
UNIT 11 INTERNATIONAL FINANCE

Objectives

After studying this unit, you should be able to understand:

- global financial system;
- basics of international monetary system;
- balance of payments;
- exchange risk management strategy and the factors affecting it;
- financing foreign trade; and
- terms of payment in international trade.

Structure

- 11.1 Introduction
- 11.2 Global Financial System
- 11.3 International Monetary System
- 11.4 International Flow of Funds
- 11.5 Foreign Exchange Market
- 11.6 Exchange Risk Management Strategy
- 11.7 Foreign Investment
- 11.8 Terms of Payment in International Trade
- 11.9 Summary
- 11.10 Key Words
- 11.11 Self-Assessment Questions
- 11.12 References/ Further Readings

11.1 INTRODUCTION

Reductions in barriers to international trade and financial flows coupled with innovations in information and communication technology, all financial operations are becoming “international” as these developments has blurred the national boundaries and each financial operations whether aimed at trade financing, investment, funding, loans, and other commercial operations have its origin to global market place.

Traditionally international finance is the branch of economics that studies the dynamics of exchange rates, foreign investment and how these affect international trade. It also studies international projects, international investments and capital flows and trade deficits. It includes the study of future and forward contract, options and currency swaps. Together with international trade theory, international finance is also a branch of international economics.

11.2 GLOBAL FINANCIAL SYSTEM

First of all we need to understand as to what is global finance. Global finance is the

financial system which consists of regulators and various financial institutions that conduct their business on an international level. Therefore, in global finance the businesses are not conducted at the national level. The primary components of global finance are the international institutions, like International Monetary Fund, World Bank and Asian Development Bank along with various national institutions and government departments, such as various Central Banks, finance ministries, and those private companies who act on a global scale.

The most prominent international institutions which are linked with global finance are as follows:

- 1) **International Monetary Fund (IMF):** The International Monetary Fund is tasked with for encouraging international trade, ensuring financial stability and economic growth and reducing global poverty. IMF oversees economic development, lending, and capacity development at global level. The International Monetary Fund also helps member states to address disequilibrium in balance of payments, grants long term loans for financial stability and act as a lender of last resort to avoid sovereign default.
- 2) **World Bank:** It is an institution which aims to offer funding for development projects which, for most of the part, is offered to developing nations. The World Bank assumes the credit risk of these developing nations; and tends to provide financing to projects that otherwise would not be able to access such funding.
- 3) **World Trade Organization (WTO):** WTO frames policies for orderly conduct of trade, commerce and global financing. Further, it advocates rule-based and transparent policy architecture and dispute resolution procedure. WTO agreement on Trade-Related Investment Measures (TRIMS) recognizes that certain investment measures can restrict and distort trade as some nation-states can discriminate against other on the grounds of being a foreign products, quantitative restrictions, and local content requiring which has its implications for business firms on matters of global finance.

11.3 INTERNATIONAL MONETARY SYSTEM

The International Monetary System is primarily the set of policies, institutions, practices, regulations and mechanism that determine the rate at which one currency is exchanged for another (Shapiro, 2004). The year 1252 marked the minting of the very first gold coin in Western Europe, since then, the International Monetary System has evolved and transformed into the modern system that we use today. The modern system came into existence in the beginning of the 19th century. Since then it has crossed many stages. These are as follows:

- The Classic Gold Standard (1821-1914)
- The Interwar Period (1919-1939)
- The Bretton Woods Era (1944-1971)
- The Post-Bretton Woods Era or Dirty Float (1971 to present)

Let us discuss each stage in brief.

- **The Classic Gold Standard (1821-1914):** In 1821 England returned to the gold standard and this is the period when more and more countries joined the gold standard. By 1880 most of the nations followed gold standard in one form or the other. But this was a difficult time as adhering strictly to gold standard resulted in lots of fluctuations. There were many bouts of inflation and deflation. The reason for this can be owed to high cost involved in locating, mining and minting gold. Despite lots of difficulties, this period is considered to be the most remarkable period in the world economic history.
- **The Interwar Period (1919-1939):** This is the period when gold standard broke International Finance down during World War I. The gold exchange standard was reinstated for a short period from 1925-1931. In this period only USA and England could keep gold reserves and other nations could keep both gold and dollars or pounds as reserves. In 1931, England departed from gold standard.
- **The Bretton Woods Era (1944-1971):** In 1944, a conference was held in Bretton Woods, New Hampshire to chart-out a new post-war monetary system. Two new institutions namely International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank) were created to implement the new system. Under this system each country pledged to maintain a fixed or pegged exchange rate for its currency with dollars or gold. One ounce of gold was equivalent to \$35. The fixed exchange rates were maintained by official intervention in the foreign exchange markets. The fixed exchange rate received a great deal of uncertainty from international trade and investment transaction.

This system collapsed with the dissolution of the gold standard. The reasons for the collapse were due to:

- a) Inflation in US
- b) Vietnam war in mid 60s
- c) Major countries like West Germany, Japan and Switzerland refused to accept economic costs associated with inflationary pressures of US\$ depreciation.

The above reasons resulted in sharp depreciation of dollar resulting in collapse of Bretton Woods's system.

