3. Economies of Scale: It helps to reduce the labour cost per unit of output

Natural Advantage

1. Natural Resources
2. Climatic Conditions

Example: A. India - Production of Rice, wheat, sweet mangoes, grapes, Tea, Coconuts, Cashew nuts, cotton, etc.

B. Sri Lanka - Production of Tea & Rubber

C. USA - Production of wheat

Aquired Advantage

1. Technology
2. Skills

Example: Japan - Advantages in steel production through imports of steel & coal England - Production of Textiles France - Production of Wine

Absolute Advantage Theory: Significance

1. More quantity of both products
2. Increased standard of living for both countries
3. Increased production efficiency
4. Increase in global efficiency and effectiveness
5. Maximization of global productivity and other resources productivity

Absolute Advantage Theory: Limitations

- No absolute advantages for many countries
- Country size varies
- Country by country differences in specializations
- Deals with labour only and neglects other factors of production
- Neglected transport cost
- Theory is based on an assumption that Exchange rates are stable and fixed.
- It also assumes that labor can switch between products easily and they will work with same efficiency which in reality cannot happen.

When a home currency is exchanged for a foreign currency to buy foreign goods, then the home currency faces downward pressure, leading to increased foreign demand for the country's products. On the other way, Exchange rates will not automatically correct any international trade balances when other forces are at work.

2.2 Agencies that facilitate international flows

2.2.1 International Monetary fund

The IMF is an organization of 183 member countries. Established in 1946, it aims

- to promote international monetary cooperation and exchange stability;
- to foster economic growth and high levels of employment; and
- to provide temporary financial assistance to help ease imbalances of payments.
- promote cooperation among countries on international monetary issues,
- promote stability in exchange rates
- provide temporary funds to member countries attempting to correct imbalances of international payments
- promote free mobility of capital funds across countries
- Promote free trade.

Its operations involve surveillance, and financial and technical assistance. In particular, its *compensatory financing facility* attempts to reduce the impact of export instability on country economies. The IM F uses a *quota* system, and its unit of account is the *SDR (special drawing right)*. It is clear from these objectives that the IMF's goals encourage increased internationalization of business

2.2.2 World Bank Group

- Established in 1944, the Group assists development with the primary focus of helping the poorest people and the poorest countries.
- It has 183 member countries and is composed of five organizations - IBRD, IDA, IFC, MIGA and ICSID.

2.2.3 IBRD: International Bank for Reconstruction and Development

- Better known as the World Bank, the IBRD provides loans and development assistance to middle-income countries and creditworthy poorer countries.
- In particular, its *structural adjustment loans* are intended to enhance a country's long-term economic growth.
- The IBRD is not a profit-maximizing organization. Nevertheless, it has earned a net income every year since 1948.
- It may spread its funds by entering into *cofinancing agreements* with official aid agencies, export credit agencies, as well as commercial banks.

2.2.4 IDA: International Development Association

- IDA was set up in 1960 as an agency that lends to the very poor developing nations on highly concessional terms.
- IDA lends only to those countries that lack the financial ability to borrow from IBRD.
- IBRD and IDA are run on the same lines, sharing the same staff, headquarters and project evaluation standards.

2.3.3 The Bretton Woods Era (1946 to 1971)

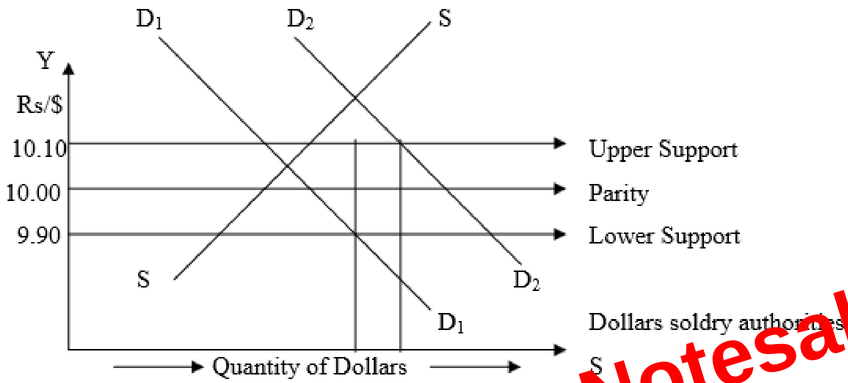
To streamline and revamp the war ravaged world economy & monetary system, allied powers held a conference in 'Bretton Woods', which gave birth to two super institutions - IMF and the WB. In Bretton Woods modified form of Gold Exchange Standard was set up with the following characteristics :

