

(NEW RECEIVED)

UNIT 12: INTERNATIONAL BUSINESS FINANCE

12.0: Objectives:

After studying this unit you should be able to:

- Understand why companies need to think of International financial management.
- Explain the concept of foreign exchange management.
- Explain the translation and economic exposures.
- Explain how to hedge foreign exchange exposure.
- Discuss the various sources of finance in the International Markets.

12.1: Introduction:

Companies today operate within a global market place. It is necessary to understand the financial and real linkages between the domestic and world economies and examine how these linkages affect business viability. Starting in 1991, the first half of the present decade ushered in policy initiatives aimed at integrating the Indian economy with the international economy. Considerable reduction in import duties, liberalization of foreign direct and portfolio investments, establishment of a unified market determined exchange rate, phased introduction of current account convertibility have opened up the Indian economy to a great extent.

Overseas involvement of Indian firms is increasing and this trend is expected to continue. Many projects are being set up abroad particularly in Africa and South Asian countries. More and more finances are being raised from international capital markets.

Today financial globalization has occurred. A Company can shop around the world for a loan with a lower interest rate and borrow in foreign currency.

12.2: Forces driving towards globalization of finance :

1. Advances in information and computer technologies have made it easier and faster for market participants to collect, process, and monitor and manage financial risk of various instruments.
2. Globalization of national economies has advanced significantly as real economic activity – production, consumption, physical investment has been dispersed over different countries or regions.
3. Liberalization of national financial and capital markets.
4. Competition among the providers of financial intermediary services.

Difference between Domestic and International Financial Management:

Finance theory, in general rests on the premise that the goal of a firm is to maximize the value of the firm to its equity holders. International Financial Management, to a great extent is similar to domestic financial management.

Financing decisions, in respect of whether a domestic or an international company aims at minimizing the overall cost of capital providing optimum liquidity while striving for maximizing the shareholders' wealth.

However, International Financial Management has a wider scope than domestic financial management – the reasons are:

1. Multinational corporations operate in different economic, political, legal, cultural and tax environments.
2. They operate across and within varied ranges of product and factor markets, which may vary in terms of competition and efficiency.
3. They trade in different currencies of various countries as a result of which foreign exchange market is quite essential.
4. They have access to unregulated international capital markets, which differ in terms of efficiency and competitiveness.

5. Accounting standards are different in different countries. For example: US GAAP (Generally Accepted Accounting Practices) and Indian Accounting Standards.

The greater the degree of involvement of the firm in the international arena, the greater is the complexities. Working Capital Management is more complex in an Multinational Corporation because it involves cash movement and other material from one political and tax jurisdiction to another. Dividend decision of a subsidiary company is also quite challenging decision.

Yet again, in an international firm, foreign exchange management is very crucial as it operates in different countries.

Check your progress A:

1. *What are the forces that drive a company to look towards globalisation?*

2. *How does the international financial management widens the scope of a company?*

12.3: Foreign Exchange Market:

The volume of international transactions has grown enormously over the past 50 years. International trade and investments would not be possible without the ability to buy and sell foreign exchange currencies.

The trading of currencies takes place in foreign exchange market whose primary function is to facilitate international trade and investment knowledge of the operation and mechanics of the markets, therefore, is important for any fundamental understanding of international financial management.

The foreign exchange market is the market in which currencies of various countries are bought and sold against each other. It is a market for converting the currency of one country into that of another country.

Example: an Indian garment company exports to US and receives payment in US dollars. The exporter converting the dollars into rupees is typically a foreign exchange transaction.

The foreign exchange market is an over the counter market. This means that there is no single marketplace or organized exchange (stock exchange) where traders meet and exchange currencies.

Most transactions are channeled through the worldwide interbank market, the wholesale market in which only major bank trade with one another. This market accounts for 95% of foreign exchange transactions.

Foreign exchange market is not a physical place, rather it is an electronically linked network of banks, foreign exchange brokers, and dealers whose function is to bring together buyers and sellers of foreign exchange. It is not confined to any one country but dispersed throughout the leading financial centres of the world: London, New York, Paris, Zurich, Amsterdam, Tokyo, Hong Kong, Toronto, Frankfurt, Milan etc.

Trading is done by telephone, telex or the SWIFT system (society for worldwide interbank financial transactions) or international bank communications network, electronically linking all brokers and traders.

