Biyani's Think Tank

Concept based notes

International Financial Management

(MBA)

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Preface

I am glad to present this book, especially designed to serve the needs of the students. The book has been written keeping in mind the general weakness in understanding the fundamental concepts of the topics. The book is self-explanatory and adopts the "Teach Yourself" style. It is based on question-answer pattern. The language of book is quite easy and understandable based on scientific approach.

Any further improvement in the contents of the book by making corrections, omission and inclusion is keen to be achieved based on suggestions from the readers for which the author shall be obliged.

I acknowledge special thanks to Mr. Rajeev Biyani, *Chairman* & Dr. Sanjay Biyani, *Director* (*Acad.*) Biyani Group of Colleges, who are the backbones and main concept provider and also have been constant source of motivation throughout this endeavour. They played an active role in coordinating the various stages of this endeavour and spearheaded the publishing work.

I look forward to receiving valuable suggestions from professors of various educational institutions, other faculty members and students for improvement of the quality of the book. The reader may feel free to send in their comments and suggestions to the under mentioned address.

Author

Syllabus

Financial Management in a Global Perspective: Increasing Independence in the Global Economy-Trends in International Trade and Cross Border Financial Flows – India in the Global Economy – Recent Developments In Global Financial Markets – Liberalization – Integration and Innovation – Challenges of International Financial Management – Gains from International Trade and Investment.

International Monetary System and Financial Markets – An overview: Balance of Payments – International Monetary System – An Overview of International Financial Markets – Exchange Rate Determination and Forecasting

International financial management: Genesis international flow of funds. envelopments in international monetary system, exchange rate mechanism. Emergence of multinational financial management. Balance of payment. Risk: political and country risk. Raising capital: international.

intricacies of Foreign Exchange Markets-Structure and participants-types of transactions-mechanics of currency dealing-exchange rate quotations-arbitrage-forward rates-evolution of exchange control and foreign exchange market
in India. Exchange rate computation

Parity conditions in International Finance- Purchasing Power Parity, Covered Interest Parity, Real Interest Parity, Parity Conditions and Managerial Implications.

Short term and long term borrowings in international markets: short term funding and Investment-centralized vs. decentralized cash management-pooling-exposure management. The costs and risks of foreign currency borrowing syndicated loans, country risk assessments.

Unit-1

International Monetary System and Financial Market

Q.1 Explain the IMF and its objective and functions.

Ans 1 IMF

The International Monetary Fund was originally created as part of the Bretton Woods system exchange agreement in 1944.During the Great Depression, countries sharply raised barriers to foreign trade in an attempt to improve their failing economies. The IMF was formally organized on December 27, 1945, when the first 29 countries signed its Articles of Agreement. The International Monetary Fund was one of the key organizations of the international economic system; its design allowed the system to balance the rebuilding of international capitalism with the maximization of national economic sovereignty and human welfare, also known as embedded liberalism.

The members of the IMF are 188 members of the UN and the Republic of Kosovo All members of the IMF are also International Bank for Reconstruction and Development (IBRD) members and vice versa. Member countries of the IMF have access to information on the economic policies of all member countries, the opportunity to influence other members' economic policies, technical assistance in banking, fiscal affairs, and exchange matters, financial support in times of payment difficulties, and increased opportunities for trade and investment.

Organization

Board of Governors: The Board of Governors consists of one governor and one alternate governor for each member country. Each member country appoints its two governors. While the Board of Governors is officially responsible for approving quota increases, special drawing right allocations, the admittance of new members, compulsory withdrawal of members, and amendments to the Articles of Agreement and By-Laws.

Executive Board: 24 Executive Directors make up Executive Board. The Executive Directors represent all 188 member-countries. Countries with large economies have their own Executive Director, but most countries are grouped in constituencies representing four or more countries.

Managing Director: The IMF is led by a Managing Director, who is head of the staff and serves as Chairman of the Executive Board. The Managing Director is assisted by a First Deputy Managing Director and three other Deputy Managing Directors.

Voting power: Voting power in the IMF is based on a quota system. Each member has a number of "basic votes" plus one additional vote for each Special Drawing Right (SDR) of 100,000 of a member country's quota. The Special Drawing Right is the unit of account of the IMF and represents a claim to currency.

Functions

- The IMF works to foster global growth and economic stability.
- It provides policy advice and financing to members in economic difficulties and also works with developing nations to help them achieve macroeconomic stability and reduce poverty.
- It provides balance of payments financing and the justification for official financing.
- fixed exchange rate arrangements between countries.
- The IMF also researched what types of government policy would ensure economic recovery.

Q.2 What are the new challenges for the International Financial Management?

Ans Challenges of international financial management

Financial management of a company is a complex process, involving its own methods and procedures. It is made even more complex because of the globalization taking place, which is making the worlds financial and commodity markets more and more integrated. The integration is both across countries as well as markets. Not only the markets, but even the companies are becoming international in their operations and approach.

Managers of international firms have to understand the environment in which they function if they are to achieve their objective in maximizing the value of their firms, or the rate of return from foreign operations. The environment consists of:

1. The international financial system, which consists of two segments: the official part represented by the accepted code of behavior by governments comprising the international monetary system, and the private part, which consists of international banks and other multinational financial institutions that participate in the international money and capital markets.
2. The foreign exchange market, which consists of multinational banks, foreign exchange dealers, and organized exchanges where currency futures are regularly traded.
3. The foreign country's environment, consisting of such aspects as the political and socioeconomic systems, and people's cultural values and aspirations. Understanding of the host country's environment is crucial for successful operation and essential for the assessment of the political risk.

The multinational financial manager has to realize that the presence of his firm in a number of countries and the diversity of its operations present challenges as well as opportunities. The challenges are the unique risks and variables the manager has to contend with which his or her domestic counterpart does not have to worry about. One of these challenges, for example, is the multiplicity and complexity of the taxation systems, which impact the MNC's operations and profitability. But this same challenge presents the manager with opportunities to reduce the firm's overall tax burden, through transfer of funds from high- to low-tax affiliates and by using tax havens.

The financing function is another such challenge, due to the multiplicity of sources of funds or avenues of investment available to the financial manager. The manager has to worry about the foreign exchange and political risks in positioning funds and in mobilizing cash resources. This diversity of financial sources enables the MNC at the same time to reduce its cost of capital and maximize the return on its excess cash resources, compared to firms that raise and invest funds in one capital market.

In a real sense MNCs are particularly situated to make the geographic, currency, and institutional diversity work for them. This diversity, if properly managed, helps to reduce fluctuations in their earnings and cash flows, which would translate into higher stock market values for their shares. This observation is especially valid for the well-diversified MNCs.

This is not to suggest that the job of the manager of an MNC is easier, or less demanding, than if he or she were to operate within the confines of one country. The challenges and the risks are greater, but so are the rewards accruing to intelligent, flexible, and forward-looking management. The key to such a management is to make the diversity and complexity of the environment work for the benefit of the firm and to lessen the adverse impact of conflicts on its progress.

Q.3 What are the gains from the international financial market?

Ans Gain from the international Financial Market

Better allocation of capital international investment has been improvement in the global allocation of capital and an enhanced ability to diversify investment portfolios.

Increased prosperity the major gain of international trade is that it has brought about increased prosperity by allowing nations to specialize in producing those goods and services at which they are relatively efficient.

Economic trends : The modern economic trends are revealing that International Trade is helping the growth of Developing Nations. The openness to international trade has been lucrative to the developing countries for rapid economic growth

Growth and Development: International trade is one of the most crucial elements in the economic growth of a developing country. As per the study of

Joseph Francois of Erasmus University in Rotterdam, new trade relations would generate US$ 90 billion – US $190 billion per year.

Confidence and Energy: The present economic slowdown in trade would be harmful for the developing economies. New trade relations would help induce extra energy and confidence into the financial markets, and support economic growth and opportunity, in the short run.

Opening of Agriculture Market: International trade and new trade relations would lead to the liberalization of the global market of agriculture. As agriculture plays an important part in many of the developing countries, opening of the agricultural market would be a major contribution to wards the elimination of poverty.