- **The Post Bretton Woods Era or Dirty Float (1971 to present):** The world officially shifted to floating exchange rate in 1971 when dollar was devalued to 1/38 of an ounce of gold. Post 1971 saw many events happening on the international economic front. These are listed as follows:

OPEC and Oil Crisis: 1971-1974

US Dollar Crisis: 1977-1978

Rising Dollar: 1980-1995

Sinking Dollar: 1985-1987

Asian Financial Crisis: 1997

At the moment the international arena is witnessing lots of changes with trade and tariff wars, pandemic induced economic shocks, and technological advancements. IMF and other financial institutions are on toes to manage the International Monetary System.

Activity 1

Collect available literature from different sources related to Bretton Woods system. List out the lessons which can be drawn from the Bretton Woods’s system.

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11.4 INTERNATIONAL FLOW OF FUNDS

Covid-19 pandemic has brought the global economic system to standstill affecting economic activities, international trade, and movement of capital and labour which affected adversely the international flows of funds. After witnessing a contraction in 2020, world trade is rebounding and has surpassed the pre-pandemic level touching to historic level of almost \$ 22 trillion but regional challenges remain. According to WTO, global merchandise trade volume growth is more than 10.5% in 2021. Even with rebounding of international trade, the financial challenges remain for many vulnerable states across the world. These include:

- Loss of Services Trade,
- Ever increasing National Debts
- Depreciation of Currencies
- Loss of National Income
- Quantitative easing and Exchange Rate Instability

These challenges are intertwined and inter-linked causing problems of orderly flow of international funds thus resulting in economic woes to many nation-states in the world. Let us now discuss one of the major parts of international flow of funds i.e. Balance of payments (BoPs). Now the question arises what is BoPs?

Balance of Payments (BoPs)

The BoPs is an accounting statement that summaries all the economic transactions between the residents of the home country to that of residents of all other countries (Shapiro, 2002).

The balance of payments (BoPs) is the economic barometer which the countries use to monitor all international monetary transactions at a specific period of time. Usually, the

BoPs is calculated every quarter and every calendar year. All the transactions both by the private and public sectors are accounted for in the BoPs so as to determine the amount of money coming-in and going-out of a country. If a country has received money, (inflows) this is accounted as a ‘credit’ and if a country has paid or given money (outflows), the transaction is accounted as a ‘debit’. Conceptually, the BoPs should be zero, meaning that assets (credits) and liabilities (debits) should balance, but practically this is a rare. Thus, the BoPs can tell the observer if a country has a ‘deficit’ or a ‘surplus’ and from which part of the BoPs account the discrepancies arise.

Categories of Balance of Payments

The BoPs has four main categories (Table 11.1): the trade account, the current account, the capital account and the financial account.

- Trade Account which records the flow (export & import) of merchandized goods;
- Current Account, which records the flows of services, remittances and other invisible transfers;
- Capital Account, Which shows public and private investments and lending& borrowing activities,
- Financial or Official Reserves Account, which measures changes in holdings of gold, Special Drawing Rights (SDR) and foreign currencies i.e. resource assets by official monetary institutions.

The statement of balance of payment (Table 11.1) of a country can be understood as under:

Table 11.1: Structure of Trade Account/ Merchandise Account

Particulars	Credit	Debit	Net
Merchandise Export	-----	-----	
Merchandise Import	-----	-----	
Balance of Trade			(- +)
1. Tradable Services ¹	-----	-----	
a. Travel			
b. Transportation			
c. Insurance			
d. Government not elsewhere classified			
e. Miscellaneous			
2. Unilateral Transfers	-----	-----	
a. Private Remittances			
b. Officials Grants			

¹According to Appendices 10 of India’s Foreign Trade Policy, there are 161 tradable services classified in 12 heads. India’s Services Export Rules 2007 allow export of 118 services only.

3. Investment Income	-----	-----	
Current Account / Invisibles Account		(-+)......	
1. Loans Consist of:	-----	-----	
a. External Assistance			
i. By India			
ii. To India			
b. Commercial Borrowings (MT and LT)			
i. By India			
ii. To India			
c. Short-term Loan to India			
i. By India			
ii. To India			
2. Foreign Investments	-----	-----	
a. Direct Investments			
i. Acquisitions			
ii. Joint Ventures			
iii. Green Field Investments			
b. Portfolio Investments			
i. Depository Receipts (ADR/GDR)			
ii. Foreign Institutional Investors			
iii. Foreign Currency Convertible Bonds			
3. Banking Capital	-----	-----	
a. Commercial Banks			
i. Assets			
ii. Liabilities			
iii. Non-resident Deposits			
b. Other			

4. Rupee Debt Service	-----	-----	
5. Other Capital	-----	-----	
Capital Account Balance			(- +)
1. IMF Account	-----	-----	
2. SDR Account	-----	-----	
3. Reserves & Monetary Gold	-----	-----	
Official Account Balance			(- +)

Source: Adapted from Reserve Bank of India.

