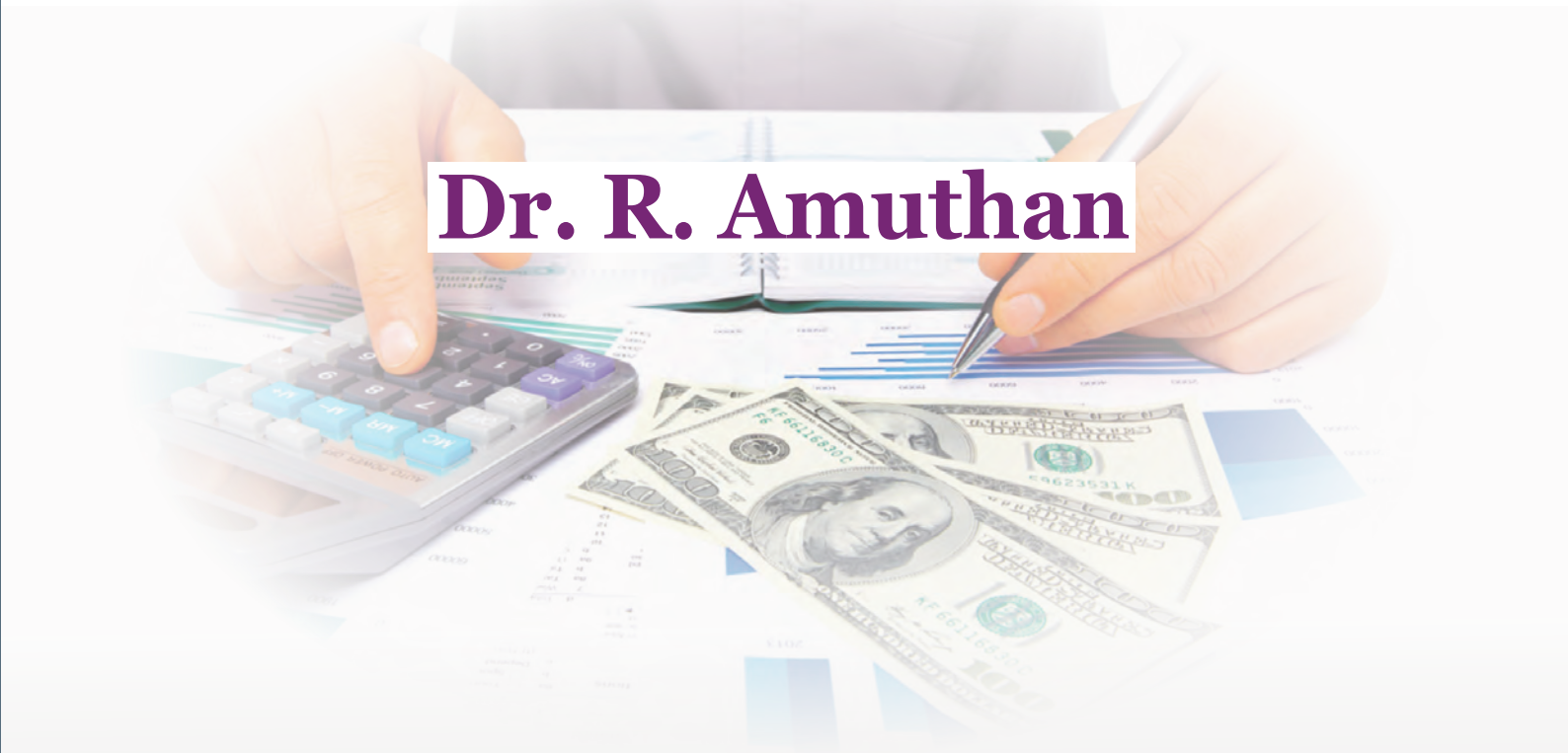


INTERNATIONAL FINANCIAL MANAGEMENT

Dr. R. Amuthan



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INTERNATIONAL FINANCIAL MANAGEMENT