Since foreign exchange dealers are spread across the globe, the time of transaction differs from one place to other. If a dealer in India transacts at 10 am, it will be 4.30 am in London. In order to accommodate dealers from different countries, the foreign exchange market has to function round the clock.

12.4: Participants in foreign exchange markets:

The major participants in the foreign exchange market are the large commercial banks, foreign exchange brokers in the interbank market, commercial customers, multinational corporations, central banks of countries, which intervene in market from time to time to smoothen exchange rate fluctuations.

The foreign exchange market in India consists of three segments or tiers:

1. Transactions between RBI and authorized dealers (ad's) (ad's are mostly commercial banks)
2. Transactions among authorized dealers (ad's) themselves.
3. Transactions among authorized dealers (ad's) and their corporate customers.

The other major participants in the foreign exchange market are arbitrageurs, traders, hedgers and speculators.

12.5: Types of transactions:

- Spot transactions: when two parties agree to exchange currency and execute the deal immediately, the transaction is referred to as a spot exchange. It is the rate at which a foreign exchange dealer converts one currency into another currency on a particular day.
- Forward exchange rate: it occurs when two parties agree to exchange currency and execute the deal at some specific date in the future. Exchange rates governing such future transactions are referred to as forward exchange rates. They are quoted for 30, 90, 180 days into the future.
- Swap transactions: it is a combination of spot and forward transactions. Two currencies are exchanged in the beginning and again at maturity. The two currencies are re-exchanged.

Check your progress B:

1. Who are the participants in a forex market?

2. *What is SWIFT system?*

3. *What are the different types of transaction in the forex market?*

12.6: Instruments in foreign exchange market:

1. International bonds:

- a) Foreign bonds
- b) Straight bonds
- c) Floating rate notes (FRNs)
- d) Zero coupon and deep discount bonds
- e) Convertible bonds
- f) Cocktail bonds
- g) Yankee bonds

2. Short term and medium term instruments:

- a. Euro notes
- b. Euro commercial papers
- c. Medium term notes
- d. ADR and GDR (American Depository Receipts And Global Depository Receipts)

12.7: Functions of Foreign Exchange Market :

It serves the two main functions

1. Currency conversion: this function serves to convert currency of one country into another.
E.g.: A tourist from US converts US\$ into rupees in India.
2. Insuring against foreign exchange risk:

Second function is to provide insurance to protect against possible adverse charges in exchange rates (foreign exchange risk)

12.8: Uses of foreign exchange market:

The following are the main uses of foreign exchange market:

- a. Payments a company receives for its exports, income it receives from foreign investments, income it receives from licensing agreements with foreign firms.
- b. Companies and individuals use foreign exchange market when they must pay a foreign company for its products and services they imported.
- c. Companies and individuals use foreign exchange market when they have spare cash that they wish to invest for short terms in money markets.
- d. Finally, currency speculation is another use of foreign exchange market. Currency speculation typically involves the short-term movement of funds from one currency to another in the hope of profiting from shifts in exchange rates.

Check your progress C:

1. What are the instruments available in a forex market?

2. What are the advantages of a forex market?

12.9: Exchange rate regime and exchange control:

The exchange rate regime in India has undergone significant changes since independence and particularly during the beginning years of 1990s.

Year	Type of change
1966	The rupee was devalued by 57.5% against the pound sterling on June 6.
1967	Rupee sterling parity changed as a result of devaluation of sterling
1971	Bretton wood system broke down in August. Rupee briefly pegged to the US\$ at Rs. 7.50 before re-pegging UK Pound Sterling at Rs. 18.9677 with a 2.25% margin on either side.

1972	Sterling was floated on June 23 rd . Rupee-sterling parity revalued to Rs.18.95 and then in October to Rs.18.80
1975	Rupee pegged to an undisclosed currency basket with margins of 2.25% on either side. Intervention currency was sterling with central rate of Rs. 18.3084
1979	Margins around basket parity widened to 5% on each side in January.
1991	Rupee devalued by 22% on July 1 and July 3. Rupee dollar rate depreciated from Rs.21.20 to Rs.25.80. A version of dual exchange rate introduced through exim scrip scheme giving exporters freely tradable import entitlements equivalent to 30-40% of export earnings.
1992	LERMS (liberalized exchange rate management system) introduced with 40-60 dual rate for converting export proceeds. Market determined rate for all but specified imports. Market rate for approved capital transactions. US dollar became intervention currency from march 4. Exim scrip scheme abolished.
1993	Unified market determined exchange rate introduced for all transactions. RBI could buy spot us dollars and sell us dollars for specified purposes. It will not buy or sell forward though it will enter into dollar swaps.
1994	RBI announces substantial relaxation of exchange controls for current account transactions and a target date for moving to current account convertibility.