Activity 2

List out at least two examples each of the different categories of BoPs:

a) Current Account:

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b) Capital Account:

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c) Financial Account:

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11.5 FOREIGN EXCHANGE MARKET

Since World War II, the international transactions have grown to a large extent. This has resulted in the growth of the foreign exchange market. The foreign exchange market is a market where the foreign currencies are traded. The primary functions of a foreign exchange market are to facilitate international trade and investments. There are two types of important markets under foreign exchange market. These are:

- **Spot Market**, where currencies are traded for immediate delivery;
- **Forward Market**, where currencies are traded for future delivery (Shapiro, 2002).

Need of Foreign Exchange Market: This market is required because there is no single international currency. Therefore, the main aim of such kind of market is to facilitate the exchange and trading of one currency with another. For e.g. an Indian exporter sells pharmaceuticals to U.S. based importer for US Dollars which has to be exchanged in equivalent INR and similarly when a Kenyan importer buys automobiles from the US based supplier, he has to convert equivalent Kenyan Shilling into US\$ to pay. Each country of world does not have hard currency i.e. freely convertible currency. As a result; most of such kind of exchange transaction(s) occurs through worldwide interbank market.

Interbank Market: This market is known as the foreign exchange market. Basically this market is an ‘Over the Counter Market’ (OTC) i.e., it is not a physical place but exist everywhere and functions round the clock, days & nights, anywhere around the world. Usually, the currencies traded in the foreign exchange markets are hard, stable and convertible currencies.

The major players who participate in the foreign exchange markets are the large commercial banks, individuals, firms, governments, and sometimes the international agencies. There are two tiers in the foreign exchange market (Saran 2003) and these are:

Tier I – Transactions between ultimate customer and the banks;

Tier II – Transactions between banks.

Figure 11.1 depicts various linkages between banks and their customers; this linkage is with currency futures and options markets.

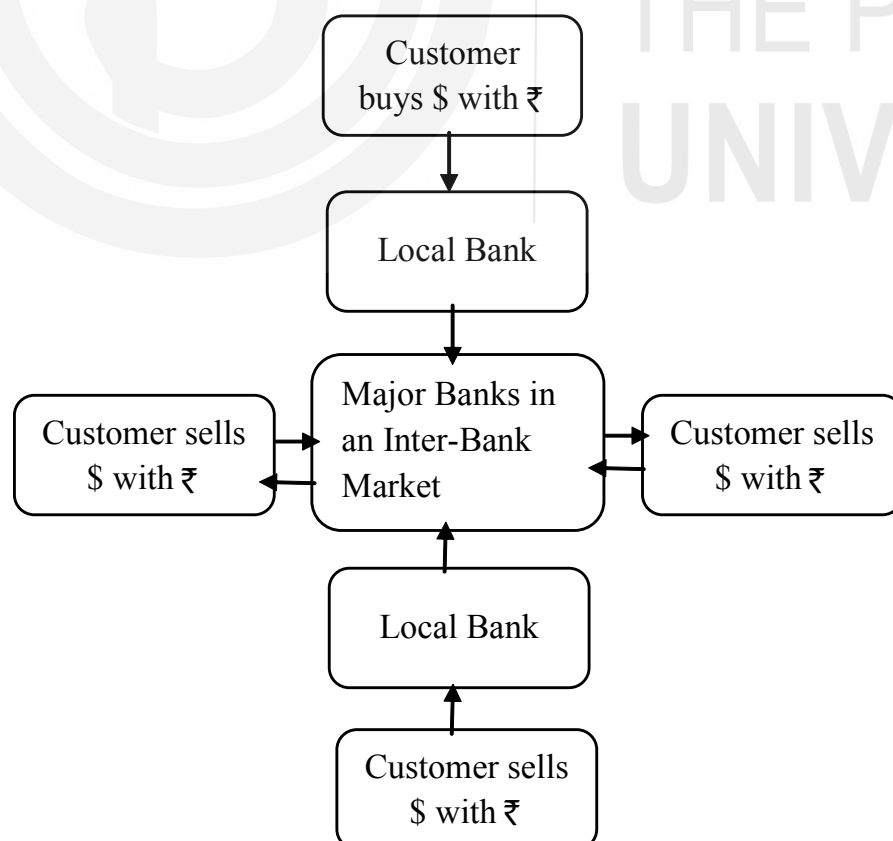


Figure 11.1: Linkages between Bank and Customers in a Foreign Exchange Market

Transactions in the Interbank Market: Transactions in the foreign exchange market can be executed on a spot, forward, or swap basis.

Spot Transactions: A spot transaction requires almost immediate delivery of foreign exchange. In the interbank market, a spot transaction involves the purchase of foreign exchange with delivery and payment between banks to take place normally, on the 'second day' following the business day, also known as T+2 settlement date. The date of settlement is referred to as the "value date." Spot transactions are the most important single type of transaction and constitute around 45 % of all transactions.

Outright Forward Transactions: A forward transaction requires delivery at a 'future value date' of a specified amount of one currency for a specified amount of another currency. The exchange rate to prevail at the 'value date' is established at the time of the agreement, but payment and delivery are not required until maturity. Forward exchange rates are normally quoted for 'value date(s)' of one, two, three, six, and twelve months. Actual contracts can also be arranged for other lengths. Outright forward transactions only account for about 9 % of all foreign exchange transactions.