Uruguay Round: After this the potential for more global trade in developing countries increased. The market accessibility pertaining to agricultural sector, manufacturing sector, and services sector was enhanced. It also established new and improved rules pertaining to the trading system, and agriculture.

Opening Markets is opening opportunities: The open markets of the developing countries would be the assurance of long-term economic growth for the same. The developing countries need to participate in the trading system and global economy. The new global trade negotiations would be helped by the new WTO global trading system, which puts the developing nations parallel to the developed nations

Consumer Benefits: With the open market policy the consumers have more and better options to choose from the market.

Q4 What do you mean by globalization and what are the reasons of integration of financial integration.?

Ans **Globalization** is the process of international integration arising from the interchange of products, ideas, and other aspects of culture. Put in simple terms, globalization refers to processes that promote world-wide exchanges of national and cultural resources. Advances in transportation and telecommunications infrastructure, including the rise of the Internet, are major factors in globalization, generating further interdependence of economic and cultural activities.

Reason of Financial integration

(A) The development of new financial integration.
(B) Liberalization of regulation governing the financial market.
(C) Increased cross penetration of foreign ownership.

Q5 What are the role of EXIM bank of India in trade?

Ans The EXIM Bank of India was set up to finance and promote foreign trade. Exim Bank is managed by a Board of Directors, which has representatives from the Government, Reserve Bank of India, Export Credit Guarantee Corporation of India, a financial institution, public sector banks, and the business community.

EXIM bank has several operating groups :

(A) Corporate Banking Group
(B) Project Finance / Trade Finance Group
(C) Small and Medium Enterprise:
(D) Export Services Group offers variety of advisory and value-added information services aimed at investment promotion.
(E) Export Marketing Services
(F) Support Services groups, which include: Research & Planning, Corporate Finance, Loan Recovery, Internal Audit, Management Information Services, Information Technology, Legal, Human Resources Management and Corporate Affairs.

The main functions of the EXIM Bank are as follows:

(i) Financing of exports and imports of goods and services, not only of India but also of the third world countries;
(ii) Financing of exports and imports of machinery and equipment on lease basis;
(iii) Financing of joint ventures in foreign countries;
(iv) Providing loans to Indian parties to enable them to contribute to the share capital of joint ventures in foreign countries;
(v) to undertake limited merchant banking functions such as underwriting of stocks, shares, bonds or debentures of Indian companies engaged in export or import; and
(vi) To provide technical, administrative and financial assistance to parties in connection with export and import.

Q6 Explain the different factors those affect the international financial Market?

Ans Factors affecting the F M

1. Interest Rates

"Benchmark" interest rates from central banks influence the retail rates financial institutions charge customers to borrow money. For instance, if the economy is under-performing, central banks may lower interest rates to make it cheaper to borrow; this often boosts consumer spending, which may help expand the economy. To slow the rate of inflation in an overheated economy, central banks raise the benchmark so borrowing is more expensive.

2Economic Growth and health

Reports such as Empolyment levels, retail sales ,GDP ,capacity utilization detail the levels of a country economic growth and health.

3 balance of trade: A country's balance of trade is the total value of its exports, minus the total value of its imports. If the country exports are greater than imports than the BOT is favorable another unfavorable. Favorable balance increases the demand of currency because foreign buyers must exchange more of their home currency in order to buy its goods. A trade deficit, on the other hand, increases the supply of a country's currency and could lead to devaluation if supply greatly exceeds demand.

4Employment Outlook

Employment levels have an immediate impact on economic growth. As unemployment increases, consumer spending falls because jobless workers have less money to spend on non-essentials. Those still employed worry for the future and also tend to reduce spending and save more of their income

5 Inflation levels and trade: a currency will loose value if there is high level of inflation in the country because inflation erodes the purchasing power.

Unit-2
Balance of Payment

Q.1 What do you mean by balance of Payment?

Ans. Balance of payments (BoP) accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, financial capital, and financial transfers.

The IMF definition

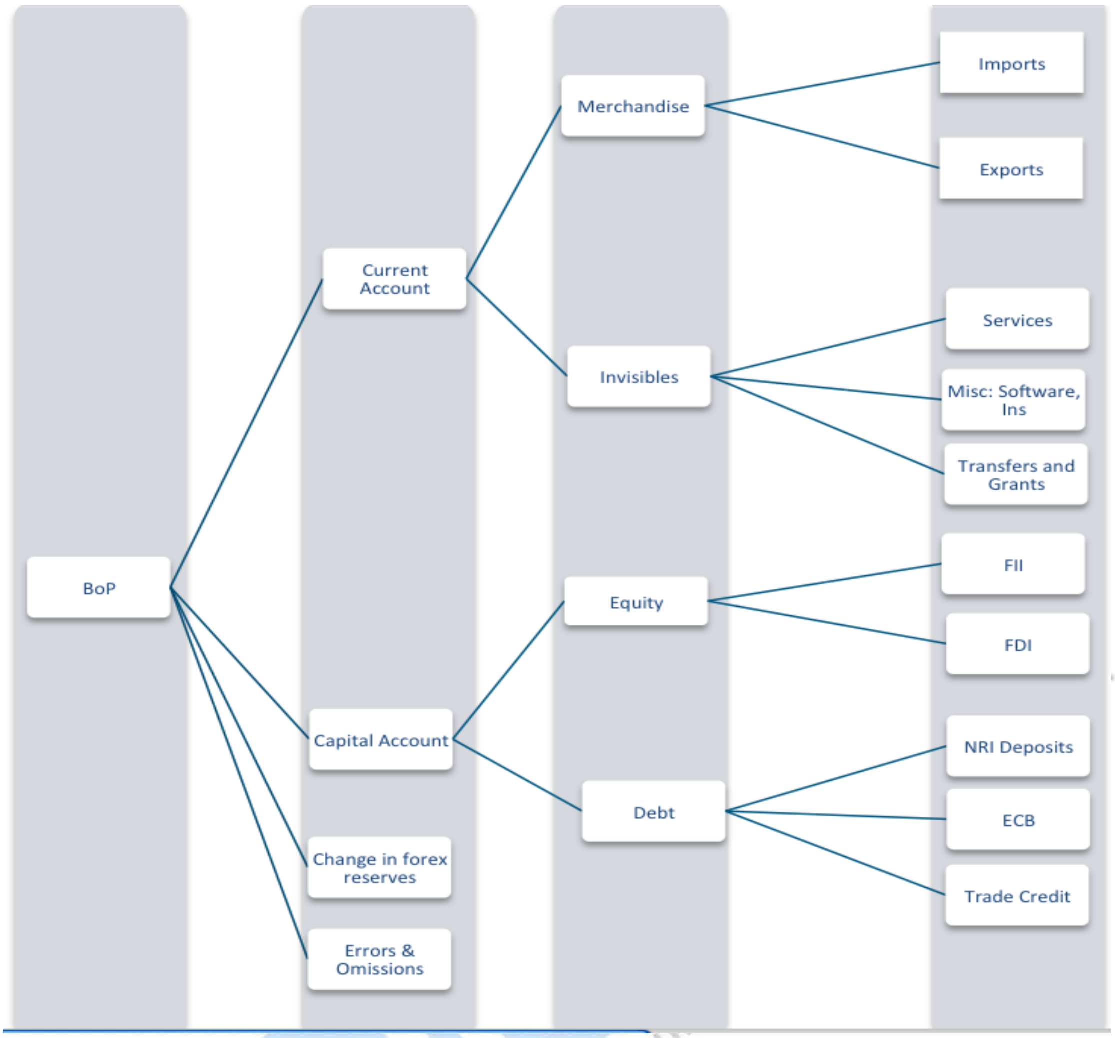
The International Monetary Fund (IMF) use a particular set of definitions for the BOP accounts, which is also used by the Organization for Economic Cooperation and Development (OECD), and the United Nations System of National Accounts (SNA).

