1947. GATT continued its functions among the member countries despite its institutional deficiencies, The GATT managed to function as a *de facto* international organization, sponsoring eight rounds of multilateral trade negotiations. The Uruguay Round, conducted from 1987 to 1994, culminated in the Marrakesh Agreement, which established the World Trade Organization (WTO).

The World Trade Organization (WTO) has emerged as the most important instrument of globalization. It has produced stringent new regulations and rules of global economic engagement. It has centralized within its ambit, the most important instruments of regulating global trade - investment, production and capital flows.

The other international organization is Bank for International Settlements. BIS was established in 1930 to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks.

Though all these international organizations are working for the overall growth of the economies across the globe, regional disparities continue to exist. Economic disparity in Asian continent is one of the main concerns in this regard. In a Ministerial Conference on Asian Economic Cooperation held by the United Nations Economic Asian Economic Cooperation in 1963 the idea to establish Asian Development Bank became a reality to foster economic growth and cooperation in Asia, one of the poorest regions in the world.

Let us see how these multilateral organizations facilitated various economies of the world to weather the turbulent times of financial crises that are erupting every now and then.

Example: World Bank's help to Sri Lanka

In March 2022, to help Sri Lanka, which was going through a severe economic crisis, and help it meet payment requirements for essential imports, the World Bank agreed to extend $ 600 million in financial assistance. This was planned to be released in two phases. The first instalment of $ 400 million would be released immediately to meet medicinal drugs and health needs, social security, agricultural and food security, and gas needs.

Source: https://www.timesnownews.com/world/world-bank-agrees-to-provide-600-million-in-financial-assistance-to-sri-lanka-says-colombo-article-91114486, dated 6th February 2022. (Accessed on 13th June, 2022)

3.2 Objectives

After studying this unit, you will be able to:

- Discuss the origin of Bretton Woods System and the reasons of its failure Explain the purpose of new multilateral financial institutions like IMF, World Bank

- Evaluate the objectives and purpose of the World Trade Organization and other international monetary institutions to know their role in international trade
- Analyze the functionality of Bank of International Settlements to understand its role in international markets
- Discuss the relevance of the international monetary institutions which have been flexible enough to analyze their roles in the post-crises era (1990s crisis and sub-prime crisis of the first decade of 21st century)

3.3 Bretton Woods System

World War II was a global military conflict from 1939 to 1945 that was fought between the Allied powers of the United States, United Kingdom and Soviet Union against the Axis powers of Germany, Italy and Japan, with their respective allies.

By 1944, the result of the world war was apparent. To build the war-ridden nations under the leadership of US and the UK, an economic enclave "The Bretton Woods Conference, 1944" officially known as the United Nations Monetary and Financial Conference, took place with a gathering of delegates from 44 nations. The conference met from July 1 to 22, 1944 in Bretton Woods, New Hampshire. The conference was held to agree upon a series of new rules for the post-World War II international monetary system.

The outcome of the conference was as follows:

Two new institutions, namely International Monetary Fund (IMF) and International Bank for Reconstruction and Development (IBRD) were established. The IMF was positioned to be more significant and powerful than the World Bank. All the member countries were required to work according to the guidelines and instructions provided.

- Adjustable peg system (exchange rate system) was established.
- Currencies must be convertible with regard to trade related activities and other current account transactions, in spite of government's regulations on capital flows.
- The countries could change the exchange rate up to 10% of initial rate, within one year of the rates being determined.
- All the member countries must subscribe towards IMF's capital.

In addition to IMF and the World Bank, two more institutions namely International Finance Corporation (IFC) and International Development Association (IDA) were also established.

3.3.1 International Monetary Fund

International Monetary Fund (IMF) was established to maintain proper working of the international monetary system. One of IMF's main functions is to provide reserve credit to its member countries and solve Balance of Payment (BOP) problems.

IMF is managed by an executive board consisting of 24 directors, among whom six directors are appointed by the governments which hold largest quotas[31]. The highest governing body of IMF is Board of Governors which meets annually to make major policy decisions. IMF provides finance to its member countries under various schemes such as Buffer Stock Financing, Compensatory Financing, Trust Fund, etc.

Organization and Structure: IMF Membership as on October 2021 was 190 countries It is headed by a managing director, who chairs the board of governors. Each member's voting and borrowing rights are a function of its quota (membership fee). These quotas provide the financial resources that the IMF uses to assist its members. A member country can easily borrow up to 25% of its quota, which is called the first tranche. However, borrowing against additional tranches becomes progressively more difficult. The IMF's ability to impose stringent economic discipline on loan recipients played a crucial and successful role in the international debt crisis of the early 1980s. It also played a crucial role in managing the transition of the former socialist bloc countries to market economies.

Special Drawing Rights (SDRs): One of the difficulties faced by the IMF, the shortage of gold and US dollars in the world trading system, gave rise to the Triffin Paradox. A Triffin Paradox is a conflict of economic interest between short-term domestic and long-term international objectives of the countries whose currency serves as reserve for global currency. One response to this problem was the creation of the Special Drawing Rights (SDR) in 1969. The SDR is a unit of account which represents a weighted average of a basket of currencies. It supplements existing world reserves by giving countries access to a new source of liquidity.

The SDR has not become a more important currency because of the fact that innovative financial instruments were designed in the American and European financial markets. These financial instruments effectively eliminated the worldwide shortage of liquidity. Nevertheless, SDRs have been important for developing countries as a source of additional financial resources. Other facilities available from IMF include: standby arrangements, extended facilities and enhanced structural adjustment facilities.

---

[31] Every member country of IMF must contribute to a currency pool (maintained by IMF) in accordance with its quota which is fixed on the basis of its importance in the world trade.

Financial Liberalization: The IMF's mandate seems to include liberalization of trade and capital movements. Some believe that financial liberalization has been largely responsible for the Asian crisis of 1997. In the absence of proper regulatory and supervisory structures, it is highly probable to have such financial crises in future. The IMF has therefore taken responsibility to increase the surveillance of the financial market practices of emerging market economies.

Future of IMF: In recent years, in the wake of several economic crises, the IMF's primary role has been a surveillance function. However, critics argue that the IMF acts to increase the role of market discipline. Others argue that the IMF should act as an international country-rating agency and become an international bankruptcy court. The adoption of flexible exchange rates by most industrial countries and the increase in IMF membership have placed tremendous pressure on the IMF to reform. Supporters of the IMF argue that quick action by the IMF can prevent the contagious effect in financial crises.

3.3.2 World Bank Group

The World Bank Group (WBG) is a family of five international organizations that make leveraged loans to developing countries. The Group consists of:

1. The International Bank for Reconstruction and Development (IBRD), established in 1945, which provides debt financing on the basis of sovereign guarantees.
2. The International Finance Corporation (IFC), established in 1956, which provides various forms of financing without sovereign guarantees, primarily to the private sector.
3. The International Development Association (IDA), established in 1960, which provides concessional financing (interest-free loans or grants), usually with sovereign guarantees.
4. The International Centre for Settlement of Investment Disputes (ICSID), established in 1965, which works with governments to reduce investment risk.
5. The Multilateral Investment Guarantee Agency (MIGA), established in 1988, which provides insurance against certain types of risk, including political risk, primarily to the private sector.