• One US dollar conversion rate was fixed by the USA as one dollar = 35 ounce of Gold

• Other members agreed to fix the parities of their currencies vis-àvis dollar with respect to permissible central parity with one per cent (± 1%) fluctuation on either side. In case of crossing the limits, the authorities were free hand to intervene to bring back the exchange rate within limits.

The mechanism of Bretton Woods can be understood with the help of the following illustration:

Suppose there is a supply curve SS and demand curve DD for Dollars. On Y-axis, let us draw price of Dollar with respect to Rupees (See fig.)



Relationship between exchange rate and demand/supply of currency

Suppose Indian residents start demanding American goods & services. Naturally demand of US Dollar will rise. And suppose US residents develop an interest in buying goods and services from India, it will increase supply of dollars from America.

Assume a parity rate of exchange is Rs. 10.00 per dollar. The ± 1% limits are therefore Rs. 10.10 (Upper support and Rs. 9.90 lower support).

As long as the demand and supply curve intersect within the permissible range; Indian authorities will not intervene.

Suppose demand curve shifts towards right due to a shift in preference of Indians towards buying American goods and the market determined exchange rate would fall outside the band, in this situation, Indian authorities will intervene and buy rupees and supply dollars to bring back the demand curve within permissible band. The vice-versa can also happen.

There can be two consequences of this intervention. Firstly, the domestic money supply, price and G.N.P. etc. can be effected. Secondly, excessive supply of dollars from reserves may lead to exhaustion or depletion of forex reserves, there by preventing all possibilities to borrow dollars from other countries or IMF.

During Bretton Woods regime American dollar became international money while other countries needed to hold dollar reserves. US could buy goods and services from her own money. The confidence of countries in US dollars started shaking in 1960s with chronological events which were political and economic and on August 15, 1971 American abandoned their commitment to convert dollars into gold at

UNIT –III

FOREIGN EXCHANGE MARKET

Function and Structure of the Forex markets, major participants, types of transactions and settlements dates, foreign exchange quotations. Process of arbitrage, speculation in the forward market.
Currency futures and options markets, overview of the other markets, Euro currency market, Euro credit market,Euro bond market, international stock market.

3.1 Foreign Exchange Market

Foreign exchange market is the market in which foreign currencies are bought and sold. The buyers and sellers include individuals, firms, foreign exchange brokers, commercial banks and the central bank. Like any other market, foreign exchange market is a system in which the transactions are not confined to only one or few foreign currencies. There are a large number of foreign currencies which are traded, converted and exchanged in the 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.

3.2 Functions of Foreign Exchange Market

Foreign exchange market performs the following three functions

3.2.1 Transfer Function

The basic function of the foreign exchange market is to facilitate the conversion of one currency into another, i.e., to accomplish transfers of purchasing power between two countries. This transfer of purchasing power is affected through a variety of credit instruments, such as telegraphic transfers, bank draft and foreign bills. In performing the transfer function, the foreign exchange market carries out payments internationally by clearing debts in both directions simultaneously, analogous to domestic clearings.

3.2.2Credit Function

It provides credit for foreign trade. Bills of exchange, with maturity period of three months, are generally used for international payments. Credit is required for this period in order to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.

- **Swap Market:** The idea of a swap by definition normally refers to a simple exchange of property or assets between parties. A currency swap also involves the conditions determining the relative value of the assets involved. That includes the exchange rate value of each currency and the interest rate environment of the countries that have issued them. 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).

3.3.2.2Central 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. They work as the lender of the last resort and the custodian of foreign exchange of the country. The central bank has the power to regulate and control the foreign exchange market so as to assure that it works in the orderly fashion. One of the major functions of the central bank is to prevent the aggressive fluctuations in the foreign exchange market, if necessary, by direct intervention. Intervention in the form of selling the currency when it is overvalued and buying it when it tends to be undervalued.