The main difference in the IMF's terminology is that it uses the term "financial account" to capture transactions that would under alternative definitions be recorded in the *capital account*. The IMF uses the term *capital account* to designate a subset of transactions that, according to other usage, form a small part of the overall capital account.[6] The IMF separates these transactions out to form an additional top level division of the BOP accounts. Expressed with the IMF definition, the BOP identity can be written:

$$\text{current account} + \text{financial account} + \text{capital account} + \text{balancing item} = 0.$$

The IMF uses the term *current account* with the same meaning as that used by other organizations, although it has its own names for its three leading sub-divisions, which are:

- The goods and services account (the overall trade balance)
- The primary income account (factor income such as from loans and investments)
- The secondary income account (transfer payments)



Q.2 Explain the current account of balance of Payment?

Ans **Current Account transactions**: The Current accounts records the transaction in merchandise and invisibles with the rest of the world. Merchandise covers imports and exports and invisibles includes travel transportation insurance , investment and other services. The current account mainly consists of 4 types of transactions.

Exports and imports of goods

- { Exports of goods are credits (+) to the current account
- { Imports of goods are debits (-) to the current account

Exports and imports of services

- { Exports of services are credits to the current account (+)
- { Imports of services are debits to the current account (-).

Interest payments on international investments.

- { Interest, dividends and other income received on U.S. assets held abroad are credits
  (+)
- { Interest, dividends and payments made on foreign assets held in the U.S. are debits
  (-).
  Since 1994, the U.S. has run a net debit in the investment income account: more payments are made to foreigners than foreigners make to U.S. investors.

Current transfers

- { Remittances by Americans working abroad, pensions paid by foreign countries to
  their citizens living in the U.S., aid offered by foreigners to the U.S. count as credits
  (+).
- { Remittances by foreigners working in the U.S., pensions paid by the United States
  to its citizens living abroad, aid offered to foreigners by the U.S. count as debits (-)
  As expected the U.S. runs a deficit in current transfers.

  The sum of these components is known as the current account balance. A negative number is called a current account deficit and a positive number called a current account surplus. As expected, given that it runs a surplus only in the services component of the current account,
  the U.S. runs a substantial current account deficit.

Q.3 Explain Capital account of Balance of payment?

Ans In the case of the capital account an increase (decrease) in he county foreign financial assets are debit (credit) whereas any increase (decrease) in the country foreign financial liabilities are credits (debits).
The transaction under the Capital account are Classified

- Foreign Investment
- Loans
- Banking Capital
- Rupee debt services
- Other debt capital

Loans include the concessional loans received by the government' or public sector bodies , long term loan and medium term borrowings from the commercial capital market in the form of loans Bond issue and short term credits. Disbursement received by Indian resident entities are the credit Items while payment and loans made by the Indians are the credit items

All inflow of the Foreign capital comes credit item of the Balance of payment/Banking capital covers the changes in the foreign assets and liabilities of commercial banks whether privately owned or the comparative and government owned.

An decrease in assets and increase in liability is a credit item.

The item Rupee debt services defined as the cost of meeting inters payments and regular contractual repayments of the principal of a loan along with the any administrate charges in rupee by India.

Q4 What are factors affecting the components of BOP account?

Ans

<table>
<tr><td>Exports of goods and services</td><td>Imports of goods or services</td></tr>
<tr><td colspan="2">Exports of goods and services affected by Following factors
The prevailing rate of domestic currency
Inflation rate
Income of foreigners
World price f the commodity
Trade barriers.
Imports of Goods and services
Level of Domestic Income
International prices
Inflation rate
Value of Domestic Currency
Trade Barriers</td></tr>
</table>

Unit-3
(International Financial management)
Risk

Q.1 What do you mean by country Risk and explain the different type of risk that need to considered while investing in foreign country?

Ans A collection of risks associated with investing in a foreign country. These risks include political risk, exchange rate risk, economic risk, sovereign risk and transfer risk, which is the risk of capital being locked up or frozen by government action. Country risk varies from one country to the next. Some countries have high enough risk to discourage much foreign investment.

Country risk can reduce the expected return on an investment and must be taken into consideration whenever investing abroad. Some country risk does not have an effective hedge. Other risk, such as exchange rate risk, can be protected against with a marginal loss of profit potential.

The United States is generally considered the benchmark for low country risk and most nations can have their risk measured as compared to the U.S. Country risk is higher with longer term investments and direct investments, which are investments not made through a regulated market or exchange.

Economic and Political Risk

The following are two main sources of risk that need be considered when investing in a foreign country.

- ***Economic risk***: This risk refers to a country's ability to pay back its debts. A country with stable finances and a stronger economy should provide more reliable investments than a country with weaker finances or an unsound economy.
- ***Political risk*****:** This risk refers to the political decisions made within a country that might result in an unanticipated loss to investors. While economic risk is often referred to as a country's *ability* to pay back its debts, political risk is sometimes referred to as the *willingness* of a country to pay debts or maintain a hospitable climate for outside investment. Even if a country's economy is if the political climate is unfriendly (or becomes unfriendly) to outside investors, the country may not be a good candidate for investment.

Q2 What do you mean by currency risk and how to manage this risk?

Ans Currency risk is a form of risk that originates from changes in the relative valuation of currencies. These changes can result in unpredictable gains and

losses when the profits or dividends from an investment are converted from the foreign currency into U.S. dollars. Investors can reduce currency risk by using hedges and other techniques designed to offset any currency-related gains or losses.
For example, suppose that a U.S.-based investor purchases a German stock for 100 euros. While holding this bond, the euro exchange rate falls from 1.5 to 1.3 euros per U.S. dollar. When the investor sells the bonds, he or she will realize a 13% loss upon conversion of the profits from euros to U.S. dollars. However, if that investor hedged his or her position by simultaneously short-selling the euro, then the profit from the euro's decline would offset the 13% loss upon conversion.

How to Manage Currency Risk
International investors have several options when it comes to managing currency risk, including things like currency futures, forwards and options. But these instruments are often expensive and complicated to use for individual investors. One simple, flexible and liquid alternative to hedge against currency risk are currency-focused exchange-traded funds (ETFs).
There are several large financial institutions that offer currency-focused ETFs. The two most popular providers are Currency Shares and Wisdom Tree, which both offer a wide variety of ETFs covering a number of different currencies around the world. These currencies include popular international investment destinations ranging from Canada to emerging markets like China and Brazil.

Unit-4
Intricacies of Foreign Exchange Markets

Q.1 Explain the basic framework of Foreign exchange market?

Ans. Foreign exchange market

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

Characteristics of foreign exchange market

- Electronic market
- Geographical Dispersal
- Transfer of purchasing power
- Intermediary
- Volume
- Provision of credit
- Minimizing Risk.

Q.2 Explain the various Market participates of foreign exchange Market?

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

Market participants

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

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

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

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

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

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

Q.3 Discuss the American depository receipts?

Ans American Depository Receipts popularly known as ADRs were introduced in the American market in 1927. ADR is the dollar denominated negotiable certificates ,it represents non US companies public traded equity.ADRs are one type of depositary receipt (DR), Each DR is issued by a domestic depositary bank when the underlying shares are deposited in a foreign custodian bank, usually by a broker who has purchased the shares in the open market local to the foreign company.

ADR Divided into three levels

- ADR Level I
- ADR level II
- ADRlevel III

- ADR Level I: This type of instrument is traded into the US OTC market. In this instrument only minimum disclosure is required to the SEC and the issuer need not to comply with the US GAAP. the issuer is not allowed to raise fresh capital or list on any one of the national Stock exchange.

- ADR level II: Significant disclosure has to be made to the SEC. the Company is allowed to AMEX and NYSE which implies that the company must meet the listing requirement of the particular Exchange

- ADR level III Used to issue the fresh capital through Public offering in the US capital Market. The Company comply with the listing requirement of AMEX/NYSE and has to be registered with the SEC.

Advantages

- ADRs are an easy and cost effective way to buy shares of a foreign company.
- Foreign entities prefer ADRs, because they get more U.S. exposure and it allows them to tap the American equity markets.