The three most important members of this group are discussed below:

International Bank for Reconstruction and Development

The World Bank was established to provide medium and long-term loans to the member countries in reconstructing their economies in the post-World War II period; at the same time, help the developing countries to increase their economic growth. The World Bank is structured like a cooperative that is owned and operated for the benefit of its 188 member countries. Starting its first bond issue in 1947, it has raised most of its funds on the world's financial markets. It has become one of the most established borrowers. The income earned by IBRD over the years has allowed it to fund development activities of 188 member countries. This is made possible as it borrows at low cost and offers sovereign clients at competitive terms.

International Finance Corporation

International Financial Corporation is the largest global development institution focused on the private sector. It works closely with businesses in the developing countries to help them succeed in ways that promote prosperity for all. IFC provides investment, advice and asset management. Together, these services give IFC a special advantage in helping the private sector create opportunity. The ability of IFC to attract other institutional investors brings additional benefits, introducing its investees to new sources of capital and better ways of doing business.

International Development Association

The International Development Association helps the world's poorest countries. Established in 1960, IDA aims to reduce poverty by providing loans (called "credits") and grants for programs that boost economic growth, reduce inequalities and improve people's living conditions. IDA is one of the largest sources of assistance for the world's 77 poorest countries, 39 of which are in Africa. IDA lends money at little or no interest and repayments are stretched over 25 to 38 years, including a 5-10 year grace period. IDA also provides grants to countries at risk of debt distress.

3.3.3 Failure of Bretton Woods System

Many countries were ready to hold dollar reserves rather than convert them into gold. As a result, the total number of dollars issued by the Federal Reserve was far more than the value of gold held by it. As conversion of all the dollars into gold was not possible, the system purely ran on the member countries' confidence. This resulted in a paradox in the system known as Triffin Paradox or Triffin Dilemma. According to Robert Triffin, Yale University professor, the US had to run Balance of Payments (BOP) deficit to supply the world with required additional dollar reserves in order to increase the international trade. When the deficit increases, the volume of dollar reserves with the other countries also increases without any simultaneous increase in US gold reserves. This situation will result in decrease of confidence in the system and consequently its breakdown. The excess supply of dollars in the international markets compared to the US gold holdings also led to the belief that the dollar was overvalued and hence a correction was necessary.

In 1960, the London market in which much of the private gold trading was carried out experienced increase in value of gold. This occurred because of the speculation that the dollar was to be devalued by increasing the gold price. To curtail the markets from varying too much with the official price of $ 35 per ounce, the US made gold pool arrangement with seven countries, according to which they sold gold in London. In the early 60's, Britain also experienced BOP deficit and it desired to devalue the pound. Due to the US objection to the same, the UK maintained the same value for some time. But in 1967, it finally devalued the pound. This was followed by France's devaluation in 1969. All these problems affected the system to a large extent. In 1968, selling of gold by the gold pool in the private market was stopped and the dollar was made non-convertible into gold with regard to private market players. As the system was experiencing many problems in addition to increased pressure on the dollar, a new reserve asset was created by the IMF in 1967. This was called Special Drawing Rights (SDRs). This international currency was given to member countries in proportion to their quotas. But the introduction of SDRs did not prove helpful and the situation worsened further. The reserve position of the US turned negative in 1979 and its BOP deficit increased further.

Post-Bretton Woods System (the Current System)

As most of the countries were following floating exchange rates after the Bretton Woods System, the IMF amended its articles accordingly in Jamaica in 1976 and the same became effective from 1 April 1978. According to the amendment, every country could choose its exchange rate system. It could either float or peg its currency. The currency could be pegged to another currency or to a basket of currencies or SDRs. The only constraint laid down by IMF was that the pegging should not be done with gold. At the same time, the member countries were not allowed to fix any official price for gold. They were required to follow the principles adopted by IMF in April 1977. These principles aimed to maintain stability in the forex markets and also prevent occurrence of any competitive devaluations. So, different countries adopted different exchange rate systems suitable to their economies.

With the collapse of the Bretton Woods fixed exchange rate system in the early 1970s, the role of IMF has changed. The IMF dealt less with the developed countries and more with the developing ones. It provided both long and short-term loans at soft rates of interest (below-market interest rates) for countries in all sorts of economic difficulty, making it less distinct from the World Bank. However, it began attaching increasing number of conditions to those loans ("conditionality"), negotiating with countries to make major changes in their domestic policies and institutions. Promoting economic growth as well as resolving specific crises became its mission. This meant that even more countries became involved in the structural adjustment programs. Indeed, in the year 2000 alone the IMF had programs with 60 countries, or more than one-third of the developing world.

Example: The New Bretton Woods

The authors of 'The Case for a New Bretton Woods,' Kevin P. Gallagher and Richard Kozul-Wright called for a new Bretton Woods moment that established a fresh set of principles that form the basis for reforming global institutions to foster stability, prosperity, and peace in the 21st century. They laid down a set of principles for a new multilateralism, based on which they made the following recommendations:

- Reform the international financial system.
- Align the international trade and investment regime.
- Scale up development finance.

Source: https://www.imf.org/en/News/Articles/2020/10/15/sp101520-a-new-bretton-woods-moment, dated 15th October, 2020. (Accessed on 13th June, 2022)

3.4 World Trade Organization

World Trade Organization is an important development in early 90's which changed the international trade scenario in the global markets.

The International Trade Organization (ITO) was established in 1944 to set rules and regulations for international trade. However, the ITO Charter was never ratified and an interim agreement called the General Agreement on Tariffs and Trade (GATT) was formed. It was replaced by the World Trade Organization, established during the Uruguay Round of Multilateral Trade Negotiations in 1994. The WTO became an international organization that set rules and regulations for international trade and also resolved disputes of its member countries. WTO members were 164 members since 29 July 2016. The WTO headquarters is situated at Geneva, Switzerland. All the member countries must provide each other the most favored nation status to boost trade among themselves with certain trade concessions. The major functions of WTO are:

- Limit harmful trade practices
- Act as a forum for multilateral trade negotiations
- Cooperate with other international institutions which are involved in global policy-making
- Oversee national trade policies
- Administer the understanding on rules and procedures governing the settlement of disputes (Dispute Settlement Understanding (DSU)

WTO Structure

WTO is headed by the Ministerial Conference. This is the supreme authority which makes decisions with regard to all the matters that fall under Multilateral Trade Agreements. All the representatives of member countries form a General Council to regulate the operations of WTO Agreement and also the decisions made by the ministerial conference. The council also acts as the Dispute Settlement Body (DSB) and a Trade Policy Review Body (TPRB) with respective chairpersons. Other councils present under WTO are Council for Trade in Goods, Council for Trade in Services and Council for Trade Related Aspects of Intellectual Property Rights (TRIPS). They are headed by a General Council and can have their subsidiaries situated elsewhere. The ministerial conference appoints a Director General to the Secretariat of the WTO.