Swap Transactions: A swap transaction involves the simultaneous purchase and sale of a given amount of foreign exchange for two different value dates. The most common type of swap is a spot against forward, where the dealer buys a currency in the spot market and simultaneously sells the same amount back in the forward market. Since this agreement is executed as a single transaction, the dealer incurs no unexpected foreign exchange risk.

Swap transactions account for about 46% of all foreign exchange transactions.

Foreign Exchange Rates and Quotations

A foreign exchange rate is the price of a foreign currency. A foreign exchange quotation or quote is a statement of willingness to buy or sell a currency at an announced rate.

Bid and Ask Quotations

Interbank quotations are given as "bid" and "ask".

A 'bid' is the exchange rate in one currency at which, a dealer will buy another currency.

An 'ask' is the exchange rate at which a dealer will sell the other currency.

Dealers buy at the 'bid' price and sell at the 'ask' price, profiting from the 'spread' or difference between the 'bid' and 'ask' prices, concluding that 'bid' < 'ask'.

'Bid' and 'ask' quotations are complicated by the fact that the 'bid' for one currency is the 'ask' for another currency. Simply putting it; a forex dealer buys currency at 'bid' price and sell them at 'ask' price.

Foreign Exchange Derivatives Market

They do not have worth of their own and derive their value from the claim they give to their owners, to own some other financial assets or securities. For instance, one takes an insurance against his house covering all risks. This insurance is also a derivative instrument on the house.

Major derivatives are as follows:-

- a) **Forward Contract:** A forward contract is an agreement between two parties to buy or sell an asset at a specified point of time in the future. In case of a forward

contract; the price which is paid/ received by the parties is decided at the time of entering into the contract. It is the simplest form of derivative contract and is mostly entered by individuals in their day to day life. Forward contract is a cash market transaction in which delivery of the instrument is deferred until the contract has been made.

- b) Futures Contract:** Futures is a standardized forward contract to buy (long) or sell (short) the underlying asset at a specified price and at a specified future date through a specified exchange. Futures contracts are traded on exchanges that work as a buyer or seller for the counterparty. Exchange sets the standardized conditions in terms of Quality, Quantity, Price quotation, Date and Delivery place (in case of commodity).
- c) Options Contract:** In case of futures contract, both parties are under obligation to perform their respective obligations out of a contract. But in an Options Contract, as the name suggests, is in some sense, an optional contract. An option is the right, but not the obligation, to buy or sell something at a stated date and at a stated price. A “call option” gives one the right to buy; a “put option” gives one the right to sell.
- d) Swaps Contract:** A swap can be defined as a barter or exchange. It is a contract whereby parties agree to exchange obligations that each of them have under their respective underlying contracts or we can say, a swap is an agreement between two or more parties to exchange stream of cash flows over a period of time in the future. The parties that agree to the ‘Swap’ are known as counter parties.

11.6 EXCHANGE RISK MANAGEMENT STRATEGY

The values of major currencies keep on changing every second thus creating income uncertainty for in international trade and investment decisions. The firms engaged in international trade and financial transactions plan to eliminate this uncertainty by locking in future exchange rates. In this context, the foreign exchange risk management strategy helps manage currency risks including anticipated fluctuations in future. Hence, the risk management strategy is based on set of procedures involving business specifics including environmental assessment, the location of its competitors, degree of cash flow visibility, its pricing parameters, decision criteria vis-a-vis risk and reward tolerance, familiarity with different risk management styles, and the weight of a currency in foreign exchange market. Figure 11.2 shows the matrix for the hedging strategy in an organization.

LOW PROFIT	
HEDGING II	SPECULATIVE I
RISK AVERSE III	RISK TAKER IV
LOW PROFIT	

Figure 11.2: Hedging Strategy in an Organization

I - High Risk - High Reward

II - High Risk - Reasonable Reward

III – Low Risk – Low Reward

IV – High Risk – Low Reward

Developing an Hedging Approach

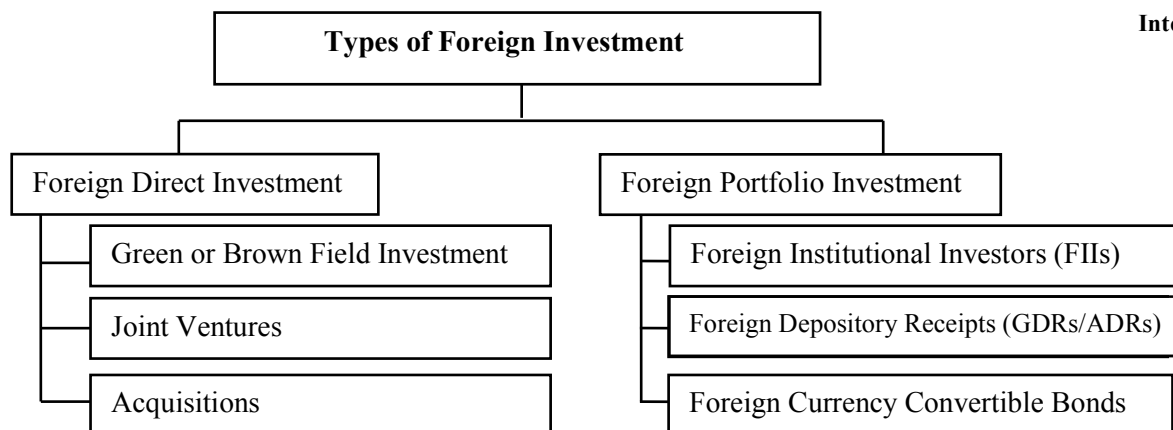
Companies involved in international trade and financial transactions should know various types of exchange risk exposures and different type of hedging instruments and techniques available to them for covering of risks. Hedging instruments are aimed at offsetting the losses in international financial transactions and investments by taking an opposite position in a related asset. Hedging instruments typically involve derivatives, such as options and futures contracts. Commonly used hedging strategies are divided into following categories:

- Full hedging (covering every exposure)
- Selective hedging (covering some selected exposures)
- Casual approach to hedging

Exchange risk management strategies will vary from organization to organization. The International Finance strategy depends upon the risk appreciation attitude of the organization, nature of exposure, significance of the risk on profitability and resources available to the organization. With experience and knowledge of exchange rate system, an organization can profit through exchange risk management. In the pandemic induced volatile and ambiguous times; more and more exporters and importers are having internal expertise in understanding exchange rates movements on the basis of macro-economic fundamental and accordingly leverage hedging instruments to maintain and earn profits.

11.7 FOREIGN INVESTMENT

Foreign investment, in its classic definition, “*is defined as a company from one country making a physical investment into building a factory in another country*”. In an era of globalisation; foreign investments definition has been broadened to include the “acquisition” of a lasting management interest in a company or enterprise outside the investing firm’s home country. As such, foreign investment in another country or foreign firm may take many forms, such as a direct acquisition/ purchase of a foreign firm, completely new construction of a facility in form of green field investments, or investment in a joint venture with foreign firm. Furthermore; foreign investment may also be in form of strategic alliance with a foreign firm with attendant input of technology/ technical knowhow; licensing of intellectual property, or entering into management contract or turnkey projects. Foreign investment primarily may be of two types i.e. Foreign Direct Investments (FDI) and Foreign Portfolio Investment (FPI) which in turn may have several sub-constituents (Figure 11.3).



Source: Shad Morris, James Oldroyd & Ram Singh (2021): International Business, Wiley India Pvt. Ltd.

Figure 11.3: Types of Foreign Investment

Foreign direct investment is an investment by foreign investors into the assets of host country structures, real estate; roads; ports; rail; plants and machinery; equipment, financial institutions such as opening a new bank/ insurance company and sometimes in host country organizations like investment in Indian Premier League (IPL) by foreign counties. Foreign direct investment does not include foreign investment into the stock markets of host countries that is separately treated as portfolio investment. In other words, the term portfolio refers to any collection of financial assets such as stocks, bonds and cash. Portfolios may be held by individual investors and/or managed by financial professionals, hedge funds, banks and other financial institutions.

Advantages of FDI

When direct investment tends to flow from one country to another, it presents benefits both to the home country as well as the host country but at the same time involves some costs also. Let us see some of the advantages of the FDI to the home as well as the host countries. The advantages to the host country are as follows:

- a) Availability of scarce factor i.e. capital
- b) Improvement in BoPs
- c) Building of economic and social infrastructure
- d) Fostering of economic linkages
- e) Strengthening of government budget

The advantages to the home country are as follows:

- a) Supply of required raw material
- b) Improvement in BoPs through dividend, royalty, etc.
- c) Enhanced employment opportunities
- d) Develops closer diplomatic ties between two nations.

These advantages although; are conditional depending on the linkage of home as well as the host country.

Activity 3

Choose two companies of your interest from different nations which have tied up together in terms of FDI. Now list the advantages of both the host and home country from your understanding of the FDI strategies adopted by them.

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11.8 TERMS OF PAYMENT IN INTERNATIONAL TRADE

Most of the MNCs along with even the small sized exporting firms, are extensively involved in foreign trade apart from the other international activities. This section highlights different modes of payment in international trade.

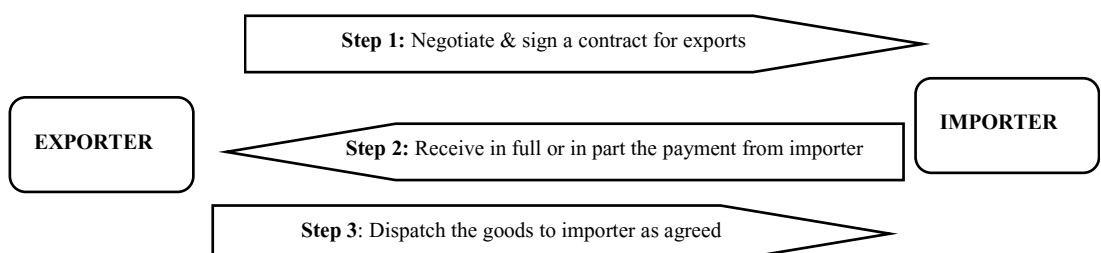
In highly competitive international markets today, the nature of payment terms offered is often play a decisive role in obtaining export orders. One has to be very careful and selective in negotiating the payment terms for a particular business. This decision is affected by various factors, which can be categorized as under:

- 1) Nature of goods
- 2) Size and amount of the transaction
- 3) Credit-worthiness of the buyer
- 4) Economic and political situation of the country of exports
- 5) Export/import policy and exchange control regulation of importing and exporting countries
- 6) Credit or payment terms offered by competitors
- 7) Financial strength of the exporter

Payment terms should be offered or accepted for trade transactions only after a careful analysis of these factors. Let us now discuss different payment terms, which are used for settlement of payments in the international trade:

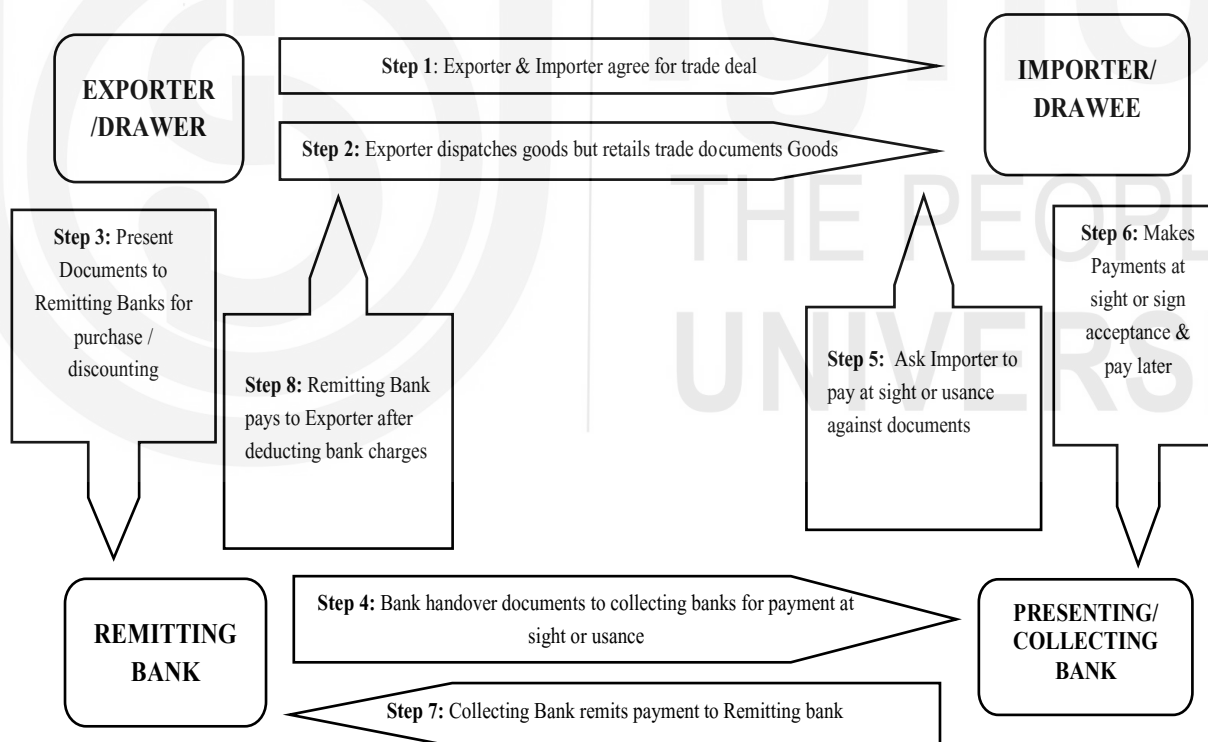
- 1) **PAYMENT-IN-ADVANCE:** Payment in advance is the safest method of payments. An exporter realizes the export proceeds in advance from an importer (Exhibit 11.1) before the actual dispatch of goods. Payment in advance is extremely favourable to an exporter and is the most risky for any importer. In actual business practice, there are rare examples of payment in advance however part payments in advance are common. Process of payment settlement under payment in advance is exhibited in 11.1 as under:

Exhibit 11.1: Process of Payment Settlement in Payment in Advance



- 2) **DOCUMENTARY COLLECTIONS:** Documentary collection is one of the most preferred methods of payment settlement in international trade. It balances the risks exposure between both the trading parties. Under this method, an exporter manufactures or procures goods and dispatches them to an importer through agreed mode of transport, delivery terms and cargo insurance policy. Exporter prepares the documents and submits them to his bank (remitting bank) as per procedure as laid down under Foreign Exchange Management Act 2000 and regulations therein. Remitting bank process the documents to collecting bank which ask for collection of payment from importer against trade documents. Documentary collections are of two types namely 'documents against payment' (D/P) also known as 'sight draft' or 'sight bill'. Under D/P transaction; an importer pays to the collecting bank before collecting the trade documents. Second type of documentary collections are known as 'documents against acceptance' (D/A) also known as 'time draft/bill' or 'usance draft/bill'. There is credit period extended by exporter to importer under D/A transactions. D/A transactions are risky and should be used with due diligence. Process of payment settlement under documentary collection is as under (exhibit 11.2).