Q.4 Discuss the GDR (Global Depository receipts and what the difference between the ADR and the GDR are.

Ans. GDR

A **global depository receipt** or **global depositary receipt** (GDR) is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account. GDRs represent ownership of an underlying number of shares. GDR are essentially those instrument which posses a certain number of underlying shares in the custodial domestic bank of the company. It is a negotiable instrument which represents the publicly traded local currency equity share. In simple words GDR is A bank certificate issued in more than one country for shares in a foreign company. The shares are held by a foreign branch of an international bank. The shares trade as domestic shares, but are offered for sale globally through the various bank branches.

Several international banks issue GDRs, such as JPMorgan Chase, Citigroup, Deutsche Bank, Bank of New York. GDRs are often listed in the Frankfurt Stock Exchange, Luxembourg Stock Exchange and in the London Stock Exchange.

Difference between ADR and the GDR

1. Global depository receipt (GDR) is compulsory for foreign company to access in any other country's share market for dealing in stock. But American

depository receipt (ADR) is compulsory for non –us companies to trade in stock market of USA.

2. ADRs can get from level -1 to level –III. GDRs are already equal to high preference receipt of level –II and level –III.
3. Indian companies prefer to get GDR due to its global use for getting foreign investment for own business projects.
4. ADRs up to level –I need to accept only general condition of SEC of USA but GDRs can only be issued under rule 144 A after accepting strict rules of SEC of USA .
5. GDR is negotiable instrument all over the world but ADR is only negotiable in USA .
6. Many Indian Companies listed foreign stock market through foreign bank's GDR. **Names of these Indian Companies are following :-** (A) Bajaj Auto (B) Hindalco (C) ITC (D) L&T (E) Ranbaxy Laboratories (F) SBI **Some of Indian Companies are listed in USA stock exchange only through ADRs** :- (A) Patni Computers (B) Tata Motors
7. Even both GDR and ADR is the proxy way to sell shares in foreign market by India companies ADRs is not substitute of GDRs but GDRs can use on the place of ADRs .
8. Investors of UK can buy GDRs from London stock exchange and Luxemburg stock exchange and invest in Indian companies without any extra responsibilities . Investors of USA can buy ADRs from New York stock exchange (NYSE) or NASDAQ (National Association of Securities Dealers Automated Quotation).
9. American investors typically use regular equity trading accounts for buying ADRs but not for GDRs .
10. The US dollar rate paid to holders of ADRs is calculated by applying the exchange rate used to convert the foreign dividend payment (net of local withholding tax) to US dollars, and adjusting the result according to the ordinary share but GDRs is calculated on numbers of Shares . One GDR's Value may be on two or six shares

Q.3 Discuss the organization and the function of the World Bank?

Ans. The **World Bank** is an international financial institution that provides loans to developing countries for capital programs. The World Bank's official goal is the reduction of poverty. the World Bank comprises:

- the International Bank for Reconstruction and Development (IBRD)
- the International Development Association (IDA)
- International Finance Corporation (IFC)
- Multilateral Investment Guarantee Agency (MIGA),
- International Centre for Settlement of Investment Disputes (ICSID).

IBRD: is an international financial institution which offers loans to middle-income developing countries. It was established in 1944 with the mission of financing the reconstruction of European nations devastated by World War II. The IBRD provides commercial-grade or concessional financing to sovereign states to fund projects that seek to improve transportation and infrastructure, education, domestic policy, environmental consciousness, energy investments, healthcare, access to food and potable water, and access to improved sanitation.

(IDA): is an international financial institution which offers concessional loans and grants to the world's poorest developing countries. It was established in 1960 to complement the existing International Bank for Reconstruction and Development by lending to developing countries which suffer from the lowest gross national income, from troubled creditworthiness, or from the lowest per capita income.

(IFC): is an international financial institution which offers investment, advisory, and asset management services to encourage private sector development in developing countries. It was established in 1956 as the private sector arm of the World Bank Group to advance economic development by investing in strictly for-profit and commercial projects which reduce poverty and promote development.

(MIGA), is an international financial institution which offers political risk insurance guarantees. Such guarantees help investors protect foreign direct investments against political and non-commercial risks in developing countries.

(ICSID) is an international arbitration institution which facilitates arbitration and conciliation of legal disputes between international investors.

Functions

- The assistance and development of territories of its members
- The promotion of a balanced growth in international trade
- Promote world development, increase productivity and standards of leaving in the less developed countries of its membership
- Ensure Environmental Sustainability.
- Develop a Global Partnership for Development

Q4 Discuss the financial instruments of the international financial market?

Ans **Financial instruments**

Spot :. A foreign exchange spot transaction, also known as FX spot, is an agreement between two parties to buy one currency against selling another currency at an agreed price for settlement on the spot date. The exchange rate at which the transaction is done is called the spot exchange rate.

Forward : The forward market is the informal over-the-counter financial market by which contracts for future delivery are entered into. Over-the-counter (OTC) or off-exchange trading is done directly between two parties, without any supervision of an exchange.

Future : Standardized forward contracts are called futures contracts and traded on a futures exchange. a futures contract (more colloquially, futures) is a standardized contract between two parties to buy or sell a specified asset of standardized quantity and quality for a price agreed upon today (the *futures price* or strike price) with delivery and payment occurring at a specified future date.

Swap : a foreign exchange swap, forex swap, or FX swap is a simultaneous purchase and sale of identical amounts of one currency for another with two different value dates (normally spot to forward).

Option : A foreign exchange option (commonly shortened to just FX option) is a derivative where the owner has the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date. The options market is the deepest, largest and most liquid market for options of any kind in the world.

Q5 Explain the letter of credit and discuss the different parties involved in the letter of credit?

Ans 5 Letters of credit are often used in international transactions to ensure that payment will be received. Due to the nature of international dealings including factors such as distance, differing laws in each country and difficulty in knowing each party personally, the use of letters of credit has become a very important aspect of international trade. The bank also acts on behalf of the buyer (holder of letter of credit) by ensuring that the supplier will not be paid until the bank receives a confirmation that the goods have been shipped.

Parties to Letters of Credit

- **Applicant (Opener):** Applicant which is also referred to as account party is normally a buyer or customer of the goods, who has to make payment to beneficiary. LC is initiated and issued at his request and on the basis of his instructions.
- **Issuing Bank (Opening Bank) :** The issuing bank is the one which create a letter of credit and takes the responsibility to make the payments on receipt of the documents from the beneficiary or through their banker. The payments has to be made to the beneficiary within seven working days from the date of receipt of documents at their end, provided the documents are in accordance with the terms and conditions of the letter of credit. If the documents are discrepant one, the rejection thereof to be communicated within seven working days from the date of of receipt of documents at their end.
- **Beneficiary:** Beneficiary is normally stands for a seller of the goods, who has to receive payment from the applicant. A credit is issued in his favour to enable him or his agent to obtain payment on surrender of stipulated document and comply with the term and conditions of the L/c.

If L/c is a transferable one and he transfers the credit to another party, then he is referred to as the first or original beneficiary.

- **Advising Bank:** An Advising Bank provides advice to the beneficiary and takes the responsibility for sending the documents to the issuing bank and is normally located in the country of the beneficiary.
- **Confirming Bank:** Confirming bank adds its guarantee to the credit opened by another bank, thereby undertaking the responsibility of payment/negotiation acceptance under the credit, in additional to that of the issuing bank. Confirming bank play an important role where the exporter is not satisfied with the undertaking of only the issuing bank.
- **Negotiating Bank:** The Negotiating Bank is the bank who negotiates the documents submitted to them by the beneficiary under the credit either advised through them or restricted to them for negotiation. On negotiation of the documents they will claim the reimbursement under the credit and makes the payment to the beneficiary provided the documents submitted are in accordance with the terms and conditions of the letters of credit.
- **Reimbursing Bank:** Reimbursing Bank is the bank authorized to honor the reimbursement claim in settlement of negotiation/acceptance/payment lodged with it by the negotiating bank. It is normally the bank with which issuing bank has an account from which payment has to be made.
- **Second Beneficiary:** Second Beneficiary is the person who represent the first or original Beneficiary of credit in his absence. In this case, the credits belonging to the original beneficiary is transferable. The rights of the transferee are subject to terms of transfer.