The *commercial banks* are the second most important organ of the foreign exchange market. The banks dealing in foreign exchange play a role of "*market makers*", in the sense that they quote on a daily basis the foreign exchange rates for buying and selling of the foreign currencies. Also, they function as clearing houses, thereby helping in wiping out the difference between the demand for and the supply of currencies. These banks buy the currencies from the brokers and sell it to the buyers.

The *foreign exchange brokers* function as a link between the central bank and the commercial banks and also between the actual buyers and commercial banks. They are the major source of market information. These are the persons who do not themselves buy the foreign currency, but rather strike a deal between the buyer and the seller on a commission basis.

3.4 Market participates of 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.

The Market Participants are discussed in brief below:

3.4.1 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.

3.4.2 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.

3.4.3 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.

3.4.4 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.

3.4.5 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

3.4.6 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.

3.5 Market rate Quotations-currency rate fluctuation

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).

Currency options are one of the most common ways for corporations, individuals or financial institutions to hedge against adverse movements in exchange rates.

- **Call options** provide the holder the right (but not the obligation) to purchase an underlying asset at a specified price (the strike price), for a certain period of time. If the stock fails to meet the strike price before the expiration date, the option expires and becomes worthless. Investors buy calls when they think the share price of the underlying security will rise or sell a call if they think it will fall. Selling an option is also referred to as "writing" an option.
- **Put options** give the holder the right to sell an underlying asset at a specified price (the strike price). The seller (or writer) of the put option is obligated to buy the stock at the strike price. Put options can be exercised at any time before the option expires. Investors buy puts if they think the share price of the underlying stock will fall, or sell one if they think it will rise. Put buyers - those who hold a "long" - put are either speculative buyers looking for leverage or "insurance" buyers who want to protect their long positions in a stock for the period of time covered by the option.
- **American option** is a version of an options contract that allows holders to exercise the option rights at any time before and including the day of expiration. An American style option allows investors to capture profit as soon as the stock price moves favorably.
- **European Option** is a version of an options contract that limits execution to its expiration date. In other words, if the underlying security such as a stock has moved in price an investor would not be able to exercise the option early and take delivery of or sell the shares. Instead, the call or put action will only take place on the date of option maturity.
- **Asian option** (also known as average price option) is an option whose payoff is determined with respect to the (arithmetic or geometric) average price of the underlying asset over the term of the option.
- While the payoff of a standard (American and European) option depends on the price of the underlying asset at a specific point of time i.e. the exercise date, the payoff of an Asian option depends on the average price of the underlying asset that prevailed over a period of time i.e. the term of the option.
- There are two types of Asian options with respect to the method of averaging: in arithmetic Asian price of the underlying is used in payoff calculations; while in geometric Asian options, geometric average is used.
- Asian options have relatively low volatility due to the averaging mechanism. They are used by traders who are exposed to the underlying asset over a period of time such as consumers and suppliers of commodities, etc.

3.8.4 Swaps

Interest Rate Swaps

In an interest rate swap, the parties exchange cash flows based on a notional principal amount (this amount is not actually exchanged) in order to hedge against interest rate risk or to speculate. For example, imagine ABC Co. has just issued $1 million in five-year bonds with a variable annual interest rate defined as the London Interbank Offered Rate (LIBOR) plus 1.3% (or 130 basis points). Also, assume that LIBOR is at 2.5% and ABC management is anxious about an interest rate rise.

Commodity Swaps

Commodity swaps involve the exchange of a floating commodity price, such as the Brent Crude oil spot price, for a set price over an agreed-upon period. As this example suggests, commodity swaps most commonly involve crude oil.

3.9.3 Clearing House

The exchange acts as a clearing house to all contracts struck on the trading floor. For instance, a contract is struck between A and B. Upon entering into the records of the exchange, this is immediately replaced by two contracts, one between A and the clearing house and another between B and the clearing house.

In other words, the exchange interposes itself in every contract and deal, where it is a buyer to every seller and a seller to every buyer. The advantage of this is that A and B do not have to undertake any exercise to investigate each other's creditworthiness. It also guarantees the financial integrity of the market. The exchange enforces delivery for contracts held until maturity and protects itself from default risk by imposing margin requirements on traders and enforcing this through a system called "marking to market".

