MBA II , Sem III,

305 FIN – International Finance (Finance Specialization)

Unit I

- Introduction to International Finance: Meaning/Importance, Scope,
- Globalization of the World Economy, Goals of International Finance, Structure and participants of the global financial system, Functioning of the global financial system in the globalization process,
- The Emerging Challenges in International Finance, Evolution of International Monetary System, Gold Standard System, Bretton Woods System, Current Exchange Rate Arrangements, Issues involved in overseas funding choices, International Financial Institutions:

- International Monetary Fund, World Bank. International credit rating agencies, Balance of Payment: Component, Collection reporting, surplus & deficits.

Introduction to International Finance:

- International finance is the branch of economics that studies the dynamics of foreign exchange,
- Foreign direct investment and how these affect international trade.
- Also studies the international Projects, international investment and the international capital flow.

International Finance includes

- International Finance is an area of study concerned with the
- Balance of Payment (BOP)
- International Monetary Fund (IMF)

International Finance: Meaning

- International finance involves MNCs, national government's rules and regulations, regarding flow of capital, across the borders of the country, the international finance discipline is vivid and complex.
- The term international finance is defined on the basis of various parameters:

  (a) It is a discipline of financing the international economic and commercial relations between countries.

- (b) It includes international markets (such as international banking, euro currency market, Eurobond, international stock exchanges, American Depository Receipts, GDRs, international

- Institutions viz., IMF, World Bank, Asian Development Bank, Brics Bank, China, WTO, UNCTAD, Letters of Credit, Bill of Lading, factoring and the like, international financial instruments foreign exchange markets, Balance of Payments and International risk management.
- (c) It is related to management, economic, commercial and accounting activities of MNCs, governments and private individuals.

- (d) It involves conversion of one currency into another.
- (e) It coordinates all financial and non-financial operations with the objectives of maximization of the shareholders' wealth.

IMPORTANCE OF INTERNATIONAL FINANCE

- India and other developing countries feel the need for increasing their share in international exchange of goods, services, capital and technology.
- Some of the important steps taken over during the last 25 years can be summarized as below —

- (i) establishment of unified market determined exchange-rate.
- (ii) introduction of current account convertibility and introduction of capital account convertibility in a phased or later period.
- (iii) reduction in import duties.
- (iv) liberalization of portfolio and FDI. Over a period of time, large size business houses, i.e., Multinational Corporations have production and sales activities spread in many countries.

SCOPE OF INTERNATIONAL FINANCE

- International finance has been viewed as management of MNCs that engage in some form of international business.
- (A business firm is considered an international player according to Fortune Magazine, when its international sales exceed 20% of total).
- These MNCs continuously devise strategies to improve their cash flows and enhance shareholder wealth. Penetration of foreign market creates opportunities for improving the company's cash flows.
- The dismantling of barriers to entry encourage companies to pursue international business.

Globalization of the World Economy

- Global finance has assumed greater relevance in the new economic world order.
- The phenomenal changes that have occurred drastically after the advent of international institutions, international markets, currency convertibility, the balance of payments position reversed to Northward journey of many economies gave a rigorous boost to international finance.
- The modern way of penetrating into the new markets by hitherto restricted markets catapulted the domain of international finance.

- The massive growth of multinational companies from international company to Global company, to transnational company, gave way to the renewed and necessary significance to international finance.
- Every country, on the growth path, transverse to financial aspects to a great extent to increase their economic growth and GDP. The main players in the international finance are multinational corporations, who are, more stronger than the national governments.

Goals Of International Finance.

There are various goals of international finance. These are:

1. **To achieve higher rate of profits: International companies search for foreign markets** that hold promise for higher rate of profits. Thus, the objective of profit affects and motivates the business to expand its operations to foreign countries.

For example, Hewlett Packard in US earned 86.2%
of its profits from the foreign markets, compared to that of domestic markets, in 2007. Apple earned, US $ 730 million as net profit from the foreign markets and only US $ 620
mn. as net profit, from its domestic market, in 2007.

Goals Of International Finance

- **2**. Expansion of production capacities: Some of the domestic companies expanded their production capacities more than the demand for the product in the domestic countries. These companies in such cases, are forced to sell their excess production in foreign developed countries. Toyota of Japan is an example.
- 3. Severe competition in the home country: The weak companies which could not meet the competition of the strong companies in the domestic country started entering the markets of the developing countries.