3.4.1 Salient Features of World Trade Organization (WTO) Agreement

The WTO was born out of negotiations, that took place during 1986–94 i.e. negotiations called the Uruguay Round and earlier negotiations under the General Agreement on Tariffs and Trade (GATT).

Accordingly, the WTO facilitates a common platform for carrying trade among its member countries with regard to agreements and associated legal instruments included in the Annexure of WTO agreement. The WTO agreement includes the following Annexures:

- The agreements and associated legal instruments included in Annexures 1, 2 and 3 of the WTO agreement are referred to as Multilateral Trade Agreements.
- The agreements and associated legal instruments included in Annexure 4 are referred to as Pluri Lateral Trade Agreements.
- General Agreement on Tariffs and Trade 1994 as specified in Annex 1A is referred to as GATT 1994 and it is legally distinct from GATT 1947.

Multilateral Agreement on Trade in Goods

The different types of trade agreements are:

i. **Agreement on Balance of Payments:** While imposing restrictions to correct balance of payment deficits, the members must consider price- based measures such as import surcharges, import deposits, etc.

ii. **Agreement on Agriculture:** It facilitates opening of national markets to international competition through normal customs duties in the place of non-tariff measures. The agreement also helps to reduce government aid by checking overproduction. It also covers subsidies and measures such as domestic subsidy, export subsidy and sanitary and phyto-sanitary measures.

Domestic subsidies are classified into non-product specific subsidies and product specific subsidies, which are summed up to arrive at total subsidies. At any point of time, total subsidies should not exceed 10% of the total agriculture production value of that particular year. In the case of export subsidies, WTO members must decrease the value of direct export subsidies to 36% below the 1986-1990 base period and at the same time their quantity by 21%. For developing countries, the reductions must be 2/3rds that of developed countries over a period of 10 years. There are no reductions for Least Developed Countries (LDCs). Sanitary and phyto-sanitary measures relate to food safety and animal and plant health measures. The agreement chalks out the procedures and criteria for the assessment of risk and determination of appropriate levels of phyto-sanitary or sanitary protection.

iii. **Agreement on Textiles and Clothing:** It facilitates integration of the textiles and clothing sector into GATT 1994, in accordance with strengthened GATT rules and disciplines. This integration of various guidelines of GATT related to trade in products such as tops and yarns, made up textile products, fabrics, etc., took place in the following four phases:

- First phase as on 1st January 1995: Each party would integrate products which accounted for not less than 16 per cent of its total volume of imports in 1990.
- Second phase as on 1st January 1998: Products which accounted for not less than 17 per cent of 1990 imports would be integrated.
- Third phase as on 1st January 2002: Products which accounted for not less than 18 per cent of 1990 imports would be integrated.
- Fourth phase as on 1st January 2005: All remaining products would be integrated at the end of the transition period.

Agreement on Trade Related Aspects of Investment Measures (TRIMs)

This agreement recommends removal of all trade related investment measures within a period of five years. While arriving to the terms and conditions of TRIMS it was recognized that certain investment measures can have trade-restrictive and distorting effects on other member states, TRIMS stated that no Member shall apply a measure that is prohibited by the provisions of GATT Article III (national treatment) or Article XI (quantitative restrictions). Hence, it requires mandatory notification of all non-conforming TRIMs and their disposal within two years for developed countries, within five years for developing countries and within seven years for least-developed countries. The WTO has established committee on TRIMs to supervise the implementation of commitments and subsequently report to the council of trade in goods annually.

General Agreement on Trade in Services

General Agreement on Trade in Services (GATS), a multilateral agreement, is the first to provide legally enforceable rights to trade in all services.

The three basic principles of GATS are:

- It covers all the services, excluding those provided in the exercise of governmental authority.
- Absence of any discrimination in favor of national providers (National Treatment Principle).
- Absence of any discrimination between other members of the agreement (Most Favored Nation [MFN] principle).

Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS)

This agreement considers seven types of intellectual property.

They are:

i. **Copyright and Related Rights:** Copyright protects the rights of authors of literary and artistic works such as books, paintings, etc., for a minimum period of 50 years after the death of the author.

ii. **Trademarks:** A sign or a combination of signs which can distinguish the goods or service of one firm from those of the other is called a trademark.

iii. **Geographical Indications:** They refer to the identity of a good originating in the territory of a member / region / locality where a given quality or reputation is essentially attributed to its geographical origin.

iv. **Industrial Designs:** These designs are protected for a period of 10 years. The main purpose is to provide protection for the investment results in the development of new technology.

v. **Patents:** Patents are provided for inventions in different areas of technology and they must be capable of industrial application.

vi**. Integrated Circuits:** They provide protection to the layout designs/ topographic for a period of 10 years.

vii. **Trade Secrets:** Any trade secret having commercial value will be protected against the breach of confidence or unfair commercial use.

Dispute Settlement System

Any dispute brought to the notice of WTO by the member countries will be settled by specially appointed independent experts on the basis of their interpretation of the agreements and commitment of the individual country. This system recommends settlement of differences between countries through consultation or seeking justice from the WTO on legal grounds.

Plurilateral Trade Agreements (PTA)

The plurilateral trade agreement includes the following agreements:

i. Agreement on Trade in Civil Aircraft

ii. Agreement on Government Procurement

iii. International Dairy Agreement

iv. International Bovine Meat Agreement

Activity 3.1
Juice India, a food beverages company in India, has registered a trade mark "applecart". But the same name is used by some other company in Italy manufacturing the same product i.e. Apple Juice. What is the legal remedy available? **Answer:**

3.4.2 Regional Trade Agreement (RTA)

Regional Trade Agreement is coming together of a group of countries which engage in international trade together and are usually related through a free trade agreement or other association. The purpose of such agreements is to increase trade among them and/or to gain economic benefits from cooperation on some level. Most prominent trade blocks are OPEC (Organization of Petroleum Exporting Countries), EFTA (European Free Trade Association), NAFTA (The North American Free Trade Agreement, an agreement signed by Canada, Mexico and the United States, creating a trilateral trade bloc in North America., CACM (Central American Common Market), SAFTA (South Asian Free Trade Area), Association of South East Asian Nation (ASEAN) etc. Generally, the WTO aims to create a level playing field for all and thereby contribute to the overall growth and development of the world economy. However, in recent decades, there has been a phenomenal growth in RTAs, which pose a major threat to the multilateral trading system advocated by WTO. While the RTAs are consistent with the provisions of the GATT, they are not an efficient way to promote international trade. RTAs are inconsistent with the multinational trading principle and most favored nation (MFN) principle, causing discriminatory trade practices. This is because RTAs provide trade preference to member countries to promote bilateral trade. Globally, it has been witnessed that RTAs are deepening and new ones are being negotiated, diluting the impact of multilateral trading.