3.9.4 Margins

Like all exchanges, only members are allowed to trade in futures contracts on the exchange. Others can use the services of the members as brokers to use this instrument. Thus, an exchange member can trade on his own account as well as on behalf of a client. A subset of the members is the "clearing members" or members of the clearing house and non- clearing members must clear all their transactions through a clearing member.

The exchange requires that a margin must be deposited with the clearing house by a member who enters into a futures contract. The amount of the margin is generally between 2.5% to 10% of the value of the contract but can vary. A member acting on behalf of a client, in turn, requires a margin from the client. The margin can be in the form of cash or securities like treasury bills or bank letter of credit.

3.9.5 Marking to Market

The exchange uses a system called marking to market where, at the end of each trading session, all outstanding contracts are reprised at the settlement price of that trading session. This would mean that some participants would make a loss while others would stand to gain. The exchange adjusts this by debiting the margin accounts of those members who made a loss and crediting the accounts of those members who have gained. This feature of futures trading creates an important difference between forward contracts and futures. In a forward contract, gains or losses arise only on maturity. There are no intermediate cash flows.

Whereas, in a futures contract, even though the gains and losses are the same, the time profile of the accruals is different. In other words, the total gains or loss over the entire period is broken up into a daily series of gains and losses, which clearly has a different present value.

3.9.6 Actual Delivery is Rare

In most forward contracts, the commodity is actually delivered by the seller and is accepted by the buyer. Forward contracts are entered into for acquiring or disposing off a commodity in the future for a gain at a price known today.

In contrast to this, in most futures markets, actual delivery takes place in less than one per cent of the contracts traded. Futures are used as a device to hedge against price risk and as a way of betting against price movements rather than a means of physical acquisition of the underlying asset. To achieve this, most of the contracts entered into are nullified by a matching contract in the opposite direction before maturity of the first.

Block chain Ventures: Amid rising popularity of block chains, many crypto exchanges have emerged. Such exchanges are venues for trading crypto currencies and derivatives associated with that asset class. Though their popularity remains limited, they pose a threat to the traditional stock market model by automating a bulk of the work done by various stock market participants and by offering zero- to low-cost services.

Significance of the Stock Market

The stock market is one of the most vital components of a free-market economy.

It allows companies to raise money by offering stock shares and corporate bonds. It lets common investors participate in the financial achievements of the companies, make profits through capital gains, and earn money through dividends, although losses are also possible. While institutional investors and professional money managers do enjoy some privileges owing to their deep pockets, better knowledge and higher risk taking abilities, the stock market attempts to offer a level playing field to common individuals.

The stock market works as a platform through which savings and investments of individuals are channelized into the productive investment proposals. In the long term, it helps in capital formation & economic growth for the country.

where its cost is no longer offset by gains from its higher interest rate, it reaches interest rate parity and further investment flows from abroad come to a halt.

Currency traders, then, hope to predict future exchange rate movements by paying attention to the relative levels of inflation in the countries of their target currency pairs in addition to where each country is in its monetary policy cycle, and the size and pace of currency flows moving into and out of each country.

4.10 Purchasing Power Parity Theory

Under the theory of Purchasing Power Parity, the change in the exchange rate between two countries' currencies is determined by the change in their relative price levels locally that are affected by inflation. It is generally agreed that this theory mostly holds true over the long run, but economists have found that it can suffer distortions over the short term because of trade and investment barriers, local taxation, and other factors.

As a result of this relationship, one can expect the currencies of countries with higher inflation rates to weaken over time versus their peers, whereas currencies of countries with lower inflation rates tend to strengthen. In economies with weak production of local goods and services, the depreciation of the local currency can at times even be accelerated by the "pass-through effect" of importing foreign goods with relatively higher prices.

When a country’s inflation rate rises relative to that of another country, decreased exports and increased imports depress the high-inflation country’s currency because of worsening trade and current account balances. Purchasing Power Parity (PPP) theory attempts to quantify this inflation-exchange rate relationship.

Interpretations of PPP

- The absolute form of PPP is an extension of the law of one price. It suggests that the prices of the same products in different countries should be equal when measured in a common currency.
- The relative form of PPP accounts for market distortions like transportation costs, labor costs, tariffs, taxes, and quotas. It states that the rate of price changes should be similar.