- 4. Limited home market: When the size of the home market is limited due to the smaller size of the population or due to lower purchasing power of the people or both, the companies internalize their operations.
- For example, most of the Japanese automobile and electronic firms entered the U.S., Europe and even African markets due to the smaller size of the home market. I.T.C. entered the European market due to the lower purchasing power of Indians with regard to high quality cigarettes.

5. **Political stability vs. political instability**: Political stability does not simply mean that continuation of the same party in power, but it does not mean that continuation of the same policies of the Government for a quieter longer period. It is viewed that the U.S.A. is a politically stable country.

Similarly, UK, France, Germany, Italy and Japan are also politically stable countries. International companies prefer, to enter the politically stable countries and are restrained from locating their business operations in politically instable countries.

In fact, business companies shift their operations from politically instable countries to politically stable countries.

6. **Availability of technology and skilled human resources:** Availability of advanced technology and competent human resources, in some countries act as PULLING FACTORS for international companies.

The developed countries due to these reasons attract companies from the developing world American and European companies, depended on Indian companies for software products and services through their BPOs.

The cost of professionals in India is 10 to 15 times less compared to US and European markets. These factors helped Indian software industry to grow at a faster rate with world class standards. Added to this, satellite communications help Indian companies to serve the global business without going globally.

- 7. High cost of transportation: The major factor in lower profit margins to international companies, is the cost of transportation of the products. Under such conditions, the foreign companies are inclined to increase their profit margin by locating their manufacturing facilities in foreign countries, where there is enough demand either in one country or in a group of neighboring countries.
- For example, Mobil, which was supplying the petroleum products to Ethiopia, Kenya, Eritrea, Sudan, etc. from its refineries, in Saudi Arabia, established its refinery facility in Eritrea, in order to reduce the cost of transportation.

- 8. Nearness to raw materials: The source of highly qualitative raw materials and bulk raw materials is a major factor for attracting the companies from various foreign countries. Most of the US based and European based companies located their manufacturing facilities in Saudi Arabia, Bahrain, Qatar, Iran etc. due to availability of petroleum.
- 9. Availability of quality human resources: This is a major factor for software, high technology and telecommunication companies to locate their operations in India. India is a major source for high quality and low cost human resources.
- 10. Liberalization and globalization: Most of the countries in the world, liberalized their economies and opened their countries to the rest of the world.

11. **Increased Market Share:** Some of the large scale international companies like to enhance their market share in the world market by expanding and intensifying their operations in various foreign countries.

For example, Ball Corporation, the third largest beverage cans manufacturer in the USA, bought the European Packaging operations of continental can company. Then it expanded its operations in Europe and met the Europe demand, which is 200 per cent more than that of USA.

Thus, it increased its global market share of soft drink cans.

12. To achieve higher rate of economic development: International companies help the governments to achieve higher growth rate of the economy, increase the total and per capita GDP, industrial growth, employment and income levels.
13. Tariffs and import quotas: It was quite common before globalization that governments imposed tariffs or duty on imports to protect the domestic companies. Sometimes government also fixes import quotas to reduce the competition to the domestic companies from competent foreign companies.

To avoid high tariffs and quotas companies prefer direct investments to go globally. For example, companies like Sony, Honda and Toyota preferred direct foreign investment in various countries by establishing subsidiaries or through joint ventures.

Structure and participants of the global financial system

- **The International financial market:**

  The international financial market is lending and borrowing operations in currencies outside their countries of origin, and therefore not subject to direct state regulation from the sides of these countries.
- The domestic financial market:
- The domestic financial market is lending and borrowing operations of domestic residents that subordinate national legislation in the currency of the origin country.
- Currency Market:
- (Foreign Exchange Market) allows to exchange one currency for another.

- **Money Market :**Money Market is market of short-term debt, where financial institutions borrow and lend money up to 1 year.
- **The capital market includes:**
- **Fixed Income Market** is financial market, where debt instruments and short-term commercial paper are bought and sold.
- **Stock Market** is complex of economic relations of its members on the issue and circulation of securities.

Participants in the Global Financial Market

- **Investor** - the person, who owns the securities through the right of ownership or other proprietary right.
- **Lender** – the side in credit relations, which provides loans on terms of repayment, maturity and payment.
- **Issuer** – the legal entity that carries on its obligations to investors on the implementation of the rights certified by a security.
- **Borrower -** the person receiving the loan agreement or a bank loan sum of money or other things that it is obliged to return within the prescribed period.