Q 5 What are the different types of letter of credit?

Ans Types of Letter of Credit

1. Revocable Letter of Credit L/c

A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. It is rarely used in international trade and not considered satisfactory for the exporters but has an advantage over that of the importers and the issuing bank.

There is no provision for confirming revocable credits as per terms of UCPDC, Hence they cannot be confirmed. It should be indicated in LC that the credit is revocable. if there is no such indication the credit will be deemed as irrevocable.

2. Irrevocable Letter of Credit L/c

In this case it is not possible to revoked or amended a credit without the agreement of the issuing bank, the confirming bank, and the beneficiary. Form an exporters point of view it is believed to be more beneficial. An irrevocable letter of credit from the issuing bank insures the beneficiary that if the required documents are presented and the terms and conditions are complied with, payment will be made.

3. Confirmed Letter of Credit L/c
Confirmed Letter of Credit is a special type of L/c in which another bank apart from the issuing bank has added its guarantee. Although, the cost of confirming by two banks makes it costlier, this type of L/c is more beneficial for the beneficiary as it doubles the guarantee.

4. Sight Credit and Usance Credit L/c
Sight credit states that the payments would be made by the issuing bank at sight, on demand or on presentation. In case of usance credit, draft are drawn on the issuing bank or the correspondent bank at specified usance period. The credit will indicate whether the usance drafts are to be drawn on the issuing bank or in the case of confirmed credit on the confirming bank.

5. Back to Back Letter of Credit L/c
Back to Back Letter of Credit is also termed as Countervailing Credit. A credit is known as back to back credit when a L/c is opened with security of another L/c.
A back to back credit which can also be referred as credit and countercredit is actually a method of financing both sides of a transaction in which a middleman buys goods from one customer and sells them to another.
The parties to a Back toBack Letter of Credit are:

1. The buyer and his bank as the issuer of the original Letter of Credit.

2. The seller/manufacturer and his bank,

3. The manufacturer's subcontractor and his bank.

The practical use of this Credit is seen when L/c is opened by the ultimate buyer in favour of a particular beneficiary, who may not be the actual supplier/ manufacturer offering the main credit with near identical terms in favour as security and will be able to obtain reimbursement by presenting the documents received under back to back credit under the main L/c.

The need for such credits arise mainly when :
1. The ultimate buyer not ready for a transferable credit
2. The Beneficiary do not want to disclose the source of supply to the openers.
3. The manufacturer demands on payment against documents for goods but the beneficiary of credit is short of the funds

6. Transferable Letter of Credit L/c
A transferable documentary credit is a type of credit under which the first beneficiary which is usually a middleman may request the nominated bank to transfer credit in whole or in part to the second beneficiary.

The L/c does state clearly mentions the margins of the first beneficiary and unless it is specified the L/c cannot be treated as transferable. It can only be used when the company is selling the product of a third party and the proper care has to be taken about the exit policy for the money transactions that take place.

This type of L/c is used in the companies that act as a middle man during the transaction but don't have large limit. In the transferable L/c there is a right to substitute the invoice and the whole value can be transferred to a second beneficiary.

The first beneficiary or middleman has rights to change the following terms and conditions of the letter of credit:

1. Reduce the amount of the credit.
2. Reduce unit price if it is stated
3. Make shorter the expiry date of the letter of credit.
4. Make shorter the last date for presentation of documents.
5. Make shorter the period for shipment of goods.
6. Increase the amount of the cover or percentage for which insurance cover must be effected.
7. Substitute the name of the applicant (the middleman) for that of the first beneficiary (the buyer).

Standby Letter of Credit L/c

Initially used by the banks in the United States, the standby letter of credit is very much similar in nature to a bank guarantee. The main objective of issuing such a credit is to secure bank loans. Standby credits are usually issued by the applicant's bank in the applicant's country and advised to the beneficiary by a bank in the beneficiary's country.

Unlike a traditional letter of credit where the beneficiary obtains payment against documents evidencing performance, the standby letter of credit allow a beneficiary to obtains payment from a bank even when the applicant for the credit has failed to perform as per bond.

A standby letter of credit is subject to "Uniform Customs and Practice for Documentary Credit" (UCP), International Chamber of Commerce Publication No 500, 1993 Revision, or "International Standby Practices" (ISP), International Chamber of Commerce Publication No 590, 1998.

Import Operations Under L/c

The Import Letter of Credit guarantees an exporter payment for goods or services, provided the terms of the letter of credit have been met.

A bank issue an import letter of credit on the behalf of an importer or buyer under the following Circumstances

- When a importer is importing goods within its own country.
- When a trader is buying good from his own country and sell it to the another country for the purpose of merchandizing trade.

- When an Indian exporter who is executing a contract outside his own country requires importing goods from a third country to the country where he is executing the contract.

Q.6 What do you mean by forfeiting and what are the benefits of the forfeiting?

Ans The terms forfeiting is originated from a old French word 'forfait', which means to surrender ones right on something to someone else. In international trade, forfeiting may be defined as the purchasing of an exporter's receivables at a discount price by paying cash. By buying these receivables, the forfeiter frees the exporter from credit and the risk of not receiving the payment from the importer.

Benefits to Exporter

- **100 per cent financing:** Without recourse and not occupying exporter's credit line That is to say once the exporter obtains the financed fund, he will be exempted from the responsibility to repay the debt.
- **Improved cash flow:** Receivables become current cash inflow and its is beneficial to the exporters to improve financial status and liquidation ability so as to heighten further the funds raising capability.
- **Reduced administration cost:** By using forfeiting, the exporter will spare from the management of the receivables. The relative costs, as a result, are reduced greatly.
- **Advance tax refund:** Through forfeiting the exporter can make the verification of export and get tax refund in advance just after financing.
- **Risk reduction:** forfeiting business enables the exporter to transfer various risk resulted from deferred payments, such as interest rate risk, currency risk, credit risk, and political risk to the forfeiting bank.
- **Increased trade opportunity:** With forfeiting, the export is able to grant credit to his buyers freely, and thus, be more competitive in the market.

Benefits to Banks

Forfeiting provides the banks following benefits:

- Banks can offer a novel product range to clients, which enable the client to gain 100% finance, as against 80-85% in case of other discounting products.
- Bank gain fee based income.
- Lower credit administration and credit follow up.

Q.7 Explain the meaning of factoring and what are the different type of factoring?

Ans Definition of Factoring

Definition of factoring is very simple and can be defined as the conversion of credit sales into cash. Here, a financial institution which is usually a bank buys the accounts receivable of a company usually a client and then pays up to 80% of the amount immediately on agreement. The remaining amount is paid to the client when the customer pays the debt. Examples includes factoring against goods purchased, factoring against medical insurance, factoring for construction services etc.

Characteristics of Factoring

1. The normal period of factoring is 90,150 days and rarely exceeds more than 150 days.
2. It is costly.
3. Factoring is not possible in case of bad debts.
4. Credit rating is not mandatory.
5. It is a method of off balance sheet financing.
6. Cost of factoring is always equal to finance cost plus operating cost.

Different Types of Factoring

1. Disclosed
2. Undisclosed

1. Disclosed Factoring

In disclosed factoring, client's customers are aware of the factoring agreement. Disclosed factoring is of two types:

***Recourse factoring*:** The client collects the money from the customer but in case customer don't pay the amount on maturity then the client is responsible to pay the amount to the factor. It is offered at a low rate of interest and is in very common use.

Nonrecourse factoring: In nonrecourse factoring, factor undertakes to collect the debts from the customer. Balance amount is paid to client at the end of the credit period or when the customer pays the factor whichever comes first. The advantage of nonrecourse factoring is that continuous factoring will eliminate the need for credit and collection departments in the organization.