12.10: Exchange rate quotations:

An exchange rate represents the relationship between two currencies. There are two ways in which exchange rates are quoted.

Direct quote: The exchange rate for a foreign currency is quoted in terms of the number of units of local currency that are equal to a unit of foreign currency.

Ex: Exchange rate of 1 US dollar is Rs. 48.50 is a direct quote for the dollar Rs. 48.5 / US\$.

Indirect quote: Exchange rate for a foreign currency is expressed in terms of number of units of foreign currency that are equal to a unit of local currency.

Ex: when we say 2\$ are equal to Rs. 100, we have an indirect quote for the dollar.

12.11: Foreign Exchange Parity

Parity conditions mean a set of equilibrium relationship between product prices, interest rates, spot and forward exchange rates. To understand how prices are related to exchange rate movements, we first need to discuss a economic proposition known as law of one price.

Law of one price: It states that in competitive markets, free of transportation costs and barriers to trade (such as tariffs), identical products sold in different countries must sell for the same price when their price is expressed in terms of the same currency.

Covered interest arbitrage theory: This theory holds that the ratio of the forward and spot exchange rates will be equal to the ratio of foreign and domestic interest rates.

$$F_{\$/\text{₹}} / S_{\$/\text{₹}} = (1 + r_{\text{₹}}) / (1 + r_{\$})$$

Interest rates $r_{\text{₹}}$ and $r_{\$}$ must be same for the same maturity as the period for which the forward rate is being quoted.

12.11.1: Purchasing Power Parity:

If the law of one price were true for all goods, services, PPP exchange rate could be found from any individual set of prices. By comparing the prices of identical products: different currencies, it would be possible to determine the real or PPP exchange rate that would exist if markets were efficient. The dollars that can be bought for a rupee depends on the purchasing power of rupee vis-a-vis the purchasing power of dollar. In general according to the PPP theory, price level of goods must be the same in two countries. Now, the purchasing power of rupee changes over a period of time due to inflation- higher the rate of inflation in India, the greater the decline in the purchasing power of rupee. Likewise the purchasing power of dollar changes over a period of time, in response to inflationary pressures in the US. The relationship between inflation, exchange rates is expressed to be as follows:

$$E (i_{\text{₹}} - i_{\$}) / (1 + i_{\$}) = e (S_{\$/\text{₹}} / S_{\$/\text{₹}}) - S_{\$/\text{₹}} / S_{\$/\text{₹}}$$

The equation says that the change in the ratio of domestic prices measured by inflation rates is matched by corresponding changes in exchange rates.

12.11.2: Interest rates and exchange rates:

Economic theory tells us that interest rate reflect expectations about likely future inflation rates. In countries where inflation is expected to be high, interest rates also will be high because investors want compensation for the decline in the value of their money. This relationship was first formalized by economist Irvin Fisher and is referred to as the Fisher effect. It states that a country's nominal interest

rate is the sum of required real rate of interest and the expected rate of inflation over the period for which the funds are to be lent.

$$I = r + l$$

I - nominal interest rate

R - required real rate of interest

L - time period

Ex: if real rate of interest in a country is 5% and annual inflation is expected to be 10%, the nominal interest rate will be 15%.

12.11.3: International Fisher Effect:

Since we know from the PPP theory, that there is a link between inflation and exchange rates and since interest rates reflect expectations about inflation, it follows that there must also be a link between interest rates and exchange rates. This relationship is known as International Fisher Effect (IFE). It states that for any two countries, the spot exchange rate should change in an equal amount but in the opposite direction to the difference in nominal interest rates between two countries.

Stated more formally,

$$(s_1 - s_2) / s_2 * 100 = i_{\$} - i_{\text{f}}$$

Where, $i_{\$}$ and i_{f} are the respective nominal interest rates in the United States and India. S_1 is the spot exchange rate at the beginning of the period. S_2 is the spot exchange rate at the end of the period.