Participants in the global financial market

- The financial intermediaries include:
- Broker is specialist, who buy and sell financial assets on the behalf of customers.
- Dealer is specialist, who buy and sell financial assets on his own behalf and at his own expense.
- Underwriter is specialist, who organize and take the financial responsibility for the implementation of the primary issues of securities.
- Hedger is specialist, who use derivative instruments for the insurance from the financial risks.

Financial instruments of the global financial market

- Currency Market instruments: currency and Eurocurrency.
- Money Market instruments: cash, commercial papers, short-term notes, certificate of deposit, repo.
- Fixed Income Market instruments: bonds, treasury bonds, treasure notes, treasury bills.
- Stock Market instruments: stocks, derivatives (futures, forward, options, swaps).

The Emerging Challenges in International Finance

- To keep up-to-date with significant environmental changes and analyze their implications for the firm
- To understand and analyze the complex interrelationships between relevant environmental variables and corporate responses
- To be able to adapt the finance function to significant changes in the firm's own strategic posture
- To take in stride past failures and mistakes to minimize their adverse impact
- To design and implement effective solutions to take advantage of the opportunities offered by the markets and advances in financial theory

Gold Standard

- The essential feature of the gold standard is that each country stands ready to convert its paper or fiat money into gold at a fixed price.3 This fixing of the price of gold fixes exchange rates between currencies.
- During this period in most major countries:
    A. Gold alone was assured of unrestricted coinage
    B. There was two-way convertibility between gold and national currencies at a stable ratio.
    C. Gold could be freely exported or imported.
    D. The exchange rate between two country's currencies would be determined by their relative gold contents.

- Highly stable exchange rates under the classical gold standard provided an environment that was conducive to international trade and investment.
- Misalignment of exchange rates and international imbalances of payment were automatically corrected by the price-specie-flow mechanism.

- CONTENT

- Introduction
- Goals of conference
- Expected benefit
- Outcome
- Problems
- Evaluation and Breakdown.
- Example

INTRODUCTION

- Bretton wood system established in 1944.
- Large capital movement and less controllable.
- Requirement of stabilizing system.
- Financial security and stable situation.
- Restructure international finance and currency relationships.
- Implementing a system of fixed exchange rates with the U.S. dollar as the key currency.

GOALS OF CONFERENCE

- Intended to govern currency regulations and establish legal obligations (through the IMF).
- Set a standard for exchange rates. (1 ounce gold= $35)
- Establish international monetary cooperation.
- Money pool from which member nations can borrow
- funds.

EXPECTED BENEFIT FROM THE SYSTEM

- Through capital controls, the countries would pursue the full employment and price stability (low inflation) and the external balance (keeping exchange rates stable) simultaneously.

OUTCOME

- Quotas embedded in the IMF.
- Several conferences dealing with the world monetary problems caused by the ‘Great Depression’ had ended.
- The creation of the IMF and World Bank.
- The dollar standard.

PROBLEMS

- Occasional devaluations under the supervision of the IMF to remove "fundamental disequilibria" in the balance of payments (BOP).
- United States free from external economic pressures.
- Countries were not willing to accept the high inflation
- rates.
- Countries no longer based this value on gold.

EVOLUTION AND BREAKDOWN

- The reserves of most countries became a mixture of gold and dollars.
- In 1958, countries in Europe completed the restoration of convertibility.
- National interest rates were closely linked with each other due to the opportunity to move funds across borders.
- In 1970s the balance of payment crisis were so massive that finally countries couldn’t keep up with the adjustments, so the system collapsed and replaced with a regime of floating exchange rates

What is exchange-rate regime

- the way an authority manages its currency in relation to other currencies and the foreign exchange market
- An exchange rate change is simply the price of one currency in terms of another

Different types of Regimes

Particulars	Description	Countries
Dollarization	Inhabitants of a country use foreign currency in parallel to or instead of the domestic currency.	Panama, Zimbabwe
Currency Boards	A monetary authority maintain a fixed exchange rate with a foreign currency	Hong Kong, Bulgaria,
Monetary Union	A group of countries using a common currency issued by a common regional central bank.	Euro Union (27 nations)

Float with discretionary intervention	Exchange rates are determined in the foreign exchange market, However authorities can and do intervene	India, Bangladesh, Sri Lanka
Pure Float / Independent floating	The exchange rate is determined in the market without public sector intervention.	Japan, New Zealand, The United States
Traditional Peg/Fixed	**Crawling Pegs**	**Crawling Bands**

Importance of Foreign exchange regime

- Stock market Trading
- Regime Durability
- Symbolizes growth
- Indicates Demand
- Position in world