Rationale behind PPP Theory

Suppose U.S. inflation > U.K. inflation.

$\Rightarrow$ U.S. imports from U.K.

$\uparrow$ U.S. exports to U.K., and U.S. current account$\downarrow$

Downward pressure (depreciation) is placed on the \$. This shift in consumption and the \$’s depreciation will continue until

in the U.S.: price $_{\text{U.K. goods}} \geq$ price $_{\text{U.S. goods}}$ and

in the U.K.: price $_{\text{U.S. goods}} \leq$ price $_{\text{U.K. goods}}$

Derivation of PPP

Assume that PPP holds. Over time, as inflation occurs exchange rates adjusts to maintain PPP: $P_{h1} \rightarrow P_{h0} (1 + I_h)$

Where P_{h1}=home country’s price index, year-1 end

I_h =home country’s inflation rate for the year

$P_{f1} \rightarrow P_{f0} (1 + I_f)(1 + e_f)$ where

Pf = foreign country’s price index

I_f = foreign country’s inflation rate

e_f = foreign currency’s % in value

If PPP holds $\Rightarrow P_{h1} = P_{f1}$ and $P_{h0} (1 + I_h) = P_{f0} (1 + I_f) (1 + e_f)$

Portfolio management refers to managing money of an individual under the expert guidance of portfolio managers.

In a layman's language, the art of managing an individual's investment is called as portfolio management.

Need for Portfolio Management

- Portfolio management presents the best investment plan to the individuals as per their income, budget, age and ability to undertake risks.
- Portfolio management minimizes the risks involved in investing and also increases the chance of making profits.
- Portfolio managers understand the client's financial needs and suggest the best and unique investment policy for them with minimum risks involved.
- Portfolio management enables the portfolio managers to provide customized investment solutions to clients as per their needs and requirements.

Types of Portfolio Management

Portfolio Management is further of the following types:

- Active Portfolio Management: As the name suggests, in an active portfolio management service, the portfolio managers are actively involved in buying and selling of securities to ensure maximum profits to individuals.
- Passive Portfolio Management: In a passive portfolio management, the portfolio manager deals with a fixed portfolio designed to match the current market scenario.
- Discretionary Portfolio management services: In Discretionary portfolio management services, an individual authorizes a portfolio manager to take care of his financial needs on his behalf. The individual issues money to the portfolio manager who in turn takes care of all his investment needs, paper work, documentation, filing and so on. In discretionary portfolio management, the portfolio manager has full rights to take decisions on his client's behalf.
- Non-Discretionary Portfolio management services: In non discretionary portfolio management services, the portfolio manager can merely advise the client what is good and bad for him but the client reserves full right to take his own decisions.

Modes of Global Portfolio Management

Foreign securities or depository receipts can be bought directly from a particular country's stock exchange. Two concepts are important here which can be categorized as Portfolio Equity and Portfolio Bonds. These are supposed to be the best modes of GPM. A brief explanation is provided hereunder.

Portfolio Equity

Portfolio equity includes net inflows from equity securities other than those recorded as direct investment and including shares, stocks, depository receipts (American or global), and direct purchases of shares in local stock markets by foreign investors.

Portfolio Bonds

Bonds are normally medium to long-term investments. Investment in Portfolio Bond might be appropriate if

One have additional funds to invest.

One seek income, growth potential, or a combination of the two.

Global Mutual Funds

Global mutual funds can be a preferred mode if the Investor wants to buy the shares of an internationally diversified mutual fund. In fact, it is helpful if there are open-ended mutual funds available for investment.

	Least Secure	Less Secure		More Secure	Most Secure
Exporter	**Consignment**	**Open Account**	**Documentary Collections**	**Letters of Credit**	**Cash-in-Advance**
Importer	**Cash-in-Advance**	**Letters of Credit**	**Documentary Collections**	**Open Account**	**Consignment**

International trade presents a spectrum of risk, which causes uncertainty over the timing of payments between the exporter (seller) and importer (foreign buyer).

For exporters, any sale is a gift until payment is received.

Therefore, exporters want to receive payment as soon as possible, preferably as soon as an order is placed or before the goods are sent to the importer.

For importers, any payment is a donation until the goods are received.