If the US nominal interest rate is higher than India's reflecting greater expected inflation rates, the value of the dollar against the rupee should fall by that interest rate differential in the future.

Do the interest rate differentials help predict future currency movements? The evidence seems is mixed, as in the case of PPP theory. In the long run there seems to be a relationship between interest rates differentials and subsequent changes in spot exchange rates. However, considerable deviations occur, like PPP, the international fisher effect is not a good predictor of short-term changes in spot exchange rates.

Check your progress D:

1. What is the principle of Purchasing Power Parity?

2. What is International Fischer effect?

12.12: Foreign exchange exposure and its management:

In a floating exchange rate regime the value of currency changes frequently. Such changes will have an influence on the firm, which has its operations internationally. The value of assets or liabilities changes in books and their present and future cash flow streams because of fluctuations in currencies. In other words they face foreign exchange exposure.

Types of exposure:

1. Accounting or translation exposure
2. Economic exposure:
 - a. Transaction exposure
 - b. Real operating exposure

The basic difference between the two is that former is derived from the consolidated financial statements of the parent company, will not influence the cash flow, while the latter is the result of altered cash flow of a company.

12.12.1: Accounting or translation exposure:

The accounting laws differ from country to country. The laws in many countries stipulate that the financial results of foreign subsidiaries and branches need to be consolidated with those of parent company. It is done through translating the items of financial statements of subsidiaries denominated in different currencies in to domestic currency of parent company.

If an item is translated at the current exchange rate, rate prevailing when the item came into being, it is said to be unexposed. If the value of foreign currencies changes between two successive consolidation dates, translation losses or gains arise. It is simply the difference between exposed assets and liabilities.

12.12.2: Economic exposure:

a. Transaction exposure: This is a measure of sensitivity of the home currency value of assets and liabilities which are denominated in foreign currency, to unanticipated changes in exchange rates, when assets are to be liquidated. It emerges when

- i. A currency has to be converted in order to make or receive payments for goods and services,
- ii. A currency has to be converted to repay a loan or make an interest payment, and
- iii. A currency has to be converted to make a dividend payment, royalty payment etc.

In all these cases foreign currency value of the item is fixed, uncertainty pertains to home currency value.

Ex: if an Indian exporter has receivable, worth \$10,000 due 3 months, if in the meanwhile the dollar depreciates relative to the rupee, a cash loss occurs and conversely a gain would occur if dollar appreciates relative to rupee.

b. Operating exposure: It arises when changes in exchange rate, together with rates of inflation, alter the amount and risk element of a company's future revenues and costs. The term operating is used because a change in operating cash flow will change the value of the firm. Its essence is that the exchange rate fluctuations significantly alter cost of a firm's inputs and the prices of its output and thereby alter the competitive position substantially.

Check your progress E:

1. What are the different exposures a firm may face in international market?

2. Distinguish between transaction and economic exposure?

12.12.3: Management of Foreign Exchange Exposure:

Whenever a company enters internationally through exports, imports, loans, borrowing or payments, it is exposing itself to risk. As we have already understood the various types of exposure or risk of a firm. Now the task ahead is to manage or possibly reduce the risk.

Following devices are commonly employed to manage exposure:

1. Forward market hedge.
2. Hedging through currency futures
3. Hedging through currency options
4. Roll over contracts
5. Money market hedge
6. Leading or lagging
7. Parallel loans
8. Netting and offsetting
9. Currency swaps

1. Forward market hedge:

The use of forward contract to hedge transactions exposure at a single date is quite straightforward. Here, the exporter sells forward and importer buys forward the foreign currency, in which the trade is invoiced. A contractual net inflow of foreign currency is sold forward and a contractual net outflow is bought forward. This removes all uncertainty regarding the domestic currency value of receivable or payable.

Ex: Consider a firm which is expecting a payment of \$10,000 due in 30 days on account of credit sale.

- Enter into a forward contract to sell \$10,000 in 30 days, 30 days forward rate is Rs. 49.85

- On 30th day collect from the customer, deliver the same to the dealer and collect Rs. 4,98,500.

It is the opposite way in case of credit purchases.

2. Hedging through Currency Futures:

Hedging through futures is similar to the hedging through forwards. A receivable is hedged by selling futures and payable is hedged by buying futures.