Economics of the Foreign Exchange Market

- Depends on : forces of Demand and Supply
- Echo the international trade and financial transactions that are summarized in the Balance Of Payments (BOP)
- BOP
- ▫ Current A/c – Import and export of goods and services
- ▫ Capital A/c - Capital Inflow and Capital Outflow

Economics of the Foreign Exchange Market

- Floating ERR :
- Automatic equilibrium in the balance of payments without government intervention
- Shock absorber that helps to insulate against overseas disturbances
- Increases the effectiveness of monetary policy (diminishing the Fiscal Policy)
- In India, fiscal policy has come to be overshadowed by an increased reliance on monetary policy as the primary instrument of macroeconomic stabilization

How do countries choose Exchange Rate Regimes (ERR)?

- Socio – Economic Variables Affecting choice of ERR's are :
- Openness, size, trade concentration and economic volatility indicators
- A country is less likely to adopt a fixed exchange rate if it is relatively large and closed, if its external trade is concentrated, and if the business cycle is more volatile. This suggests that what matters for the choice of the exchange rate regime is the exposure to external shocks

Variables Affecting Choice of Exchange Rate regimes

2. ***Financial depth indicators***
   - Deeper the financial markets – prone to adopting Floating Exchange rates
3. ***Inflation***
   - Not a very influential parameter
   - Socio-economic scenario
   - The inflation rate is endogenous to the institutional and political environment

Variables Affecting Choice of Exchange Rate regimes

4. Political variables

- Expected government turnover and socio- political unrest reduce the likelihood of adopting a *de facto* peg
- Use of monetary policy to raise consensus in the elections
- fragmented policymaking calls for a Float probably because greater discretion makes it easier to settle conflicts among agents involved in the decision-making process

IMF

- “It is an organization of 186 countries ,working to foster global monetary cooperation , secure financial stability ,facilitate international trade ,promote high employment and sustainable economic growth and reduce poverty” .
- The IMF is the most detailed attempt to organize the conduct of international monetary affairs.

- The International Monetary Fund was created in July 1944, originally with 45 members, with a goal to stabilize exchange rates and assist the reconstruction of the world's international payment system.
- Countries contributed to a pool which could be borrowed from, on a temporary basis, by countries with payment imbalances. (London, 2007)

Features of IMF

- International Monetary Co Operation
- To Facilitate Expansion And Balanced Growth Of International Trade
- To Promote Exchange Stability
- Generating Higher Employment And Income
- Abolition Of Exchange Restriction
- Aid To Members During Emergency
- To Shorten The Duration And Lessen The Degree Of Disequilibrium In The International Balance Of Payments Of Members.

MEMBERSHIP

- There are two types of members:
- 1) ORIGINAL MEMBERS: All those countries whose representatives took part in BRETTONWOODS CONFERENCE and who agreed to be the members of the fund prior to 31st December,1945.
- 2) ORDINARY MEMBERS: All those who became its members subsequently.

*BANK has the authority to suspend any member and similarly every member is free to resign.

World Bank

- The world bank is an internationally supported bank that provides financial and technical assistance to developing countries for development programs (e.g. bridges, roads, schools)with the stated goal of reducing poverty.

Structure of World Bank

- The organizational structure of the Bank is headed by a board of governor, composed of one governor from each member state, meeting once a year. Below the board of governors is the board of executive directors, who meet in permanent session at the Bank's headquarters.
- The 24 directors are appointed by their governments but are considered employees of, and are paid salaries by the bank.
- Voting in the bank is weighted. Meaning, the voting strength of each member state is proportionate to its financial contributions.
- The U.S. still retains its power of veto and the share and votes of the Big Five remain at nearly 40 percent. The Big Five are the United States, japan, Germany, France, and UK.

Features of World Bank

- World bank provides the largest external funds for education.
- It is a big support in reducing poverty.
- It provides fund for biodiversity projects.
- it helps to bring clean water, electricity, and transport to poor people.
- It helps in controlling emerging conflicts.

Difference Between IMF & World Bank

The International Monetary Fund	World Bank
Oversees the international monetary system	Seeks to promote the economic development of the world's poorer countries
Promotes exchange stability and orderly exchange relations among its member countries	Assists developing countries through long-term financing of development projects and programs
Assists all members--both industrial and developing countries--that find themselves in temporary balance of payments difficulties by providing short- to medium-term credits	Provides to the poorest developing countries whose per capita GNP is less than $865 a year special financial assistance through the international development association (IDA)
Draws its financial resources principally from the quota subscriptions of its member countries	Acquires most of its financial resources by borrowing on the international bond market
Has at its disposal fully paid-in quotas now totaling SDR 145 billion (about $215 billion)	Has an authorized capital of $184 billion, of which members pay in about 10 percent
Has a staff of 2,300 drawn from 182 member countries	Has a staff of 7,000 drawn from 180 member countries

International credit rating agencies

- Credit rating agency means a body corporate

which is engaged in the business of rating of securities offered by companies.