Gateway to RTA

There is a phenomenal rise in the members of RTA over the past few years. It includes a notable increase in bilateral agreements and negotiations.

Before 2016 June, Mongolia was not a member of any Regional Trade Agreement. But in June 2016 Mongolia had signed an RTA with Japan. With this, all WTO members now have one or other regional trade agreement (RTA) in force.

Hitherto, Mongolia had been the only WTO member that was not a party to an RTA. As per the facts and figures of WTO as on September 2016[32], 267 RTAs were in force. Around 134 covered trade in goods and services, while 132 covered only goods and only one RTA covered services.

Many RTAs are in force now. One of them is the trade agreement between Canada and Ukraine was established in the year 2016 and dubbed as Canada-Ukraine Free Trade Agreement (CUFTA).

North Atlantic Free Trade Agreement (NAFTA)

NAFTA stands for the North American Free Trade Agreement, which was negotiated by former U.S. President George H.W. Bush, and went into effect under President Clinton in 1994. The agreement is between the United States, Canada and Mexico, and was initially created to help lower costs of trade and bolster North American trade. The agreement eliminated almost all tariffs and taxes on imports and exports. The agreement also rid the three countries of trade barriers.

The objectives of NAFTA are

1. The objectives of this Agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favored-nation treatment and transparency, are to:
   a) Eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties;
   b) Promote conditions of fair competition in the free trade area;
   c) Increase substantially investment opportunities in the territories of the Parties;
   d) Provide adequate and effective protection and enforcement of intellectual property rights in each Party's territory;
   e) Create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes; and
   f) Establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement.

[32] www.wto.org

2. The Parties shall interpret and apply the provisions of this Agreement in the light of its objectives set out in paragraph 1 and in accordance with applicable rules of international law.

Relation to Other Agreements

1. The Parties affirm their existing rights and obligations with respect to each other under the General Agreement on Tariffs and Trade and other agreements to which such Parties are party.
2. In the event of any inconsistency between this Agreement and such other agreements, this Agreement shall prevail to the extent of the inconsistency, except as otherwise provided in this Agreement.

Relation to Environmental and Conservation Agreements

1. In the event of any inconsistency between this Agreement and the specific trade obligations set out in:
   a) The Convention on International Trade in Endangered Species of Wild Fauna and Flora, done at Washington, March 3, 1973, as amended June 22, 1979,
   b) The Montreal Protocol on Substances that Deplete the Ozone Layer, done at Montreal, September 16, 1987, as amended June 29, 1990,
   c) The Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal, done at Basel, March 22, 1989, on its entry into force for Canada, Mexico and the United States, or
   d) Such obligations shall prevail to the extent of the inconsistency, provided that where a Party has a choice among equally effective and reasonably available means of complying with such obligations, the Party chooses the alternative that is the least inconsistent with the other provisions of this Agreement.
2. The Parties may agree in writing to modify to include any amendment to an agreement referred to in paragraph 1, and any other environmental or conservation agreement.

Article 105: Extent of Obligations

The Parties shall ensure that all necessary measures are taken in order to give effect to the provisions of this Agreement, including their observance, except as otherwise provided in this Agreement, by state and provincial governments.

Association of Southeast Asian Nations (ASEAN)

The Association of Southeast Asian Nations, or ASEAN, was established on 8 August 1967 in Bangkok, Thailand, with the signing of the ASEAN Declaration (Bangkok Declaration) by the Founding Fathers of ASEAN, namely Indonesia, Malaysia, Philippines, Singapore and Thailand.

Brunei Darussalam then joined on 7 January 1984, Viet Nam on 28 July 1995, Lao PDR and Myanmar on 23 July 1997, and Cambodia on 30 April 1999, making up what is today the ten Member States of ASEAN.

Aims and Purposes

As set out in the ASEAN Declaration, the aims and purposes of ASEAN are:

1. To accelerate the economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian Nations;
2. To promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries of the region and adherence to the principles of the United Nations Charter;
3. To promote active collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific and administrative fields;
4. To provide assistance to each other in the form of training and research facilities in the educational, professional, technical and administrative spheres;
5. To collaborate more effectively for the greater utilisation of their agriculture and industries, the expansion of their trade, including the study of the problems of international commodity trade, the improvement of their transportation and communications facilities and the raising of the living standards of their peoples;
6. To promote Southeast Asian studies; and
7. To maintain close and beneficial cooperation with existing international and regional organizations with similar aims and purposes, and explore all avenues for even closer cooperation among themselves.

Fundamental Principles

In their relations with one another, the ASEAN Member States have adopted the following fundamental principles, as contained in the Treaty of Amity and Cooperation in Southeast Asia (TAC) of 1976:

1. Mutual respect for the independence, sovereignty, equality, territorial integrity, and national identity of all nations;
2. The right of every State to lead its national existence free from external interference, subversion or coercion;
3. Non-interference in the internal affairs of one another;
4. Settlement of differences or disputes by peaceful manner;
5. Renunciation of the threat or use of force; and
6. Effective cooperation among themselves.

South Asian Association for Regional Cooperation (SAARC)

The South Asian Association for Regional Cooperation (SAARC) was established with the signing of the SAARC Charter in Dhaka on 8 December 1985. SAARC comprises of eight Member States: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The Secretariat of the Association was set up in Kathmandu on 17 January 1987.

The objectives of the Association as outlined in the SAARC Charter are: to promote the welfare of the peoples of South Asia and to improve their quality of life; to accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realize their full potentials; to promote and strengthen collective self-reliance among the countries of South Asia; to contribute to mutual trust, understanding and appreciation of one another's problems; to promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields; to strengthen cooperation with other developing countries; to strengthen cooperation among themselves in international forums on matters of common interests; and to cooperate with international and regional organizations with similar aims and purposes.

Decisions at all levels are to be taken on the basis of unanimity; and bilateral and contentious issues are excluded from the deliberations of the Association.

Objectives of SAARC:

i. Promote the welfare of the peoples of South Asia and improve their quality of life;

ii. Accelerate economic growth, social progress and cultural development in the region by providing all individuals the opportunity to live in dignity and realise their full potential;

iii. Promote and strengthen collective self-reliance among the countries of South Asia;

iv. Contribute to mutual trust, understanding and appreciation of one another’s problems

v. Promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields;

vi. Strengthen co-operation with other developing countries;

vii. Strengthen co-operation among themselves in international forms on matters of common interest; and

viii. Cooperate with international and regional organisation with similar aims and purposes.

Example: Is WTO still Relevant?