Therefore, importers want to receive the goods as soon as possible but to delay payment as long as possible, preferably until after the goods are resold to generate enough income to pay the exporter.

Cash-in-Advance

With cash-in-advance payment terms, an exporter can avoid credit risk because payment is received before the ownership of the goods is transferred. For international sales, wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters. With the advancement of the Internet, escrow services are becoming another cash-in-advance option for small export transactions. However, requiring payment in advance is the least attractive option for the buyer, because it creates unfavorable cash flow. Foreign buyers are also concerned that the goods may not be sent if payment is made in advance. Thus, exporters who insist on this payment method as their sole manner of doing business may lose to competitors who offer more attractive payment terms.

Letters of Credit

Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents. The buyer establishes credit and pays his or her bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. An LC also protects the buyer since no payment obligation arises until the goods have been shipped as promised.

Documentary Collections

A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents that its buyer needs to the importer's bank (collecting bank), with instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. D/Cs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance). The collection letter gives instructions that specify the documents required for the transfer of title to the goods. Although banks do act as facilitators for their clients, D/Cs offer no verification process and limited recourse in the event of non-payment. D/Cs are generally less expensive than LCs.

Open Account

An open account transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60 or 90 days. Obviously, this is one of the most lading and attaches it to the shipment as it is passed off to the distributor, assuming the seller uses a third-party distributor.

The shipping company can use the bill of lading to double check that all goods are accounted for. Although shippers generally cannot check the contents of containers, like boxes or pallets, they can check the number and type of containers present in the shipment.

- **commercial invoice**

Commercial Invoice is a bill for the goods shipped to the buyer. It is the accounting document for seller's claim on the buyer for goods sold to the buyer. Commercial Invoice would normally contain the following information:

a) Names and addresses of the buyer and the seller
b) Date of invoice, sale contract or firm order, reference number, date and etc
c) Unit prices, if any, final sum claimed, shipment terms
d) Settlement terms viz sight, tenor, DA/DP and etc
e) Shipping marks and numbers
f) Weight/quantity of the goods
g) Name of the vessel, port of embarkation etc

5.14 Trade Finance Methods

The most popular trade financing methods are the following

Accounts Receivable Financing

It is a special type of asset-financing arrangement. In such an arrangement, a company utilizes the receivables-the money owed by the customers-as collateral in getting a finance.

Factoring

In this type of financing, the company gets an amount that is a reduced value of the total receivables owed by customers. The time-frame of the receivables exert a large influence on the amount of financing. For older receivables, the company will get less financing. It is also, sometimes, referred to as **"factoring"**.

Letters of Credit

As mentioned earlier, Letters of Credit are one of the oldest methods of trade financing.

Bankers Acceptance

A banker's acceptance (BA) is a short-term debt instrument that is issued by a firm that guarantees payment by a commercial bank. BAs are used by firms as a part of the commercial transaction. These instruments are like **T-Bills** and are often used in case of money market funds.

BAs are also traded at a discount from the actual face value on the secondary market. This is an advantage because the BA is not required to be held until maturity. BAs are regular instruments that are used in international trade.

Working Capital Finance

Working capital finance is a process termed as the capital of a business and is used in its daily trading operations. It is calculated as the current assets minus the current liabilities. For many firms, this is fully made up of trade debtors (bills outstanding) and the trade creditors (the bills the firm needs to pay).

Forfaiting

Forfaiting is the purchase of the amount importers owe the exporter at a discounted value by paying cash. The forfaiter that is the buyer of the receivables then becomes the party the importer is obligated to pay the debt.

Countertrade

6. The bank also provides technical and other assistance to importers and exporters. Depending n the country of origin there are a lot of processes and procedures involved in the import-export of goods. The EXIM bank will provide guidance and assistance in administrative matters as well.
7. Undertakes functions of a merchant bank for the importer or exporter in transactions of foreign trade.
8. Will also underwrite shares/debentures/stocks/bonds of companies engaged in foreign trade.
9. Will offer short-term loans or lines of credit to foreign banks and governments.

EXIM bank can also provide business advisory services and expert knowledge to Indian exporters in respect of multi-funded projects in foreign countries

Importance of the EXIM Bank

Other than providing financial assistance, the Export and Import Bank of India bank is always looking for ways to promote the foreign trade sector in India. In the early 1990s, EXIM introduced a program in India known as the Clusters of Excellence.