2. Undisclosed

In undisclosed factoring, client's customers are not notified of the factoring arrangement. In this case, Client has to pay the amount to the factor irrespective of whether customer has paid or not.

Unit 5
Foreign Exchange market
(Exchange rate Quotation)

Q.1 Explain the Market rate Quotations and discuss the currency rate fluctuation?

Ans A currency pair is the quotation of the relative value of a currency unit against the unit of another currency in the foreign exchange market. The quotation EUR/USD 1.2500 means that 1 Euro is exchanged for 1.2500 US dollars.

Quotes using a country's home currency as the price currency (e.g., EUR 0.735342 = USD 1.00 in the euro zone) are known as direct quotation or price quotation (from that country's perspective)[4] and are used by most countries.

Quotes using a country's home currency as the unit currency (e.g., EUR 1.00 = USD 1.35991 in the euro zone) are known as indirect quotation or quantity quotation and are used in British newspapers and are also common in Australia, New Zealand and the euro zone.

Fluctuation in the exchange rate

A market based exchange rate will change whenever the values of either of the two component currencies change.

- A currency will tend to become more valuable whenever demand for it is greater than the available supply.
- It will become less valuable whenever demand is less than available supply (this does not mean people no longer want money, it just means they prefer holding their wealth in some other form, possibly another currency).

Q.2 Explains the Bid and ask rate with the example?

Ans Bids are the highest price that the seller is offering for the particular currency. On the other hand, ask is the lowest price acceptable to the buyer. Together the two prices constitute a quotation and the difference between the price offered by a dealer willing to sell something and the price he is willing to pay to buy it back.

The rate at which a bank is ready to buy a currency will be different from the rate at which it stands to ready to sell that currency. This rate are called the bid and ask rate . The difference in these rates represents the cost of bank incur on these transaction.

The bid ask spread is amount by which the ask price exceeds the bid. It is difference bid and ask price. For example, if the bid price is $20 and the ask price is $21 then the "bid ask spread" is $1.

The spread is usually rates as percentage cost of transacting in the forex market, which is computed as follow :

Percent spread =(Ask price- Bid price)/Ask price *100

The main advantage of bid and ask methods is that conditions are laid out in advance and transactions can proceed with no further permission or authorization from any participants. When any bid and ask pair are compatible, a transaction occurs, in most cases automatically.

Q. 3 What are the important factor that effect the risk profile of International Transaction?

Ans Forex market is one of the largest financial markets in the world, where buyers and sellers conduct foreign exchange transactions. Its important in the international trade can be estimated with the fact that average daily trade in the global forex markets is over US $ 3 trillion. We shall touch upon some important topics that affect the risk profile of an International transaction.

Spot Rate
Also known as "benchmark rates", "straightforward rates"or "outright rates", spot rates is an agreement to buy or sell currency at the current exchange rate. The globally accepted settlementcycle for foreignexchange contracts is two days. Foreignexchange contracts are therefore settled on the second day after the day the deal is made.

Forward Price
Forward price is a fixed price at which a particular amount of a commodity, currency or security is to be delivered on a fixed date in the future, possibly as for as a year ahead. Traders agree to buy and sell currencies for settlement at least three days later, at predetermined exchange rates. This type of transaction often is used by business to reduce their exchange rate risk.

Forward Price vs. Spot Price
Theoretically it is possible for a forward price of a currency to equal its spot price However, interest rates must be considered . The interest rate can be earned by holding different currencies usually varies, therefore forward price can be higher or lower than (at premium or discount to) the spot prices.

RBI Reference Rate
There reference rate given by RBI is based on 12 noon rates of a few selected banks in Mumbai.

Inter Bank Rates
Interbank rates rates quotes the bank for buying and selling foreign currency in the inter bank market, which works on wafer thin margins . For inter bank transactions the quotation is up to four decimals with the last two digits in multiples of 25.

Telegraphic Transfer
Telegraphic transfer or in short TT is a quick method of transfer money from one bank to another bank. TT method of money transfer has been introduced to solve the delay problems caused by cheques or demand drafts. In this method, money does not move physically and order to pay is wired to an institutions' casher to make payment to a company or individual. A cipher code is appended to the text of the message to ensure its integrity and authenticity during transit. The same principle applies with Western Union and Money Gram.

Currency Rate
The Currency rate is the rate at which the authorized dealer buys and sells the currency notes to its customers. It depends on the TC rate and is more than the TC rate for the person who is buying them.

Cross Rate
In inter bank transactions all currencies are normally traded against the US dollar, which becomes a frame of reference. So if one is buying with rupees a currency X which is not normally traded, one can arrive at a rupee exchange rate by relating the rupee $ rate to the $X rate . This is known as a cross rate.

Long and Short
When you go long on a currency, its means you bought it and are holding it in the expectation that it will appreciate in value. By contrast, going short means you reselling currency in the expectation that what you are selling will depreciate in value.

Bid and Ask
Bids are the highest price that the seller is offering for the particular currency. On the other hand, ask is the lowest price acceptable to the buyer.Together, the two prices constitute a quotation and the difference between the price offered by a dealer willing to sell something and the price he is willing to pay to buy it back.

The bidask spread is amount by which the ask price exceeds the bid. This is essentially the difference in price between the highest price thata buyer is willing to pay for an asset and the lowest price for whicha seller is willing to sell it.
For example, if the bid price is $20 and the ask price is $21 then the "bidask spread" is $1.
The spread is usually rates as percentage cost of transacting in the forex market, which is computed as follow :

Percent spread =(Ask priceBid price)/Ask price *100

The main advantage of bid and ask methods is that conditions are laid out in advance and transactions can proceed with no further permission or authorization from any participants. When any bid and ask pair are compatible, a transaction occurs, in most cases automatically.

Buying and Selling

In terms of foreign exchange, buying means purchasing a certain amount of the foreign currency at the bid or buying price against the delivery /crediting of a second currency which is also called counter currency.

On the other hand, selling refers to a fix amount of foreign currency at the offered or selling price against the receipt / debiting of another currency.

FOREX Rates vs. Interest Rates

Forex rates or exchange rate is the price of a country's currency in terms of another country's currency. It specifies how much one currency is worth in terms of the other. For example a forex rate of 123 Japanese yen (JPY, ¥) to the United States dollar (USD, $) means that JPY 123 is worth the same as USD 1.

Choice of currency and its interest rate is a major concern in the international trade. Investors are easily attracted by the higher interest rates which in turns also effects the economy of a nation and its currency value.

For an example, if interest rate on INR were substantially higher than the interest rate on USD, more USD would be converted into INR and pumped into the Indian economic system. This would result in appreciation of the INR, resulting in lower conversion rates of USD against INR, at the time of reconversion into USD.

Calculating the Forward Rates

A forward rate is calculated by calculating the interest rate difference between the two currencies involved in the transactions. For example, if a client is buying a 30 days US dollar then, the difference between the spot rate and the forward rate will be calculated as follow:

The US dollars are purchased on the spot market at an appropriate rate, what causes the forward contract rate to be higher or lower is the difference in the interest rates between India and the United States.

The interest rate earned on US dollars is less than the interest rate earned on Indian Rupee (INR). Therefore, when the forward rates are calculated the cost of this interest rate differential is added to the transaction through increasing the rate.

USD 100,000 X 1.5200 = INR 152,000

INR 152,000 X 1% divided by 12 months = INR 126.67

INR 152,000 + INR 126.67 = INR 152,126.67

INR 152,126.67/USD 100,000 = 1.5213

Unit-6
Parity conditions in International Finance

Q1 What do you mean by purchasing power parity?

Ans **Purchasing power parity** (**PPP**) is an economic theory and a technique used to determine the relative value of currencies, estimating the amount of adjustment needed on the exchange rate between countries in order for the exchange to be equivalent to (or on par with) each currency's purchasing power. PPP theory specify a precise relationship between relative inflation rates of two countries and their exchange rates . PPP theory suggest that the equilibrium exchange rate will adjust the same magnitude as the differential in inflation rates between two countries .

Q2 Explain the covered interest rate parity?