- The debt instruments rated by CRAs include government bonds, corporate bonds, CDs, municipal bonds, preferred stock, and collateralized securities, such as mortgage-backed securities and collateralized debt obligations.

Definition International credit rating agencies

- According to CRISIL, credit rating is "an unbiased and independent opinion as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy , sell or hold a particular security"
- According to Moodys , "ratings are designed exclusively for the purpose of grading bonds according to their investment qualities"

INTERNATIONAL AGENCIES

- MOODY’S INVESTORS SERVICES
- STANDARD AND POOR’S CORPORATION(S &P)

MOODY’S INVESTORS SERVICES

- John Moody founded the Moody’s agency at the beginning of the 20th century.
- It undertakes the rating of wide range of debt related securities , international issues , commercial papers , etc. Both in USA and international markets.
- Other services include- assessing financial strength of insurance companies , mutual funds, banks , public utilities.

STANDARD AND POOR'S CORPORATION(S &P)

- One of the first credit rating institutions which has a history of 157 years, founded in the year 1860.
- Offers rating on wide range of debt securities , both in the US and overseas markets.

OTHER INTERNATIONAL AGENCIES

- Duff and Phelps Credit Rating Company
- Japan Credit Rating Agency
- Fitch Investors Service
- Thomason Bank Watch
- IBCA Ltd

CREDIT RATING AGENCIES IN INDIA

- CRISIL
- ICRA
- CARE
- FITCH RATINGS INDIA PVT. LTD.
- ONICRA
- SMERA
- BRICKWORK RATING INDIA PVT. LTD.

CRISIL

- CRISIL stands for Credit Rating Information Services of India Ltd.
- Promoted by ICICI Ltd. Along with UTI and some banks and insurance companies as a public limited company.
- Headquarter – Mumbai.
- Services offered are:

a) Credit rating services
b) Advisory services
c) Research and information services

- CRISIL is the largest credit rating agency in India and the market leader.
- S & P is the major shareholder of CRISIL with a stake of 56.5%.

ICRA

- ICRA stands for Investment Information and Credit Rating Agency Ltd.
- Promoted by IFCI,SBI,UTI(Unit Trust of India),LIC,GIC(General Insurance Corporation),HDFC,UCO bank etc.
- Moody's Investors Service is the largest shareholder.
- Services rendered by ICRA are:

a. Rating services

b. Information services

c. Advisory services

CARE

- Credit Analysis and Research Ltd
- Incorporated in 1993, is based in Mumbai
- Deals with advisory services, information and credit rating.
- Promoted by UTI, Canara Bank, IDBI and many other reputed banks and companies dealing with financial services.
- VARIOUS SERVICES OFFERED ARE:

a) Rating Services

b) Credit Reports

c) Valuations

d) Credit Appraisal

e) Reviewing Debt Market

- In 1994 commenced publication of 'CAREVIEW' a quarterly journal of CARE Ratings.

FITCH RATINGS INDIA PVT. LTD.

- DCR India Pvt Ltd or Duffs and phelps Credit rating India Pvt Ltd was a joint venture between Duffs & Phelps and Alliance group.
- It was first private sector credit rating agency in India.
- Fitch Investors Service, USA accquired 33% stake in DCR and has been renamed as Fitch Ratings India Pvt Ltd.
- DCR India Pvt Ltd has played an important role in rating India's forex debt obligations.
- Rates the securities of all kinds of companies including banking and insurance.
- Rating symbols used by Fitch are the same as that of CRISIL.

ONICRA

- First Individual Credit Rating agency in India. Individual Credit Rating is an objective assessment of the risk attached to a financial transaction with respect to an individual.
- Promoted by ONIDA, famous for consumer durables.
- ONICRA was incorporated on the business of analysis, rating, evaluation and appraisal of obligation, dues ,debts , commitments of an individual.

SMERA

- Founded in 2005
- Headquarters situated in Mumbai
- Exclusively set up for micro, small and medium enterprises.
- It provides ratings which enable MSME, SME'S, Corporate to raise bank loans at competitive rates of interest.
- Registration with SEBI as Credit Rating Agency and accreditation by RBI as an external credit assessment Institution to rate bank loans has paved way for SMERA to rate/grade various instruments such as IPO, NCD's, Commercial Papers, Bonds, FD's etc.