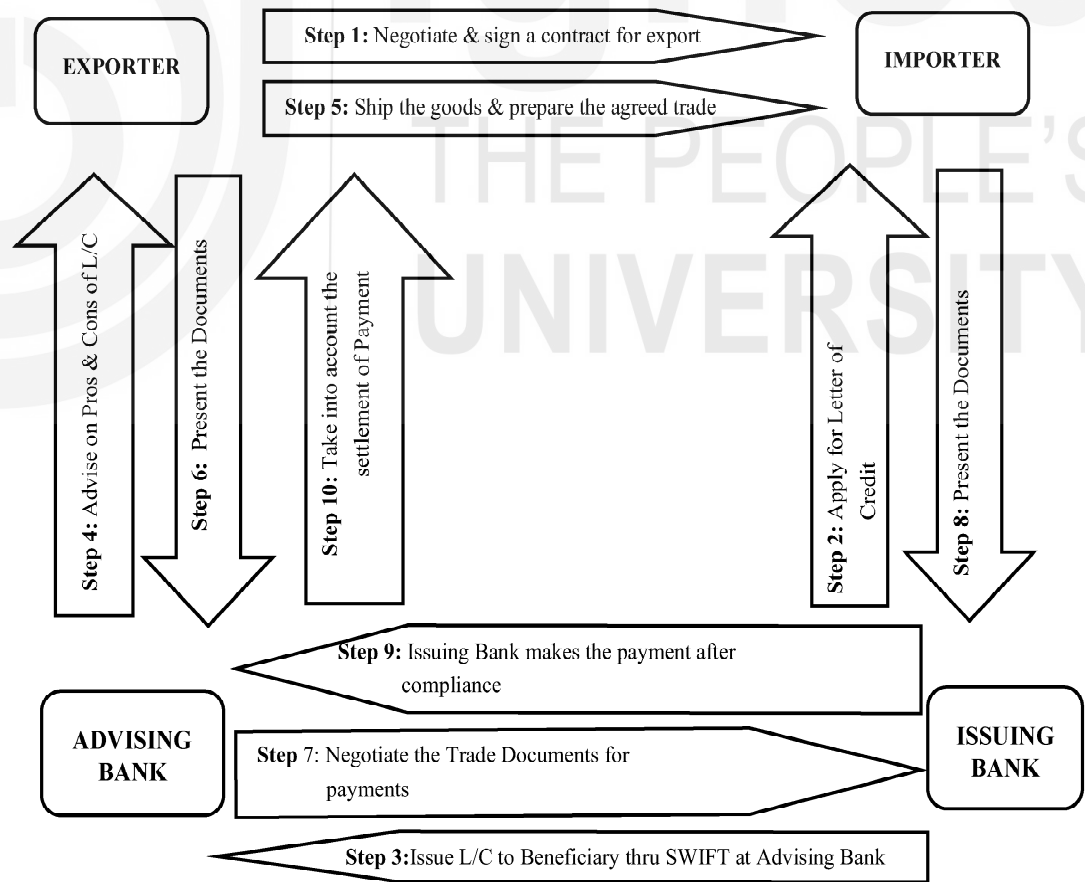
Exhibit 11.2: Process of Execution for Payment under Documentary Collections



- 3) **OPEN ACCOUNT:** Open account is most risky method of payment for an exporter and most safe for an importer. It is just opposite of Payment in Advance. Hence; it is extremely favourable to an importer and extremely risky to an exporter. Under this method, exporter negotiates and signs an export contract and ships the goods to an importer. Exporters also dispatch the trade documents evidencing the transfer of ownership from an exporter to an importer. This method of payment is used in cases of extreme trust between two trading parties, established trade relationship and sister-concerns or subsidiaries firms.

4) **LETTER OF CREDIT:** Letter of credit is widely used in high-value business transactions. It is considered a safe payment term. Exporter(s) prefer L/C terms in case of long duration business deals, doubt on importer credit worthiness or lower credit rating, new & unestablished business relationships, countries with high political or economic risks, etc. Under a letter of credit, an importer asks his bank to make a contractual agreement with beneficiary (exporter) for supply of agreed goods and services. As a result; the risk of payment passes from an importer to a bank (issuing bank). Bank undertakes a negotiable commitment for payment to an exporter subject to documentary compliance. Issuing bank issues a contractual agreement in favour of beneficiary (exporter) through SWIFT message at exporter bank, which is called an advising bank. Advising bank advises to exporter on various terms & conditions of credit and other associated risks. After dispatch of cargo, an exporter is required to submit trade documents to the bank as per negotiated terms and conditions of L/C. The negotiating bank routes the documents to issuing bank under established banking customs and procedures. Issuing Bank pays subject to fulfilment of documentary compliance. To successfully leverage L/C as payment mode, trading parties should be aware of process, parties involved and papers, which is exhibited, step by step, as under:

Exhibit 11.3: Process of Execution for Payment under L/C Mode



Documentary credit transactions are guided by a set of customs and practices published by the International Chamber of Commerce, Paris in 1993 under revised publication number 600 (effective from July 1, 2007) and titled as ‘Uniform Customs and Practices for Documentary Credit’ (UCPDC).