In 2022, WTO was facing a volley of questions on its relevance and its ability to safeguard multilateralism which seemed to be waning. More and more nations were embracing a self-reliance mode and a few biggies, including the US, were inclining towards protectionism. There were growing accusations that rich and powerful nations within the WTO were forming elite sub-groups to advance their own agenda by relentlessly pursuing what is called plurilateralism. This could threaten to alter the multilateral and consensus-based fabric of the WTO. Also, some key economies were aggressively pursuing bilateral and regional preferential pacts, which could make the global trading system redundant and defunct. In such a scenario whether the WTO can remain relevant and retain its original characteristics — member-driven, consensus-based, and multilateral or not is something only time can tell.

Source: https://economictimes.indiatimes.com/news/economy/foreign-trade/for-the-world-trade-organisation-the-battle-is-about-more-than-just-staying-relevant/articleshow/92152018.cms, dated 12th June, 2022. (Accessed on 13th June, 2022)

Check Your Progress - 1

1. Which of the following economic systems has become very visible in today's global economy?
   a. Socialism
   b. Capitalism
   c. Mixed Economy
   d. Crony Capitalism
   e. Marxism
2. Which of the following is not a member of the World Bank group?
   a. IDA
   b. IFC
   c. World Bank
   d. IMF
   e. MIGA
3. According to Trade Related Intellectual Property Rights (TRIPS), which of the following is not intellectual property?
   a. Copyrights
   b. Trademarks
   c. Industrial Designs
   d. Patents
   e. Policy Design

4. Which of the following international reserve is connected to Triffin Paradox?
   a. Gold
   b. Silver
   c. Dollar
   d. SDRs
   e. Securities

3.5 Bank for International Settlements

The Bank for International Settlements (BIS) was established in 1930 in Basel, Switzerland. It is an international organization, created pursuant to an international treaty (The Hague Agreements of 1930). Its shareholding members are central banks and monetary authorities.

The mission of the BIS is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks.

It was established to settle once and for all the question of reparation payments imposed on Germany (and to a lesser extent on other central European countries) by the Treaty of Versailles after the World War I.

The success of the European Payments Union in restoring currency convertibility in Europe in 1958 ensured the success of Bretton Woods system of freely convertible currencies at fixed exchange rates (based on the US dollar and gold). In this regard, the BIS played an important part in coordinating the response of the central banks to this challenge, mostly within the framework of the [33]Group of Ten.

In 1974, the collapse of Bankhaus Herstatt in Germany and Franklin National Bank in the United States highlighted the lack of efficient banking supervision of banks' international activities. It prompted the G10 central bank Governors to create the Basel Committee on Banking Supervision. This brought prominence to BIS to safeguard the banking systems across the economies.

As the bankers' bank, BIS serves the financial needs of member central banks. It provides gold and foreign exchange transactions for them and holds central bank reserves. The BIS is also a banker and fund manager for other international financial institutions.

Among its mandates, BIS serves as a forum where central banks can discuss and coordinate their country's monetary policies. It can also:

a. Buy and sell gold and foreign exchange;
b. Make advances or borrow from its member central banks;

[33] G10, consisting of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States, plus Switzerland as an associated member

c. Buy, sell, or discount bills such as treasury bills or other marketable securities;

d. Act as an agent or correspondent for any central bank;

e. Compile data relating to the performance of the international financial system.

It also serves as a forum for international monetary cooperation, which is especially crucial when an interest rate differential causes conflict between member countries. In recent years, BIS has become more renowned for international banking supervision as a result of a decision by the G-10 in 1974 to establish the Basel Committee on Banking Supervision.

The BIS provides the Basel Committee on Banking Supervision with its 17-member secretariat and with it has played a central role in establishing the Basel Capital Accords of 1988 and 2004 (Refer Exhibit 3.1 for the BIS triennial survey).

Exhibit 3.1: BIS Triennial Survey 2019

The Bank for International Settlements (BIS) has been conducting a global survey on foreign exchange and derivatives market activity since 1989. These surveys are conducted every three years. The 12th triennial survey was conducted in 2019. After this, the work for the 13th survey began in April, 2022 which is to be concluded by December, 2022.

In the 12th survey in 2019, almost 1,300 dealers (mainly banks) located in 53 countries participated. Let us look at the highlights of this survey report.

Major highlights of BIS Triennial Survey, 2019:

FX and OTC derivatives markets saw a marked pickup in trading between the 2016 and 2019 surveys. Following a dip in 2016, FX trading returned to its long-term upward trend, rising to $6.6 trillion per day in April 2019. Interest rate derivatives.

Trading departed sharply from its previous trend, soaring to $6.5 trillion.

The trading of FX swaps, which is concentrated in maturities of less than a week, rose from $2.4 trillion in April 2016 to $3.2 trillion in April 2019 and accounted for most of the overall increase in FX trading.

The share of emerging market currencies in global FX turnover rose to 23% in April 2019 from 19% in 2016 and 15% in 2016.

The pickup in turnover between 2016 and 2019 was especially marked in offshore markets.

Due to greater offshore trading the trading in FX markets, London, New York, Singapore and Hong Kong SAR increased their collective share of global trading to 75% in April 2019, up from 71% in 2016 and 65% in 2010.

Contd….

Currencies that are not freely convertible were among those recording the fastest growth in FX turnover between the 2016 and 2019 surveys, including the Indian rupee, Indonesian rupiah and Philippine peso. This growth was led by forwards, particularly NDFs traded in offshore markets.

Trading in FX swaps was boosted by banks' liquidity management as well as their arbitraging of interest rate differentials for funding in different currencies.

Another driver of FX trading was the recovery in prime brokerage activities4 from the subdued levels of 2016, when losses on clients' trades following idiosyncratic events in FX markets had caused some banks to retrench. For OTC interest rate derivatives,

Ehlers and Hardy (2019) highlight how changes in the level and volatility of US dollar interest rates boosted turnover in April 2019.

The marked pickup in the trading of FX and OTC derivatives between the 2016 and 2019 surveys did not lead to an increase in outstanding exposures.

Since 2015 the notional principal of outstanding OTC derivatives has trended upwards, and at end-June 2019 it reached its highest level since 2014. However, their gross market value – a more meaningful measure of amounts at risk than notional principal – has trended downward since 2012. The gross market value was $12 trillion at end-June 2019, close to its level immediately before the GFC. (Great Financial Crisis)

Source: www.bis.org, December 2019 BIS Quarterly Review | December 2019 | 08 December 2019FX and OTC derivatives markets through the lens of the Triennial Survey1

BIS has the following organizational structure to monitor the banking systems across the globe.

BIS, headquartered in Basel, Switzerland, has three main departments. Two departments encompass the two principal activities of the BIS - policy analysis and banking - and the third provides general internal support (organisation chart):

- *Monetary and Economic Department:* Undertakes research and analysis to shape the understanding of policy issues concerning central banks, provides committee support and organizes key meetings of senior central bankers and other officials in charge of financial stability. In addition, the department collects, analyses and disseminates statistical information on the international financial system.
- *Banking Department:* Provides a range of financial services to support central banks in the management of their foreign exchange and gold reserves and invests the equity of the BIS.
- *General Secretariat:* Provides the entire organisation with comprehensive corporate services, including human resources, facilities management, security, finance, communications and IT.