The aim was to improve the quality standards of our imports and exports. It also has a tie-up with the European Bank for Reconstruction and Development. It has agreed to co-finance programs with them in eastern Europe.

In order to promote exports EXIM bank also has schemes such as production equipment finance program, export marketing finance, vendor development finance, etc.

5.16 Recent amendments in EXIM policy (2002-2007)

Export Import Policy or better known as Exim Policy is a set of guidelines and instructions related to the import and export of goods. The Government of India notifies the Exim Policy for a period of five years (1997 2002) under Section 5 of the Foreign Trade (Development and Regulation Act), 1992. The current policy covers the period 2002- 2007. The Export Import Policy is updated every year on the 31st of March and the modifications, improvements and new schemes becames effective from 1st April of every year. All types of changes or modifications related to the Exim Policy is normally announced by the Union Minister of Commerce and Industry who coordinates with the Ministry of Finance, the Directorate General of Foreign Trade and its network of regional offices.

5.16.1 Highlight of Exim Policy 2002 - 07

i) Service Exports

Duty free import facility for service sector having a minimum foreign exchange earning of Rs. 10 lakhs. The duty free entitlement shall be 10% of the average foreign exchange earned in the preceding three licensing years . However, for hotels the same shall be 5 % of the average foreign exchange earned in the preceding three licensing years. Imports of agriculture and dairy products shall not be allowed for imports against the entitlement. The entitlement and the goods imported against such entitlement shall be non transferable.

ii) Status Holders

Duty free import entitlement for status holder having incremental growth of more than 25% in FOB value of exports (in free foreign exchange). This facility shall however be available to status holder having a minimum export turnover of Rs. 25 core (in free foreign exchange).

Annual Advance Licence facility for status holder to be introduced to enable them to plan for their imports of raw material and component on an annual basis and take advantage of bulk purchase.

Status holder in STPI shall be permitted free movement of professional equipments like laptop/computer.

iii) Hardware/Software

EOUs are now required to be only net positive foreign exchange earner and there will now be no export performance requirement.

Period of Utilization raw materials prescribed for EOUs increased from 1 years to 3 years.

Gems and jewellery EOUs are now being permitted sub contracting in DTA.

Gems and jewellery EOUs will now be entitled to advance domestic sales.

viii) EPCG Scheme

The Export Promotion Capital Goods (EPCG) Scheme shall allow import of capital goods for preproduction and post production facilities also.

The Export Obligation under the scheme shall be linked to the duty saved and shall b 8 times the duty saved.

To facilities upgradation of existing plant and machinery, import of spares shall be allowed under the scheme.

To promote higher value addition in export, the existing condition of imposing an additional Export Obligation of 50% for products in the higher product chain to be done away with.

Greater flexibility for fulfillment of export obligation under the scheme by allowing export of any other product manufactured by the exporter. This shall take care of the dynamics of international market.

Capital goods up to 10 years old shall also be allowed under the Scheme.

To facilitate diversification in to the software sector, existing manufacturer exporters will be allowed of fulfill export obligation arising out of import of capital goods under the scheme for setting up of software units through export of manufactured goods of the same company.

Royalty payments received from abroad and testing charges received in free foreign exchange to be counted for discharge of export obligation under EPCG Scheme.

ix) DEPB Scheme

Facility for pro visional Duty Entitlement Pass Book (DEPB) rates introduced to encourage diversification and promote export of new products.

DEPB rates rationalize in line with general reduction in Customs duty.

x) DFRC Scheme

Duty Free Replenishment Certificate (DFRC) scheme extended to deemed export to provide a boost to domestic manufacturer.

Value addition under DFRC scheme reduced from 33% to 25%.

xi) Others

- Actual user condition for import of second hand capital goods up to 10 years old dispensed with.
- Reduction in penal interest rate from 24% to 15% for all old cases of default under Exim policy
- Restriction on export of warranty spares removed.

IEC holder to furnish online return of importers/exporters made on yearly basis.

Export of free of cost goods for export promotion @ 2% of average annual exports in preceding three years subject to ceiling of Rs. 5 lakhs permitted.