BRICKWORK RATING INDIA PVT. LTD.

- Incorporated in 2007
- Corporate office in Bangalore
- BWR, A SEBI registered Credit Rating agency has also been accredited by RBI and empanelled by National Small Industries Corporation with an objective of providing strong research based information for Indian Investors.
- Provides rating services for various capital market instruments, Financial Institutions, Municipal and Urban Local Bodies.
- BWR also provides other rating services such as Corporate Governance Ratings, FD Ratings etc.

Balance of Payment: Component, Collection reporting, surplus & deficits.

BALANCE OF PAYMENT

A country has to deal with other countries in respect of the following

1. **Visible items** which include all types of physical goods exported and imported.

2. **Invisible items** which include all those services whose export and import are not visible. e.g. transport services, medical services etc.

3. **Capital transfers** which are concerned with capital receipts and capital payment.

Balance of Payments

According to Kindle Berger, "The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time".

It is a double entry system of record of all economic transactions between the residents of the country and the rest of the world carried out in a specific period of time

when we say "a country's balance of payments" we are referring to the transactions of its citizens and government.

Balance Of Payment : Definition

The balance of payments of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world. It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents and payments made by them on account of goods imported and services received from the capital transferred to non-residents or foreigners.

- **Reserve Bank of India**

Features

- It is a systematic record of all economic transactions between one country and the rest of the world.
- It includes all transactions, visible as well as invisible.
- It relates to a period of time. Generally, it is an annual statement.
- It adopts a double-entry book-keeping system. It has two sides: credit side and debit side. Receipts are recorded on the credit side and payments on the debit side.

Balance of Trade

The difference between a country's imports and its exports. Balance of trade is the largest component of a country's balance of payments.

Debit items include imports, foreign aid, domestic spending abroad and domestic investments abroad.

Credit items include exports, foreign spending in the domestic economy and foreign investments in the domestic economy.

When exports are greater than imports than the BOT is favorable and if imports are greater than exports then it is unfavorable

Balance of Trade V/s Balance of Payment

The Balance of Payment takes into account all the transaction with the rest of the worlds

The Balance of Trade takes into account all the trade transaction with the rest of the worlds

Importance of Balance Of Payments

1. BOP records all the transactions that create demand for and supply of a currency.
2. Judge economic and financial status of a country in the short-term
3. BOP may confirm trend in economy's international trade and exchange rate of the currency. This may also indicate change or reversal in the trend.
4. This may indicate policy shift of the monetary authority (RBI) of the country.
5. BOP may confirm trend in economy's international trade and exchange rate of the currency. This may also indicate change or reversal in the trend.

The General Rule in BOP Accounting

a. If a transaction earns foreign currency for the nation, it is a credit and is recorded as a plus item.

b. If a transaction involves spending of foreign currency it is a debit and is recorded as a negative item.

The various components of a BOP statement

1. Current Account
2. Capital Account
3. Reserve Account
4. Errors & Omissions

Current Account Balance

- BOP on current account is a statement of actual receipts and payments in short period.
- It includes the value of export and imports of both visible and invisible goods. There can be either surplus or deficit in current account.
- The current account includes:- export & import of services, interests, profits, dividends and unilateral receipts/payments from/to abroad.
- BOP on current account refers to the inclusion of three balances of namely – Merchandise balance, Services balance and Unilateral Transfer balance

Types of Balances

Trade Balance

Merchandise: exports - imports of goods

Services: exports - imports of services

Income Balance

Net investment income: net income receipts from assets

Net international compensation to employees: net compensation of Employees

Net Unilateral Transfers

Gifts from foreign countries minus gifts to foreign countries

Capital Account Balance

- The capital account records all international transactions that involve a resident of the country concerned changing either his assets with or his liabilities to a resident of another country. Transactions in the capital account reflect a change in a stock – either assets or liabilities.
- It is difference between the receipts and payments on account of capital account. It refers to all financial transactions.
- The capital account involves inflows and outflows relating to investments, short term borrowings/lending, and medium term to long term borrowing/lending.

Capital Account Balance

- There can be surplus or deficit in capital account.
- It includes: - private foreign loan flow, movement in banking capital, official capital transactions, reserves, gold movement etc.
- These are classifies into two categories-
  - Direct foreign investments
  - Portfolio investments
  - Other capital

The Reserve Account

Three accounts: IMF, SDR, & Reserve and Monetary Gold are collectively called as The Reserve Account.