Ans This term refers to a condition where the relationship between interest rates and the spot and forward currency values of two countries are in equilibrium. As a result, there are no interest rate arbitrage opportunities between those two currencies.

When the no-arbitrage condition is satisfied *with* the use of a forward contract to hedge against exposure to exchange rate risk, interest rate parity is said to be *covered*. Investors will still be indifferent among the available interest rates in two countries because the forward exchange rate sustains equilibrium such that the dollar return on dollar deposits is equal to the dollar return on foreign deposit, thereby eliminating the potential for covered interest arbitrage profits. Furthermore, covered interest rate parity helps explain the determination of the forward exchange rate. The following equation represents covered interest rate parity.

$$(1 + i_\$) = \frac{F_t}{S_t}(1 + i_c)$$

where

F_t is the forward exchange rate at time *t*

The dollar return on dollar deposits, $1 + i_\$$, is shown to be equal to the dollar return on euro deposits, $\frac{F_t}{S_t}(1 + i_c)$.

Q 3 Discuss the uncovered interest rate parity?

Ans When the no-arbitrage condition is satisfied *without* the use of a forward contract to hedge against exposure to exchange rate risk, interest rate parity is said to be *uncovered*. Risk-neutral investors will be indifferent among the available interest rates in two countries because the exchange rate between those countries is expected to adjust such that the dollar return on dollar deposits is equal to the dollar return on foreign deposits, thereby eliminating the potential for uncovered interest arbitrage profits. Uncovered interest rate parity helps explain the determination of the spot exchange rate. The following equation represents uncovered interest rate parity.[1]

$$(1 + i_\$) = \frac{E_t(S_{t+k})}{S_t}(1 + i_c)$$

where

$E_t(S_{t+k})$ is the expected future spot exchange rate at time $t + k$

k is the number of periods into the future from time t

S_t is the current spot exchange rate at time t

$i_\$$ is the interest rate in the US

i_c is the interest rate in a foreign country or currency area (for this example, following a US perspective, it is the interest rate available in the Eurozone)

The dollar return on dollar deposits, $1 + i_\$$, is shown to be equal to the dollar return on euro deposits, $\frac{E_t(S_{t+k})}{S_t}(1 + i_c)$

Unit-7
Syndicated loan

Q1 What do you mean by loan syndication?

Ans loan offered by a group of lenders (called a syndicate) who work together to provide funds for a single borrower. The borrower could be a corporation, a large project, or a sovereignty (such as a government). The loan may involve fixed amounts, a credit line, or a combination of the two. Interest rates can be fixed for the term of the loan or floating based on a benchmark rate such as the London Interbank Offered Rate (LIBOR).

Typically there is a lead bank or underwriter of the loan, known as the "arranger", "agent", or "lead lender". This lender may be putting up a proportionally bigger share of the loan, or perform duties like dispersing cash flows amongst the other syndicate members and administrative tasks.

Also known as a "syndicated bank facility".

Q2 Why sell a participation in a syndicated loan?

Ans A lender under a syndicated loan may decide to sell its commitment in a f Facility for one or more of the following reasons:

Releasing capital the loan is a long-term facility, a lender may need to sell its share of the commitment to realize capital or take advantage of new lending opportunities;.

Risk and portfolio management: a lender may consider that its loan portfolio is weighted with too much emphasis on a particular type of borrower or Loan or may wish to alter the yield dynamics of its loan portfolio. By selling its commitment in this loan, it may lend elsewhere, thus diversifying its portfolio

Regulatory Capital Requirements: a bank's ability to lend is subject to both internal and external requirements to retain a certain percentage of its capital as cover for its existing loan obligations.

Crystallise a loss: the lender might decide to sell its commitment if the borrower runs into difficulties -specialists dealing in distressed debts provide a market for such loans.

However, before the lender can go ahead and transfer its participation in a syndicated loan, it must consider the implications of the methods of transfer available to it under the Syndicated Loan Agreement.

Unit-8
Country risk

Q.1 What do you mean by country Risk?

Ans **Country risk** refers to the risk of investing in a country, dependent on changes in the business environment that may adversely affect operating profits or the value of assets in a specific country. For example, financial factors such as currency controls, devaluation or regulatory changes, or stability factors such as mass riots, civil war and other potential events contribute to companies' operational risks. This term is also sometimes referred to as political risk; however, country risk is a more general term that generally refers only to risks affecting all companies operating within a particular country.

Q2 What are the factors responsible for country risk?

Ans

Political factors	Financial Factors	Economical factors	Subjective
Wars	Interest rates	Possibility of recession	Social pressures
Attitude of host govt.	Inflation rates	Diversification of economy	Consumer behavior of host country
Corruption	Fund transfer	Currency devaluation	Productivity restriction
Blockage of fund	Exchange rates	Frequency of	Country attitude

transfer		govt. intervention	towards private enterprises.
Currency inconvertibility	Financial Distress		

Case Study

CASE I. Use the information in the table below to answer the following questions.
SHOW YOUR WORK.

	The Economist Price per issue	Exchange Rate (12/2/99)
United States	\$3.95	--
Canada	C\$ 4.95	1.47 C\$/\$
Japan	¥920	102 ¥/\$

A. Calculate the dollar price of the economist magazine in Canada and Japan as of 12/2/99.

B. Calculate the implied purchasing power parity exchange rates between Canada and the US, and between Japan and the US based on the price of the Economist magazine.

C. Is the US dollar overvalued or undervalued with respect to the Canadian dollar and the Japanese yen in terms of purchases of the Economist? State why it is over or undervalued.

CASE II. Use the information in the table below to answer the following questions.

	Big Mac Price	Exchange Rate (6/4/98)
United States	\$2.53	--
South Korea	won 2600	1475 won/\$
Israel	shekel 12.50	3.70 sh/\$
Poland	zloty 5.30	3.46 zl/\$

A. Calculate whether the won, the shekel, and the zloty are overvalued or undervalued with respect to the US dollar in terms of purchases of Big Macs. Explain what it means to be over or undervalued.

B. What would the exchange rates have to be in order equalize big Mac prices between South Korea and the US, Israel and the US, and Poland and the US?

C. If in the long run the exchange rate moves to satisfy Big Mac PPP, will the won, shekel and zloty, respectively, appreciate or depreciate in terms of dollars? Explain the logic.

Multiple Choice Questions

Q1 Which of the following would likely have the least direct influence on a country's current account?
   a. inflation.
   b. national income.
   c. exchange rates.
   d. tariffs.
   e. a tax on income earned from foreign stocks.

Ans E

Q2 The primary component of the current account is the:
a. balance of trade.
b. balance of money market flows.
c. balance of capital market flows.
d. unilateral transfers.

Ans (A)

Q3 A General Agreement on Tariffs and Trade (GATT) accord in 1993 called for:
a. increased trade restrictions outside of North America.
b. lower trade restrictions around the world.
c. uniform environmental standards around the world.
d. uniform worker health laws.

Ans: B

Q4 The North American Free Trade Agreement (NAFTA) increased restrictions on:
a. trade between Canada and Mexico.
b. trade between Canada and the U.S.
c. direct foreign investment in Mexico by U.S. firms.
d. none of the above.

Ans: D

Q5 Futures contracts are typically _______; forward contracts are typically _______.
a. sold on an exchange; sold on an exchange
b. offered by commercial banks; sold on an exchange
c. sold on an exchange; offered by commercial banks
d. offered by commercial banks; offered by commercial banks

Ans: C

Q6 Eurobonds are certificates representing bundles of stock.
a. true.
b. false.

Ans: B

Q7 European currency options can be exercised _______; American currency options can be exercised _______.

a. any time up to the expiration date; any time up to the expiration date
b. any time up to the expiration date; only on the expiration date
c. only on the expiration date; only on the expiration date
d. only on the expiration date; any time up to the expiration date

Ans: D

Q8 Currency options are only traded on exchanges. That is, there is no over-the-counter market for options.

a. true.
b. false.