Difference between futures and forward is that futures contracts are standardized amount, quantity and delivery date etc. The advantage of futures is that it will have greater access and more liquidity.

3. Hedging through Currency Options:

Options provide a flexible means to cover transaction exposure. A contracted foreign currency outflow is hedged by purchasing a call option (or selling a put option) on the currency. While an inflow can be hedged by buying a put option or selling a call option. Number of strategies can be made with options.

4. Rollover contracts:

In Indian foreign exchange market forward contracts are available only for a maturity period of 6 months because quotations beyond 6 months will not be available. Exposures with longer time periods.

For example interest as well as principal repayments on a medium term foreign currency loans have to be hedged by means of roll over forward contracts. It is a contract, which is booked initially six months forward and then extended every six months. At every rollover date, customer does a swap with the bank, selling spot and buying forward.

5. Money Market Hedge:

In this kind of hedging, exposed position in a foreign currency is covered through borrowing or lending in the money market.

Ex: An UK firm has a liability of \$10,000 on account of purchases from US supplier, payable after 30 days. The 30-day money market rates in the UK and US are 1% for lending and 1.5% for borrowing. In order to hedge.

- Determine the present value of the foreign currency liability \$10000 by using the money market rate applicable to the foreign country. It is $(\$10,000 / 1.01) = \$9,901$ in the US money market.

Money market hedge may be covered or uncovered. Here an importer who has to cover future payables first borrows local currency, then converts local currency into currency of payables and finally invests the converted amount for a period matching the payments to be made for the import.

6. Leading and Lagging:

It is one of the internal ways of managing exposure is to shift the timing of exposure by leading or lagging payables and receivables. The general rule is lead, i.e. Advance payables and lag postpone receivables in strong currencies and conversely lead receivables and lag payables in weak currencies. Leading and lagging are practiced between two independent firms.

7. Parallel Loan:

It is known as back to back or credit swap loan. The amount of loan moves with the country but it serves the purpose of a cross border loans. These loans are not exposed to the changes in exchange rate because funds do not move outside the country.

8. Netting and offsetting:

A firm with receivables and payables in different currencies can reduce risk by matching payables with receivables. A firm with exports to and imports from USA need not cover each transaction separately. It can use a receivable to settle all or part of a payable and take a hedge only for the net dollar payable or receivable.

9. Currency Swaps :

A currency swap involves two different currencies. The two currencies involved are exchanged in the beginning and at maturity the two currencies are re-exchanged.

12.13: Financing international operations

The growing internationalization of capital markets and the increased sophistication of companies means that the search for capital no longer stops at one point or one instrument. There is wide range of sources of funds available that the companies tap on an ongoing basis.

Potential sources of funds:

1. Funds generated internally by the foreign affiliates.
2. Funds from within the corporate family.
3. Funds from source external to the corporate family.

The choice among the sources of funds ideally involves simultaneously minimizing the cost of external funds after adjusting for foreign exchange risk, choosing internal sources in order to minimize worldwide taxes and political risk.

Funds generated internally by the foreign affiliates	Depreciation and other non cash changes
	Retained earnings
Funds from within the corporate family	Equity investment.
	Cash loans
	Leads and lags in paying intra company a/c
Funds from sources external to corporate family	Banks and other financial institutions
	Securities markets or money markets
	Local currency debt.
	Individual and local shareholders
	Joint venture partners

The international financial market can be divided into two segments:

1. International money market, which is, represented by the flow of short term funds.
2. International capital market forms the other segment where medium and long term funds flow.

There are a number of agencies and instruments through which funds move to the resource needy institutions or firms. These agencies may be official or non-official.

Official sources:

Multilateral agencies

1. International development banks. Ex: World Bank, International Financial Corporation.
2. Regional development banks, (i.e.) Asian Development Bank.
3. Bilateral agencies

Non official sources:

1. Borrowing and lending market involving international banks
2. Securities market: debt & equities.

The major market segments:

A. Bonds

1. Foreign bonds
2. Euro bonds

B. Syndicated credits

C. Medium term notes (MTN)

A. Bonds

The difference between foreign bond and Euro bond is in case of foreign bond, the issuer selects a foreign financial market where the bonds are issued in the currency of that very country.

Ex: if an Indian company issues bonds in New York, the bond is denominated in US dollar, it will be called a foreign bond.