The IMF account contains purchases (credits) and re-purchase (debits) from International Monetary Fund.

Special Drawing Rights (SDRs) are a reserve asset created by IMF and allocated from time to time to member countries. It can be used to settle international payments between monetary authorities of two different countries.

Errors & Omissions

- The entries under this head relate mainly to leads and lags in reporting of transactions
- It is of a balancing entry and is needed to offset the overstated or understated components.

Receipts (Credits)	Payments (Debits)
1) Exports of goods	1) Imports of goods
Trade Account Balance	
2) Exports of services	2) Imports of services
3) Interests, profits and dividends received	3) Interests, profits and dividends paid
4) Unilateral receipts	4) Unilateral Payments
Current Account Balance (1 to 4)	
5) Foreign Investments	5) Investments abroad
6) Short term borrowing	6) Short term lending
7) Medium and long term borrowing	7) Medium and long term lending
8) Statistical discrepancy (Errors and omission)	
Capital Account Balance (5 to 8)	
9) Change in reserves (+)	9) Change in reserves
Total Receipts = Total payments	

Disequilibrium In The Balance Of Payments

A disequilibrium in the balance of payment means its condition of Surplus Or deficit

- ✓ A Surplus in the BOP occurs when Total Receipts exceeds Total Payments. Thus,

BOP= CREDIT>DEBIT

- ✓ A Deficit in the BOP occurs when Total Payments exceeds Total Receipts. Thus,

BOP= CREDIT<DEBIT

Causes of Disequilibrium In The Bop

- Cyclical fluctuations
- Short fall in the exports
- Economic Development
- Rapid increase in population
- Structural Changes
- Natural Calamites
- International Capital Movements

Measures To Correct Disequilibrium in the BOP

1. Monetary Measures **:-**

- Monetary Policy
- The monetary policy is concerned with money supply and credit in the economy. The Central Bank may expand or contract the money supply in the economy through appropriate measures which will affect the prices.
- Fiscal Policy
- Fiscal policy is government's policy on income and expenditure. Government incurs development and non - development expenditure,. It gets income through taxation and non - tax sources. Depending upon the situation governments expenditure may be increased or decreased.

Measures To Correct Disequilibrium in the BOP

c) *Exchange Rate Depreciation*

By reducing the value of the domestic currency, government can correct the disequilibrium in the BoP in the economy. Exchange rate depreciation reduces the value of home currency in relation to foreign currency. As a result, import becomes costlier and export become cheaper. It also leads to inflationary trends in the country,

d) *Devaluation*

devaluation is lowering the exchange value of the official currency. When a country devalues its currency, exports becomes cheaper and imports become expensive which causes a reduction in the BOP deficit.

Measures To Correct Disequilibrium in the BOP

e) Deflation

- Deflation is the reduction in the quantity of money to reduce prices and incomes. In the domestic market, when the currency is deflated, there is a decrease in the income of the people. This puts curb on consumption and government can increase exports and earn more foreign exchange.

f) Exchange Control

- All exporters are directed by the monetary authority to surrender their foreign exchange earnings, and the total available foreign exchange is rationed among the licensed importers. The license-holder can import any good but amount if fixed by monetary authority.

Measures To Correct Disequilibrium in the BOP

II. Non- Monetary measures :-

a) *Export Promotion*

To control export promotions the country may adopt measures to stimulate exports like:

- export duties may be reduced to boost exports
- cash assistance, subsidies can be given to exporters to increase exports
- goods meant for exports can be exempted from all types of taxes.

b) *Import Substitutes*

Steps may be taken to encourage the production of import substitutes. This will save foreign exchange in the short run by replacing the use of imports by these import substitutes.

Measures To Correct Disequilibrium in the BOP

- Import Control
- Import may be kept in check through the adoption of a wide variety of measures like quotas and tariffs. Under the quota system, the government fixes the maximum quantity of goods and services that can be imported during a particular time period.
  - Quotas – Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system, the deficit is reduced and the balance of payments position is improved.