Ans: B

Q9 Primary result of the Bretton Woods Agreement was:

a. the establishment of the European Monetary System (EMS).
b. establishing specific rules for when tariffs and quotas could be imposed by governments.
c. establishing that exchange rates of most major currencies were to be allowed to fluctuate 1% above or below their initially set values.
d. establishing that exchange rates of most major currencies were to be allowed to fluctuate freely without boundaries (although the central banks did have the right to intervene when necessary).

Ans c

Q10 Which of the following are examples of currency controls?

a. import restrictions.
b. prohibition of remittance of funds.
c. ceilings on granting credit to foreign firms.
d. all of the above

Ans: D

Q 11 A potential advantage of exchange rate target zones is that they may stabilize international trade patterns by reducing exchange rate volatility.

a. true.
b. false.

Q12 Currency devaluation can boost a country's exports, but currency revaluation can increase foreign competition.

a. true.   b. false.

.Q13 The international Fisher effect (IFE) suggests that:

a. a home currency will depreciate if the current home interest rate exceeds the current foreign interest rate.
b. a home currency will appreciate if the current home interest rate exceeds the current foreign interest rate.
c. a home currency will appreciate if the current home inflation rate exceeds the current foreign inflation rate.
d. a home currency will depreciate if the current home inflation rate exceeds the current foreign inflation rate.

Ans: A

.Q14 Research indicates that deviations from purchasing power parity (PPP) are reduced over the long run.

a. true.   b. false.

Ans: A

Q15 Which of the following forecasting techniques would best represent the use of today's forward exchange rate to forecast the future exchange rate?

a. fundamental forecasting.
b. market-based forecasting.
c. technical forecasting.
d. mixed forecasting.

Ans: B

Q16 Which of the following is not a method of forecasting exchange rate volatility?

a. using the absolute forecast error as a percentage of the realized value.
b. using the volatility of historical exchange rate movements as a forecast for the future.
c. using a time series of volatility patterns in previous periods.
d. deriving the exchange rate's implied standard deviation from the currency option pricing model.

Ans: A

Q17 Translation exposure reflects:

a. the exposure of a firm's ongoing international transactions to exchange rate fluctuations.
b. the exposure of a firm's local currency value to transactions between foreign

exchange traders.

c. the exposure of a firm's financial statements to exchange rate fluctuations.
d. the exposure of a firm's cash flows to exchange rate fluctuations.

Ans: C

Q18 Which of the following operations benefits from depreciation of the firm's local currency?

a. borrowing in a foreign country and converting the funds to the local currency prior to the depreciation.
b. purchasing foreign supplies.
c. investing in foreign bank accounts denominated in foreign currencies prior to depreciation of the local currency.
d. A and B

Ans: C

.Q19 Which of the following is the least effective way of hedging transaction exposure in the long run?

a. long-term forward contract.
b. currency swap.
c. parallel loan.
d. money market hedge.

Ans: D

Q20 An effective way for an MNC to assess its economic exposure is to look at the firm's:

a. income statement.
b. liquidity.
c. retained earnings.
d. level of stockholder's equity.

Ans: A

Q 21

. As opposed to transaction exposure, managing economic exposure involves developing a ________ solution.

a. short-term
b. long-term
c. immediate
d. none of the above

Ans: B

Q22 A limitation of hedging translation exposure is that translation losses are not tax deductible, whereas gains on forward contracts used to hedge translation exposure are taxed.

a. true.
b. false.

Ans: **A**

Q23 Which of the following is a reason to consider international business?

a. economies of scale.
b. exploit monopolistic advantages.
c. diversification.
d. all of the above

Ans: D

Q24

Which of the following is not true regarding host government attitudes towards foreign direct investment (FDI)?

a. Host governments may offer incentives to MNCs in the form of subsidies in certain circumstances.
b. Host governments generally perceive FDI as a remedy to eliminate a country's political problems.
c. The ability of a host government to attract FDI is dependent on the country's markets and resources.
d. Some types of FDI will be more attractive to some governments than to others.
e. All of the above are true.

Ans: B

Q25 .When economic conditions of two countries are ________, then a firm would _______ its risk by operating in both countries instead of concentrating just in one.

a. highly correlated; reduce
b. not highly correlated; not reduce
c. not highly correlated; reduce
d. none of the above

Ans: C

Q26

Which of the following is not an example of multinational restructuring?

a. An MNC builds a new subsidiary in Malaysia.
b. An MNC acquires a company in Germany.
c. An MNC downsizes its operations in Hong Kong.
d. An MNC shifts some production from its Swiss subsidiary to its Dutch subsidiary.
e. All of the above are examples of multinational restructuring.

Ans: E

Q27 MNC Corporation has a beta of 2.0. The risk-free rate of interest is 5%, and the return on the stock market overall is expected to be 13%. What is the required rate of return on MNC stock?

a. 21%.
b. 41%.
c. 16%.
d. 13%.
e. none of the above

Ans: A
5% + 2 (13% - 5%) = 21%.

Key Terms

Bids : are the highest price that the seller is offering for the particular currency.

Ask : is the lowest price acceptable to the buyer.

Bis Ask spread: The bid ask spread is amount by which the ask price exceeds the bid.

Long : When you go long on a currency, its means you bought it and are holding it in the expectation that it will appreciate in value.

Short : going short means you reselling currency in the expectation that what you are selling will depreciate in value.

Currency rate : The Currency rate is the rate at which the authorized dealer buys and sells the currency notes to its customers.

Spot :. A foreign exchange spot transaction, also known as FX spot, is an agreement between two parties to buy one currency against selling another currency at an agreed price for settlement on the spot date. The exchange rate at which the transaction is done is called the spot exchange rate.

Forward : The forward market is the informal over-the-counter financial market by which contracts for future delivery are entered into. Over-the-counter (OTC) or off-exchange trading is done directly between two parties, without any supervision of an exchange.

Future : Standardized forward contracts are called futures contracts and traded on a futures exchange. a futures contract (more colloquially, futures) is a standardized contract between two parties to buy or sell a specified asset of standardized quantity and quality for a price agreed upon today (the *futures price* or strike price) with delivery and payment occurring at a specified future date.

Swap : a foreign exchange swap, forex swap, or FX swap is a simultaneous purchase and sale of identical amounts of one currency for another with two different value dates (normally spot to forward).

Option : A foreign exchange option (commonly shortened to just FX option) is a derivative where the owner has the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date. The options market is the deepest, largest and most liquid market for options of any kind in the world.

GDR (Global Depository receipts.

ADR : **American depository receipts**

Currency risk : is a form of risk that originates from changes in the relative valuation of currencies.

Political risk: This risk refers to the political decisions made within a country that might result in an unanticipated loss to investors.

Current accounts: records the transaction in merchandise and invisibles with the rest of the world.

Loan syndication : loan offered by a group of lenders (called a syndicate) who work together to provide funds for a single borrower.

Balance of payments (BoP :) accounts are an accounting record of all monetary transactions between a country and the rest of the world.

Globalization : is the process of international integration arising from the interchange of products, ideas, and other aspects of culture.

Correlation: it is a statistical measure that tells hoe securities rare related to each other.

Portfolio: it is a collection of investment (stocks, bonds, options t-bills commercial papers)

Liquidity: any stock converted into cash within short time period.

Derivatives: derivative is the financial instrument that drives the value of the underlying assets like bonds stock currency etc.

Yield: return earned by the investor on a security.

Risk: Risk means uncertainty and the variability in the returns.

Regulators: Company Law Board, The Reserve Bank of India, The Security exchange board of India, The department of economics and affairs, The department of company affairs.

Merchant bankers: they are registered with the SEBI and specialized in managing the new issue of securities.

APT: generates the riskless profit in the security market; it is selling of security at higher price and purchase the security at the lower prices.

Systematic risk: is also known non diversifiable or market risk, is the portion of the security that cannot be eliminated through the diversification.

Unsystematic risk: also called diversifiable and the business risk. , is the portion of security which we can eliminate by the diversification.

Beta: shows relationship between the market risk (systematic risk) and security return. It is denoted by the Greek letter beta β.