UCPDC defines letter of credit, explains, clarifies various situations and doubts, roles of different parties involved and documents required, hence it is very important to know and refer UCPDC while transacting under documentary credits. Following are the main parties who are generally involved in such transaction:

- 1) Buyers/applicant/importer
- 2) Issuing bank
- 3) Advising bank
- 4) Confirming bank
- 5) Negotiating bank
- 6) Reimbursing bank
- 7) Seller/beneficiary/exporter

Different types of Letter of Credit are described as under (Table 11.2) detailing their salient features, uses and risks for both the parties to trade transaction, i.e. exporter and importer.

Table 11.2: Risks Assessment for Exporter and Importer with Different Types of Letter of Credits

Types of L/C	Time of Payment	Goods Available to Importer	Risk to Exporter	Risk to Importer
Irrevocable L/C	Payment at sight on presentation of documents to issuing bank; or on specified date in case of Time L/C	Goods available After Payment	Risk lies with confirming bank if L/C is confirmed	No Credit Risk however other commercial risks exist
Sight Draft L/C	On Presentation of Documentation once shipment is made	Goods available After Payment	Risk lies with local confirming bank if L/C is confirmed	Shipment of goods is assured however importer is exposed to commercial risks i.e. quality issues, different goods, sub-standard goods
Revolving L/C	Payment Period is Variable and subject of mutual negotiation	Variable	Same as in case of Irrevocable L/C	No Credit Risk however other commercial risks exist
Back to Back L/C	Same as in case of any Irrevocable L/C	Goods available After Payment	None	No Credit Risk however other commercial risks exist
Time Draft L/C	At maturity of draft or Time draft can be discounted with Bank	Usually before payment	Risk lies with local confirming bank	Assured shipment is made, but relies on exporter to ship goods described in the documents

**International Business
Functions**

Red Clause L/C	A percentage of total amount before shipment and rest as in case of any other L/C transaction	Goods available After Payment	Same as in case of Irrevocable L/C	Percentage of payment made in advance is full risks however other risks are same as in case of any other L/C transaction
Standby or Special L/C	Payment settlement after the delivery of goods	Usually before payment	Delay in payment is expected as standby L/C is used as last resort to realize the payment	No Credit Risk however other commercial risks exist
Transferable L/C	Same as in case of Irrevocable L/C	Goods available After Payment	Same as in case of Irrevocable L/C	No Credit Risk however other commercial risks exist

Source: Ram Singh (2020): Export-Import Management, Sage Books, 1st Edition, 2020.

It can thus be concluded that various terms of payment serves the following four basic functions (Schapiro, 2002):

- a) to understand where risks lies in a transaction;
- b) to pinpoint who bears those risks that remain;
- c) to facilitate the transfer risk to a third party; and
- d) to facilitate financing.

Activity 4

Analyse the following documentary credits with respect to the risk associated with the exporter and importer:

a) Revocable L/C

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b) Irrevocable L/C

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11.9 SUMMARY

Global finance is the financial system which consists of regulators and various financial institutions that conduct their business on an international level. Therefore, in global finance the businesses are not conducted at the national level. The primary components of global finance are the international institutions, like International Monetary Fund, World Bank and Asian Development Bank along with various national institutions.

Exchange risk management strategy depends upon a company's attitude towards risk and reward or profit motivation. There could be four possibilities: low risk and low reward; high risk and low reward; high risk and reasonable reward; and high risk and high reward. For covering exchange risks, a company has to develop a basic hedging approach which could either be full hedging, selective hedging or casual hedging. The technique of Risk Management Grid, based on exchange rate trends of the currencies can help a company in maximizing its profits. There are several factors that influence strategy on exchange risk management, and the main factors include type and size of exposure, stability of currencies, maturity period, ability to forecast exposure, treasury management expertise available with the firm, access to hedging instruments, etc.

Mode of payments is used to settle payments in international trade transactions. Each payment is unique and has advantages associated with either party of trade, i.e. exporter and importer. There are five payment terms used in international trade. These are; Payment in Advance, Open Account, Documents against Payment, Documents against Acceptance and Letter of Credit.

11.10 KEY WORDS

- Hedging** : A technique to mitigate risks arising from fluctuations in exchange rates.
- Foreign Direct Investment (FDI)** : FDI is an investment by foreign investors into the assets of host country economic system and may be in the forms of green field investments, joint ventures and acquisitions.
- International Monetary System** : It refers to set of policies, institutions, practices, regulations and mechanism that determine the rate at which one currency is exchanged for another.
- Balance of Payments (BoPs)** : An accounting statement that summaries the economic transactions between the residents of the home country to that of residents of all other countries.
- Documentary Credit** : An arrangement whereby a bank issues generally an irrevocable undertaking on behalf of its client to pay or to accept to pay or authorize another bank to pay or to accept to pay subject to compliance of conditions or terms stipulated.

11.11 SELF-ASSESSMENT QUESTIONS

- 1) What are the two basic parameters of the exchange risk management strategy? Based on these parameters, what could be the different possibilities or options for a firm?

- 2) Why is it necessary for an international firm to have a hedging strategy? On what factors would it depend upon? What benefits would ensue to the firm for developing a suitable strategy?
- 3) Differentiate between forward contracts from future contracts.
- 4) Explain briefly the various terms of payment in international trade.
- 5) Write notes on the following:
 - Spot market
 - Forex market
 - International cash flows

11.12 REFERENCES/FURTHER READINGS

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