There remain significant differences between the United States, European Union and United Nations officials regarding the degree of capital adequacy and reserve controls that global banking now requires. In other words, the United States, as of 2006, favored strong strict central controls in the spirit of the original 1988 accords, while the EU was more inclined to a distributed system managed collectively with a committee able to approve some exceptions.

Example: Is BIS taking a Stand or is it Taking Sides?

On March 10, 2022, the Bank for International Settlements announced that it was suspending the Bank of Russia, deepening Moscow's financial isolation over its war in Ukraine. The access of the Central Bank of Russia to all BIS services, meetings, and other BIS activities were suspended. This was viewed by some as a radical departure from the neutral stance it adopted during the second world war.

Sources: i) https://www.wsj.com/livecoverage/russia-ukraine-latest-news-2022-03-11/card/russia-suspended-from-bank-for-international-settlements-gEiXwjyiIlkp9jSTV7sU#:~:text=The%20Bank%20for%20International%20Settlements,Basel%2C%20Switzerland%2Dbased%20institution, dated 11th March, 2022. (Accessed on 13th June, 2022)

ii) https://newmoneyreview.com/index.php/2022/03/12/bis-ditches-neutrality-over-russia/, dated 12th March, 2022. (Accessed on 13th June, 2022)

3.5.1 Basel I, II and III

Established in 1930, the BIS is owned by 60 central banks, representing countries from around the world. Its head office is in Basel, Switzerland. The purpose of BIS is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks.

The Basel Committee, headquartered at the Bank for International Settlements in Basel, was established to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation between its member countries on banking supervisory matters.

Basel I: The Basel Capital Accord, a capital measurement system commonly referred to as the *Basel Capital Accord* was approved by the G10 Governors and released to banks in July 1988. This Accord called for a minimum ratio of capital to risk-weighted assets of 8% to be implemented by the end of 1992. Ultimately, this framework was introduced not only in member countries but also in virtually all countries with active international banks and all the banks across the world have adhered to this norm.

Basel II: The new capital framework was initiated in 1999. In June 1999, the Committee issued a proposal for a new capital adequacy framework to replace the 1988 Accord. This led to the release of a revised capital framework in June 2004. "Basel II", the revised framework comprised three pillars:

1. Minimum capital requirements, which sought to develop and expand the standardized rules set out in the 1988 Accord
2. Supervisory review of an institution's capital adequacy and internal assessment process
3. Effective use of disclosure as a lever to strengthen market discipline and encourage sound banking practices

The new framework was designed to improve the way regulatory capital requirements reflect underlying risks and to better address the financial innovation that had occurred in recent years. The changes aimed at rewarding and encouraging continued improvements in risk measurement and control.

BIS came up with Basel III accord, which was agreed by members of Basel Committee on Banking Supervision (BCBS) in the year 2010-11. Basel III accord was introduced in the year 2013. Basel III addressed the inadequacies of Basel II.

Basel III: A comprehensive set of reform measures. It was developed by the BCBS to strengthen the regulation, supervision and risk management of the banking sector.

The enhanced Basel framework revises and strengthens the three pillars established by Basel II, and extends it in several areas. Most of the reforms were being phased in between 2013 and 2019:

- Stricter requirements for the quality and quantity of regulatory capital, in particular reinforcing the central role of common equity
- An additional layer of common equity - the capital conservation buffer - that, when breached, restricts payouts to help meet the minimum common equity requirement
- A countercyclical capital buffer, which places restrictions on participation by banks in system-wide credit booms with the aim of reducing their losses in credit busts
- A leverage ratio - a minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting
- Liquidity requirements - a minimum liquidity ratio, the Liquidity Coverage Ratio (LCR), intended to provide enough cash to cover funding needs over a 30-day period of stress; and a longer-term ratio, the Net Stable Funding Ratio (NSFR), intended to address maturity mismatches over the entire balance sheet
- Additional requirements for systemically important banks, including additional loss absorbency and strengthened arrangements for cross-border supervision and resolution

3.6 Asian Development Bank (ADB): An Overview[34]

The Asian Development Bank was conceived as a financial institution that would be Asian in character and foster economic growth and cooperation in one of the poorest regions in the world.

Asian Development Bank was established in December 1966, with 31 members who came together to serve a predominantly agricultural region as one of the funding agencies for the developmental activities in Asian countries. Takeshi Watanabe was ADB's first President.

ADB's First Decade (1966-1976): When ADB was established in 1966, the Asia and Pacific region was undergoing a process of deep change. Several countries gained independence and a sense of regional identity was emerging. The region was defined by poverty and feeding people remained a primary concern, even while the Green Revolution was under way. The first oil crisis in 1973 tested many Asian economies.

During this decade there was a new beginning of a regional development bank for Asia. During its formative years, ADB dealt with administrative, organizational and funding issues to establish itself as a sound and credible institution. ADB's first President, Takeshi Watanabe, envisioned ADB's role as Asia's "family doctor",

The Bank conducts field studies on the issues like energy, transport, agriculture of the region before lending. The lending activities of ADB gained momentum in the latter half of the first decade after its inception.

ADB's Operations in Second Decade (1977-1986): The Asia and Pacific region continued to grow despite a difficult external global environment, demonstrating resilience after a second oil shock and the international debt crisis that followed.

ADB responded to the growing diversity among its developing member countries. During this decade, ADB sought to position itself as a "regional resource center" with a broader role of providing not only financial assistance but also becoming a center of new thinking on development issues in the region. ADB moved closer to the ground by opening its first Resident Office in Bangladesh in 1982. New lending products were introduced, including program and sector lending, direct lending to private sector without government guarantees and equity investment. As the decade closed, two key historical landmarks occurred: ADB made its first loan to India and the People's Republic of China became a member.

ADB's New Role in 1990's-Third Decade (1987-1996): The growth momentum within the region continued. Intra-regional trade and investment grew rapidly as Asian economies drew increasing strength from within the region. Interest was

[34] www.adb.org

growing both within and outside Asia to understand and assess policy recipes for rapid and sustained “miracle growth”,

The decade opened with recommendations from a panel of eminent development experts for a new role for ADB in the 1990s. Donor expectations evolved and placed greater emphasis on aid effectiveness of development assistance. In response, ADB strengthened internal procedures and gave greater attention to project quality. ADB moved to a new headquarters to centralize its operations. New members joined from Central Asia and some existing but non-active members renewed their regular links with ADB. Lending picked up considerably while regional activities began to grow. The challenges and development of ADB is discussed below.

ADB’s Challenges towards Asian Crisis – Fourth Decade (1997-2006): The 1997 Asian financial crisis hit the region and became a defining moment for Asia and ADB. As ADB participated in coordinated crisis responses, Asian policy-makers reassessed their economic policies in a fundamental way.