In case of Euro bonds, they are denominated in a currency other than the currency of the country where the bonds are issued.

Ex: if a Indian company's bond is denominated in US dollars, the bonds will be issued in any country other than the USA, then it is a Euro bond.

1. Straight bonds : it is a traditional type of bond. Interest rate is fixed. Interest rate is called coupon rate. It is fixed with reference to rates or treasury bonds for comparable maturity. It can be bought by an investor either in the primary market or secondary market. Repayment of principal is made at end of maturity period, known as bullet redemption.
2. Sinking fund bonds: used by small risky companies to assure the investors that they will get their money back. Issuer would redeem a fraction of the issue each year, so that small amount remains to be redeemed at maturity.
3. Floating rate note: it is a bond, which do not carry fixed rate of interest. It is a bond with a coupon rate varying typically every six months. Interest rate payable for the next six months is set with reference to a market index such as (Libor) London interbank offer rate. It was first issued in Italy during 1970's.
4. Zero coupon bonds: this bond is purchased at substantial discount from the face value and redeemed at face value on maturity. There are no interim interest payments.
5. Deep discount bonds: they do pay a coupon rate but below the market rate for a corresponding straight bond.
6. Convertible bonds: these are bonds that can be exchanged for equity shares either of issuing company or some other company. It commands a higher market value because of convertibility privilege.
7. Cocktail bonds: bonds are often denominated in a mixture of currency. There are two forms of cocktail bonds. One is denominated in Special Drawing Rights (SDRs) and other is denominated

in euros. The SDRs represent weighted average of five currencies. Euro represent a basket of 11 currencies. It will offer currency diversification benefits.

There are other bonds such as Yankee bonds, Samurai bonds, Tibias bonds, Geisha bonds, Public bonds, Bull dog bonds, Unlisted bonds issued in different countries with various features.

B. Syndicated credits:

A traditional Euro syndicated loan is usually a floating rate loan with fixed maturity and specific repayment schedule. One, two or even three banks act as lead managers, distribute the loan among themselves. One of the lead bank acts as the agent bank, one manages the loan after execution, disbursing funds to the borrower, collecting, distributing interest payments and principal repayments among leading banks. Normally loans would have maturity period of 10 years and interest rate is set with reference to Libor.

C. Medium Term Instruments: (MTN)

Euro notes:

It is similar to a promissory note issued by companies and mainly used for processing short-term funds. They are denominated in any currency other than the currency of the country where they are issued. They have a feature of low cost funding route. They can be customized to suit the requirements of different kind of borrowers.

Euro Commercial Papers:

It is another short-term debt instrument. It is not underwritten. Only those companies that possess a high degree of rating issue it. They are normally investors driven. Euro Commercial Papers (ECP) are denominated in US dollar. But, they are different from the US commercial papers in the sense that ECP have longer maturity period going up to 1 year. The features of ECP's vary from one country to another.

Medium Term Notes (MTN's):

They represent a medium term, non-underwritten, fixed interest rate source of funding. The issuers are mainly banks, sovereigns, international agencies.