- Tariffs – Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduced the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes

INDIA'S BALANCE OF PAYMENT

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- A country, like India, which is on the path of development generally, experiences a deficit balance of payments situation.
- This is because such a country requires imported machines, technology and capital equipment's in order to successfully launch and carry out the programme of industrialization

Table 1: Major Items of India's Balance of Payments

(US$ Billion)

	Apr-Jun 2015 P			Apr-Jun 2014 PR		
	Credit	Debit	Net	Credit	Debit	Net
A. Current Account	**126.6**	**132.7**	**-6.2**	**139.2**	**147.0**	**-7.8**
1. Goods	68.0	102.2	-34.2	81.7	116.3	-34.6
Of which:						
POL	8.2	24.7	-16.5	16.8	40.4	-23.6
2. Services	38.0	20.6	17.4	37.6	20.6	17.0
3. Primary Income	3.2	8.8	-5.6	2.3	9.0	-6.7
4. Secondary Income	17.3	1.1	16.2	17.6	1.1	16.4
B. Capital Account and Financial Account	**140.3**	**133.6**	**6.6**	**144.6**	**136.6**	**8.0**
Of which:						
Change in Reserve (Increase (-)/Decrease (+))	0.0	11.4	-11.4	0.0	11.2	-11.2
C. Errors & Omissions (-) (A+B)	**0.0**	**0.5**	**-0.5**	**0.0**	**0.1**	**-0.1**

P: Preliminary; PR: Partially Revised

Note: Total of subcomponents may not tally with aggregate due to rounding off.

BOP OF INDIA

DIMR

- India's current account deficit (CAD) narrowed to US$ 6.2 billion (1.2 per cent of GDP) in Q1 of 2015-16 from US$ 7.8 billion (1.6 per cent of GDP) a year ago.
- This improvement was mainly on account of the merchandise trade deficit (US$ 34.2 billion during Q1 of 2015-16) which contracted on a year-on-year (y-o-y) basis due to a larger absolute decline in merchandise imports relative to merchandise exports.
- The reduction in the CAD was also enabled by higher net earnings through services and lower outflow on account of primary income (profit, dividend and interest).
- Private transfer receipts, mainly representing remittances by Indians employed overseas, amounted to US$ 16.2 billion, a marginal decline from their level a year ago.

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BOP OF INDIA

- In the financial account, net inflows of foreign direct investment were higher on a y-o-y basis, however, portfolio investment declined sharply.
- Non-resident Indian (NRI) deposits received by commercial banks during the quarter at US$ 5.9 billion were more than double the net inflow into these accounts in Q1 of last year.
- Net loans availed by banks witnessed an inflow of US$ 5.4 billion, mainly on account of a fall in foreign currency assets held abroad by banks.
- In April-June 2015 there was net accretion of US$ 11.4 billion to India's foreign exchange reserves on a BoP basis; which was marginally higher than the accretion in the corresponding quarter of last year .

REASONS FOR POOR PERFORMANCE OF INDIA'S EXPORT TRADE

- There are Several reasons for India's Poor performance. Some off them are:

I. **Export - Related Problems** :-

1. **High Prices** :-

- As compared to other Asian Countries the price of Indian goods is high. Prices are high due to documentation formalities, high transaction costs & also to make higher profits.

2. **Poor - Quality** :-

- Many Indian exporters do not give much importance to quality control, so their products are of poor quality. Due to low quality many times Indian goods are rejected & sent back to India by foreign buyers.

REASONS FOR POOR PERFORMANCE OF INDIA'S EXPORT TRADE

3.Poor Negotiation Skills :- Indian exporters lack Negotiation Skills due to poor training in Marketing. They fail to Convince & induce the foreign buyers to place orders.

4.Inadequate Promotion :-For Export Marketing, Promotion is important. Many Indian Exporters do not give much importance to promotion. A good no. of Indian exporters are not professional in advertising & Sales promotion. They do not take part in trade fairs & exhibitions.

5.Poor follow-up of sales :-Indian exporters are ineffective in providing after- sale-service. They do not bother to find out the reactions of buyers after sale. This results in poor performance of India's export trade.

II. **General Causes**

1. **Good Domestic Market**

- Sellers find a ready market for their goods within the country, so they do not take parts to get orders from overseas markets.

2. **Number of formalities**

- There are number of documentation & other formalities due to which the some marketers do not enter the export field. So there is a need to simplify formalities.

REASONS FOR POOR PERFORMANCE OF INDIA'S EXPORT TRADE

3. Problem of Trading Blocs

- Trading blocs reduce trade barriers on member nations, but they impose trade barriers on non-members. As India is not a member of some powerful trading blocs, it has to face some problems.

4. Negative Attitude

- Some of the overseas buyers have a negative attitude towards Indian goods. They feel that Indian goods are inferior goods. Thus there is a need to correct this attitude.

5. Poor Infrastructure

- Indian infrastructure is poor. Indian exporters find it difficult to get orders & also to deliver them at time.