The events happened during this period depict how ADB met the challenges of designing strategies to respond to rapid changes in the region following the Asian financial crisis *and shift in the thought process on international developments*. Several important policies and strategies were approved, including ADB’s Poverty Reduction Strategy as well as ADB’s first Long-Term Strategic Framework to 2015. ADB embarked on two major reorganizations (in 2002 and 2006) and committed to an internal reform agenda to be a more responsive, relevant, and results-oriented organization.

ADB’s Global Development Agenda-Fifth Decade (2007-2016): The 1997 Asian financial crisis hit the region and became a defining moment for Asia and ADB. As ADB participated in coordinated crisis responses, Asian policy-makers reassessed their economic policies in a fundamental way.

ADB met the challenges of designing strategies to respond to rapid changes in the region following the Asian financial crisis and changes in international development thinking. Several important policies and strategies were approved, including ADB’s Poverty Reduction Strategy as well as ADB’s first Long-Term Strategic Framework to 2015. ADB embarked on two major reorganizations (in 2002 and 2006) and committed to an internal reform agenda to be a more responsive, relevant and results-oriented organization.

[35]ADB’s achievements FY 2020

According to Annual Report of ADB, the coronavirus disease (COVID-19) outbreak in 2020 has caused a tragic loss of life and exacted a heavy economic toll that has fallen hardest on the poor and other vulnerable groups. The pandemic now threatens to reverse the region’s hard-earned development gains.

---

[35] Source: www.adb.org/sites/default/files/institutional-document/691766/adb-annual-report-2020.pdf

From the very early stage of the pandemic, ADB provided support to address the health emergency followed by a comprehensive $20 billion COVID-19 response package in April 2020. By the end of 2020, quick disbursing financing under ADB's new COVID-19 Pandemic Response Option had provided rapid fiscal support to 26 countries.

ADB's assistance is bolstering health systems, protecting vulnerable groups, supporting small businesses, and laying the path for recovery. ADB launched a $9 billion Asia Pacific Vaccine Access Facility in December 2020. All these measures are crucial for getting economies through the pandemic and back on their feet.

ADB committed a record $31.6 billion in loans, grants, equity investments, guarantees, and technical assistance in 2020, both to governments and to the ADB non-sovereign investments totaled $4.5 billion, including $2.9 billion for COVID-19 response in 2020.

ADB extended project co-financing of $16.4 billion, of which $10.8 billion was pandemic related.

In 2020, ADB provided $4.3 billion in climate finance and remain unwavering in tune with ADB's Strategy 2030 by providing $80 billion in cumulative financing by 2030. Private sector operations made up 21% of the number of ADB's total operations, relative to a target of one third by 2024.

ADB successfully mobilised a record-high borrowing program of over $35 billion, including thematic and local currency bonds in 2020

ADB replenished more-than $4 billion under Asian Development Fund 13 which would help poorest members of ADB over 2021–2024 as it would help these countries to meet the pandemic and tackle transformational agendas including promoting gender equity, regional public goods, debt sustainability, and quality infrastructure.

The following table provides the contribution of ADB for the period 2016-2020.

Table 3.1: ADB Commitments During the Period 2016-2020 *($ in Million*)

Region	2016	2017	2018	2019	2020	
	Total	**Total**	**Total**	**Total**	**Total**	**Covid-19 Response**
Central and West Asia	4,237	6,067	5,700	6,111	6,577	3,964
East Asia	2,022	2,810	3,162	2,663	2,893	385
Pacific	266	740	369	461	1,150	671
South Asia	3,925	7,238	7,623	7,307	9,034	3,983
Southeast Asia	4.326	4,668	7,141	7,181	11,629	7,039
Regional	154	265	523	294	310	105
TOTAL	**14,930**	**21,788**	**24,518**	**24,017**	**31,594**	**16,147**

Source: ADB Annual Report 2020

Outlook of ADB: COVID-19 posed serious setbacks to the development progress and poverty reduction efforts in many DMCs (Developing member Countries). To help ease the pandemic's heavy burden on the poor and vulnerable, ADB ramped up its investments in poverty reduction and social inclusion. To make quality health care more accessible and inclusive, sector interventions were aimed not only at emergency response during the onset of COVID-19 but also toward strengthening health systems, increasing resilience to future pandemics. In addition, ADB committed 35 social protection projects in 2020, more than the combined number of such projects in 2017–2019. Of the 35 projects, 24 used the CPRO to support vulnerable populations in DMCs. ADB's investments helped governments strengthen social protection systems by scaling up existing programs or introducing new ones. This included greater assistance to women and children, improved social insurance, and expanded labor market programs, including wage subsidies and support to MSMEs. ADB is working to help DMCs adapt, strengthen, and rejuvenate education systems. This includes promoting quality, relevance, and inclusion in education and harnessing education technology to help improve learning. In Sri Lanka, for example, ADB committed a $400 million loan for a major new secondary education sector improvement program.

Example: Loans from ADB to India

The Asian Development Bank (ADB) on February 6, 2022, announced that it provided a record $ 4.6 billion in loans to India in 2021, including $ 1.8 billion for coronavirus response. This record $ 4.6 billion in sovereign lending to India in 2021 was for 17 loans, including $1.8 billion for the country's coronavirus disease (COVID-19) pandemic response. Of the COVID-19-related assistance, $1.5 billion was towards vaccine procurement and $300 million was to strengthen the primary health care in urban areas and improve the country's future pandemic preparedness.

Source: https://www.moneycontrol.com/news/india/adb-lends-record-4-6-billion-loans-to-india-in-2021-8046521.html, dated 6th February, 2022. (Accessed on 13th June, 2022)

Activity 3.2

Altra Modern Food Products Private Limited, a company, requires $ 20 million for expansion. The company approached the International Finance Corporation (IFC) for loan without government guarantee. What are the details required for the proposal?

Answer:

Check Your Progress - 2

5. Which of the following international organizations is considered to be the bankers' bank?
   a. WTO
   b. IMF
   c. IBRD
   d. BIS
   e. WEF
6. Which of the following is the aim of WTO when it is contemplating to create a level playing field for all and thereby contribute to the overall growth and development of the economy?
   a. Safer trade environment
   b. Regional trade
   c. Focus on developed economies
   d. Focus on developing economies
   e. Focus on under developed economies
7. What is the minimum period that a copyright is protected after the death of the author?
   a. 30
   b. 40
   c. 50
   d. 60
   e. 70
8. Which of the following provides a protection to the layout designs/topographic for a period of 10 years?
   a. Patents
   b. Trademarks
   c. Copyrights
   d. Integrated circuits
   e. Trade secrets
9. Which of the following agreement recommends the removal of all trade related investment measures within a period of five years?
   a. GATS
   b. TRIPS
   c. TRIMS
   d. GATTS
   e. Patents

10. Which of the following International organizations would take care of trade related issues among member countries?
    a. IMF
    b. UNCTAD
    c. IFC
    d. World Bank
    e. WTO