D. Equity financing in the international markets:

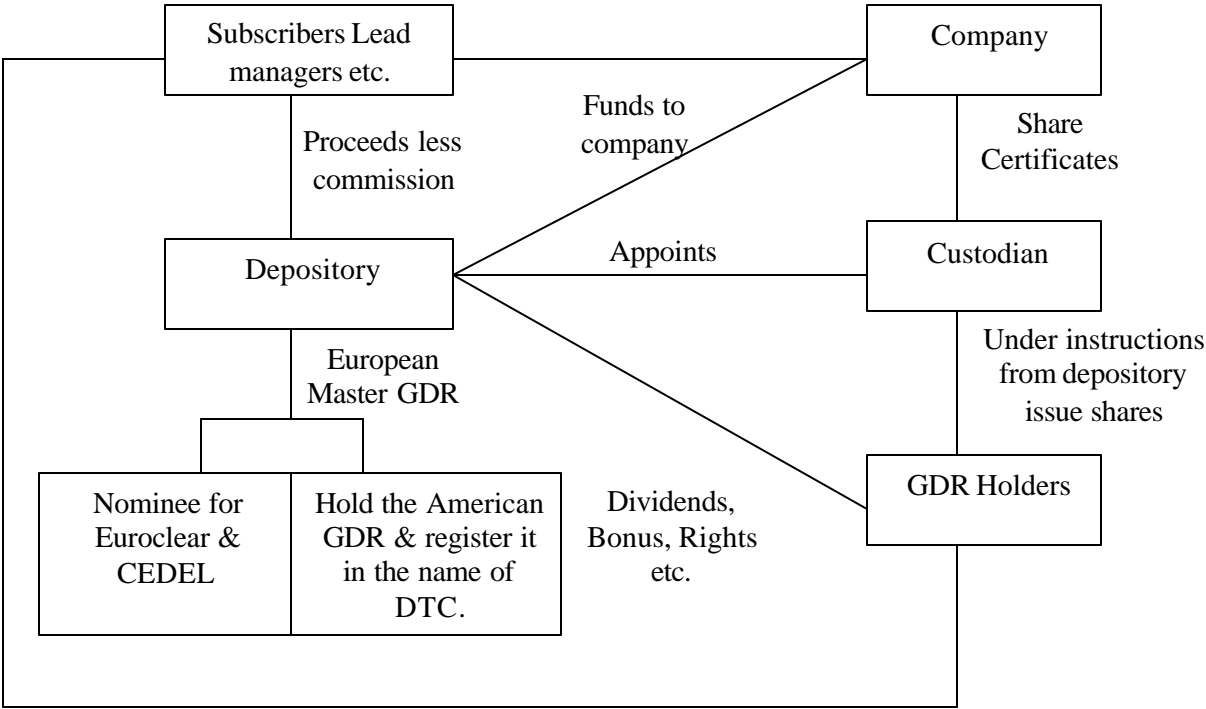
After the economic liberalisation, Indian companies started to tap foreign markets. The two principal mechanisms used by Indian companies are depository receipts, Euro convertible issues. Depository receipts represent indirect equity investment, while the latter is debt with an option to convert it into equity.

In the depository receipt mechanism the shares issued by a firm are held by a depository usually a large international bank, who receive dividends, reports etc and issues claims against these shares. These claims are called depository receipts with each receipt being a claim on a specified number of shares.

The depository receipts are denominated in a convertible currency usually US dollars. The depository receipts may be listed and traded on major stock exchanges or may trade in the Over The Counter market. The issuer firm pays dividends in its home currency, which is converted into dollars by the depository and distributed, to the holders of depository receipts. This way the issuing firm avoids listing fees and onerous disclosure and reporting requirements, which would be obligatory, if it were to be directly listed on the stock exchange. This mechanism originated in the US – the so-called American depository receipts. Recent years have seen the emergence of European depository receipts (EDR's) and global depository receipts (GDR's) which can be used to tap multiple markets

The structure of GDR is given in Figure 12.1 given below:

The structure of GDR issue:



During the later half of 1993, a number of Indian companies successfully tapped the global capital markets by means of GDR and foreign currency convertible bond issues.

Company	Vehicle	Amount(\$million)	Effective cost (%)
Reliance Industries	GDR	150.4	3.80
Grasim	GDR	80	3.85
Hindalco	GDR + warrants	108	3.79
Essar Gujarat	5 year 5.5% coupon	75	3.25
ITC	5% premium bonds, GDR + warrants	91.8	3.95
ICICI	10.5 year 3.5% coupon 12.5% premium coupon bonds	100	3.45
SPIC	GDR	75	3.75
M&M	GDR	75	3.50

E. Financing and insuring exports:

Trade deals require finance. Availability of finance enables the exporter to export more and the importers to import more. Availability of finance encourages trading activities. Banks are the most important source of foreign trade finance. Importers borrow from the banks, but the exporters are the major beneficiaries.

Different forms of credit are

a. Pre shipment finance

b. Post shipment finance

a. *Pre-shipment finance*: It is provide to the exporter meant for processing raw materials, processing and packaging of goods and for some other additional processes till goods are really shipped. It is also known as packing credit. Packing credit, a short-term credit is normally required to be liquidated within 180 days by negotiation of export bills or receipt of proceeds for exports. Credit is extended in the form of a loan amount. A separate account is maintained for each export order. Inputs purchased out of such credits are hypothecated or pledged to the bank.

b. *Post shipment finance*: This is extended by the banks after the goods have been shipped and against the submission of export documents evidencing the shipment of goods. It is also a short-

term credit. The rate of interest is lower upto 90 days but increases and is still higher beyond 180 days. There are different forms:

1. Purchase / discounting of documentary export bills
 2. Advance against export bills sent for collection
 3. Advance against duty draw back, cash subsidy.
1. Purchase/discounting of documentary export bills:

A commercial bank may purchase export bills drawn payable at sight or discount using export bills covering confirmed sales and supported by relevant documents like the bill of lading, post parcel receipts etc.