3.7 Summary

- Globalization essentially involves integrating various markets. It facilitates development of new financial instruments, liberalizing financial market regulations and increasing cross penetration of foreign ownership.
- Globalization is all about ‘the march of capital all over the world in search of consumers and markets’.
- In 1944, the representatives of 44 countries met in Bretton Woods, New Hampshire, USA and signed an agreement to bring into force a new monetary system called the Bretton Woods System – IMF and IBRD were the offshoot of such a system.
- In addition to IMF and the World Bank, two more institutions namely International Finance Corporation and International Development Association were also established.
- International Trade Organization was established in 1944 to set rules and regulations for international trade.
- However, the ITO charter was never ratified and an interim agreement called the General Agreement on Tariffs and Trade was formed. It was replaced by the World Trade Organization, established during the Uruguay Round of Multilateral Trade Negotiations in 1994.
- Bank for International Settlement, based in Switzerland, is the world’s oldest international financial institution. In the aftermath of World War I, it was created by the central banks of the United States, Great Britain, France, Germany, Italy, Belgium and Japan to coordinate German war reparations.
- As the bankers’ bank, Bank of International Settlement (BIS) serves the financial needs of member central banks. It provides gold and foreign exchange transactions for them and holds central bank reserves. The BIS is also a banker and fund manager for other international financial institutions.

3.8 Glossary

CACM: Central America Common Market is an association of five Central American nations that was formed to facilitate regional economic development through free trade and economic integration.

EFTA: European Free Trade Association. EFTA is an inter-governmental organization of Iceland, Liechtenstein, Norway and Switzerland, set up for the promotion of free trade and economic cooperation between its members, within Europe and globally.

Globalization: The process of integration of the world community into a common system – either economic or social.

International Development Association (IDA): IDA aims to reduce poverty by providing loans (called “credits”) and grants for programs that boost economic growth, reduce inequalities, and improve people’s living conditions.

NAFTA: The North American Free Trade Agreement (NAFTA) is a piece of regulation implemented on January 1, 1994 simultaneously in Mexico, Canada and the United States that eliminates most tariffs on trade between these nations.

OPEC: The Organization of the Petroleum Exporting Countries (OPEC) is a permanent, inter-governmental organization, created at the Baghdad Conference on September 10–14, 1960, by Iran, Iraq, Kuwait, Saudi Arabia and Venezuela.

Regional Trade Agreement: It is the coming together of a group of countries which engage in international trade together and are usually related through a free trade agreement or other association.

SAFTA: South Asian Free Trade Area. The purpose of SAFTA is to encourage and elevate common contract among the countries such as medium and long term contracts. Contracts involving trade operated by states, supply and import assurance in respect of specific products etc. It involves agreement on tariff concession like national duties concession and non-tariff concession.

Special Drawing Rights (SDR): A unit of account which represents a weighted average of a basket of currencies. It supplements existing world reserves by giving countries access to a new source of liquidity.

Triffin Dilemma / Paradox: It is the conflict of economic interests that arises between short-term domestic and long-term international objectives for countries whose currencies serve as global reserve currencies.

3.9 Self-Assessment Test

1. Explain about Bretton Woods System.
2. Write a note on Regional Trade Agreements.
3. What is WTO? Explain its functions.
4. Write a note on General Agreement on Trade in Services (GATS).

3.10 Suggested Readings/Reference Material

1. Anthony Saunders, Marcia Cornett, Anshul Jain (2021). Financial Markets and Institutions. McGraw-Hill. 7th edition
2. I.M. Pandey, Financial Management (2021). 12th edition, Vikas Publishing House.
3. Jeff Madura (2020). Financial Markets and Institutions – Asia Edition, 13th edition; Cengage Learning
4. P. G. Apte (2020). International Financial Management; Tata McGraw-Hill Education Private Limited; 8th edition
5. Prasanna Chandra (2019). Financial Management – Theory and Practice, 10th edition, New Delhi: Tata McGraw-Hill
6. Frank J. Fabozzi, Frank J. Jones (2019). Foundations of Global Financial Markets and Institutions. Mit Press. 5th edition
7. Brealey Myers (2018). Principles of Corporate Finance, 12th edition, USA: McGraw-Hill Companies Inc.

3.11 Answers to Check Your Progress Questions

1. (b) Capitalism

Capitalism as a social and political system has become so commonplace especially after the collapse of the erstwhile USSR.

2. (d) IMF

International Monetary Fund (IMF) is not a member of the World Bank group.

3. (e) Policy design

Trade Related Aspects of Intellectual Property Rights (TRIPS) considers seven types of intellectual property viz., Copyright & Related Rights, Trademarks, Geographical Indications, Industrial Designs, Patents, Integrated Circuits and Trade Secrets. However, policy design is not an intellectual property.

4. (d) SDRs

In 1969, Special Drawing Rights (SDRs) were created to overcome the challenges faced by the IMF due to the shortage of gold and US dollars in the world trading system.

5. (d) BIS

Bank of International Settlement (BIS) as the bankers' bank serves the financial needs of member central banks. It provides gold and foreign exchange transactions for them and holds central bank reserves.

6. (e) World Trade Organization

World Trade Organization (WTO) aims to create a level playing field for all and thereby contribute to the overall growth and development of the world economy.

7. (c) 50

Copyright protects the rights of authors of literary and artistic works such as books, paintings etc., for a minimum period of 50 years after the death of the author.

8. (d) Integrated Circuits

Integrated circuits provide protection to the layout designs/topographic of integrated circuits for a period of 10 years.

9. (c) TRIMS (Trade-Related Investment Measures)

TRIMS agreement recommends removal of all trade related investment measures within a period of five years.

10. (e) WTO

World Trade Organization (WTO) established during the Uruguay Round of Multilateral Trade Negotiations in 1944 to facilitate trade development among member countries.

Global Financial Markets

Course Structure

Block 1: Overview of Global Financial Markets	
Unit 1	Introduction to Global Markets
Unit 2	Macro Issues Impacting Global Markets
Unit 3	Multilateral Institutions
Block 2: Components and Instruments in Global Financial Markets	
Unit 4	Valuation of Securities
Unit 5	Global Bond Markets
Unit 6	Mortgage and Mortgage Instruments
Unit 7	Global Stock Markets
Unit 8	Global Perspective of Money Markets and Commodities Markets
Unit 9	Global Derivative Markets and Instruments
Block 3: Global Financial Institutions	
Unit 10	Banking: An International Perspective
Unit 11	Thrift Institutions: Operational Issue and Regulatory Issues
Unit 12	Investment Banks
Unit 13	Pension Funds
Unit 14	Mutual Funds, Hedge Funds and Sovereign Wealth Funds
Block 4: Managing Risk in Global Financial Markets	
Unit 15	Understanding Subprime Mortgage Loans (2007) & Brexit (2016): Their Impact on Financial Markets
Unit 16	Credit Rating & Sovereign Risk
Unit 17	Dealing Room Operations
Unit 18	Regulatory Aspects and Corporate Governance in Global Financial Markets