2. Advance against export bills sent for collection:

Finance is provided by way of advance against export bills sent for collection after evaluating the creditworthiness of the party, standing of the drawer, nature of goods exported, insurance etc. An appropriate margin is to be maintained.

12.4: Export Import Bank Of India (EXIM):

Exim bank is the apex body in the country for the provision of direct finance or for refinance facilities for encouraging foreign trade. Exim bank is a public sector financial institution established in Jan 1982 by passing an act in the parliament. It has borrowings from central government, RBI, loan from foreign sources, public deposits etc.

Functions: it supports financially domestic entities, overseas entities and commercial banks. To the Indian entities, it provides supplier credit, pre shipment, post shipment, medium term credit, export marketing finance, export vendor development finance etc.

To commercial banks in India, it provides refinancing facilities in relation to various types of credits meant for the exporter and importers. Exim bank offers lines of credit to overseas financial institutions.

Insuring exporters: ECGC facilities:

The Export Credit Guarantee Corporation (ECGC) is a govt. Of India undertaking set up under the ministry of commerce. Its main function is to provide insurance to Indian exporters of goods and services against the risk of non-payment for exports.

Under ECGC credit insurance policy the exporter is assured that ECGC will pay if the overseas buyer fails to pay for the goods and services exported. ECGC bears the risk, pays the exporter 90% of his loss on account of commercial and political risks.

ECGC offers various policies and schemes as below:

1. Standard policy: it is also referred as comprehensive risk policy. Here exporters may however on his willingness secure himself against political risks alone. Insurance cover is extended from the date of shipment.
2. Specific policies: contracts for exports of capital goods or projects for construction works, which are not of a repetitive nature and which involves large deferred payment are insured on a case by case basis under specific policies. Standard policies provide insurance for export on a repetitive basis.
3. Guarantee for export finance: ECGC facilitate export financing. It does not extend finance directly for exports. Banks are willing to provide finance to exporters who are provided guarantees by ECGC.
4. Special schemes: ECGC has several special schemes
 - a. Transfer guarantee
 - b. Insurance for buyer credit and line of credit
 - c. Joint venture insurance
 - d. Overseas investment insurance.
 - e. Special scheme for small-scale exporters.

12.15: Key words:

American depository receipts (ADRs). Certificates representing ownership of foreign stocks, which are traded on stock exchanges in the United States.

Bid/ask spread. Difference between the price at which a bank is willing to buy a currency and the price at which it will sell that currency.

Cross exchange rate. Exchange rate between currency A and currency B, given the values of currencies A and B with respect to a third currency.

Economic exposure. Degree to which a firm's present value of future cash flows can be influenced by exchange rate fluctuations.

Fischer effect. Theory that nominal interest rates are composed of a real interest rate and anticipated inflation.

Fixed exchange rate system. Monetary system in which exchange rates are either held constant or allowed to fluctuate only within very narrow boundaries.

Foreign exchange market. Market composed primarily of banks, serving firms and consumers who wish to buy or sell various currencies.

Hedge. To insulate a firm from exposure to exchange rate fluctuations.

Interest rate parity. Theory specifying that the forward premium (or discount) is equal to the interest rate differential between the two currencies of concern.

International Financial Corporation (IFC). Firm established to promote private enterprise within countries; it can provide loans to and purchase stock of corporations.

International Fischer Effect. Theory specifying that a currency's exchange rate will depreciate against another currency when its interest rate (and therefore expected inflation rate) is higher than that of the other currency.

London Interbank Offer Rate (LIBOR). Interest rate commonly charged for loans between Eurobanks.

Spot market. Market in which exchange transactions occur for immediate exchange.

Spot rate. Currency exchange rate of currency.

Transaction exposure. Degree to which the value of future cash transactions can be affected by exchange rate fluctuations.

Translation exposure. Degree to which a firm's consolidated financial statements are exposed to fluctuations in exchange rates.

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