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PREFACE

This book is intended for all students of MBA (Finance) of various Universities and Management Institutes and the same can be used for CA, CMA and ACS courses. The objective of the book are to provide the student with a conceptual framework of financial decisions taken with regard to International Trade Finance. The purpose is to make students familiar with the unique economic fundamentals and financial factors, which challenge the financial manager in the international context. The book covers the entire syllabus as approved by UGC on the subject of International Trade Finance, with increasing prospects on Export and Import sectors through hedging, Derivative Instruments and International Trade Logistics assume significance. This book could be the perfect guide for the beginners who wish to invest in Export and Import segment. Besides, this book is presented in simple language and mathematical terms, easily understandable to the average students.

This has the advantage of harmonizing the finance function with the International Trade on the one hand and integrating with international finance on the other. At the cost of repetition, each chapter is made self-contained and related to other chapters. But this is an added advantage to students who get a recap of some of the points of significance. The material is kept as brief as possible, yet with a comprehensive coverage of all the modules as approved by various universities and autonomous institutions and in accordance with their syllabus.

This text book could be the perfect guide to the new beginners who want to know about International Trade and International Finance.

Author

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Finally, I express my heartfelt thanks to my father and friends, co-staff members and my students on giving away all kinds of motivation and cooperation in completing the book successfully.

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1

INTRODUCTION ABOUT INTERNATIONAL TRADE AND INTERNATIONAL FINANCE

Chapter Outline

- International Trade Meaning and Benefits
- Basis of International Trade
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- Review Questions

INTERNATIONAL TRADE MEANING AND BENEFITS

Meaning and Definition of International Trade

Trade means buying and selling of commodities/articles for valuable consideration. For example, shopkeeper sells the goods after receiving the money value of goods. The payment may be either in currency or by exchange of another goods or item. Trade may be within the country and outside the country.

International Trade or Foreign Trade is exchange of capital, goods, and services across international borders or territories. In most countries, it represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history, its economic, social, and political importance has been on the rise in recent centuries.

All countries need goods and services to satisfy wants of their people. Production of goods and services requires resources. Every country has only limited resources. No country can produce all the goods and services that it requires. It has to buy from other countries what it cannot produce or can produce less than its requirements. Similarly, it sells to other countries the goods which it has in surplus quantities. India too, buys from and sells to other countries various types of goods and services.

According to Wasserman and Haltman, *"International trade consists of transaction between residents of different countries".*

According to Anatol Marad, *"International trade is a trade between nations".*

International trade is in principle not different from domestic trade as the motivation and the behavior of parties involved in a trade do not change fundamentally regardless of whether trade is across a border or not. The main difference is that international trade is typically more costly than domestic trade. The reason is that a border typically imposes additional costs such as tariffs, time costs due to border delays and costs associated with differences among countries such as language, the legal system or culture. International trade consists of 'export trade' and 'import trade'. Export involves sale of goods and services to other countries. Import consists of purchases from other countries.

International trade is quickly becoming one of the hottest industries around the world, but it is not a new industry by any means. Importing and exporting is big business not only in the developed nations, but all over the world as well. Today's EXIM trade is not only highly competitive but also dynamic. It is a vital part of development strategy and it can be an effective instrument of economic growth, employment generation and poverty alleviation.

Features of International Trade

The most salient features of international trade are as follows:

1. Immobility of Factors of Production: The main feature of international trade was the international immobility of factors of production. The belief that factors of production, labour and capital; if not land, although mobile within the country were immobile between countries led the classical economists to argue that the principles which determined the relative prices differed between the domestic (inter-regional) trade and foreign (international) trade.

Table 1.1: Features of International Trade

Immobility of Factors of Production	Independent Monetary Systems
Political Boundaries	Greater Geographical Distances
Territorial Specialization	International Competition
Separation of Sellers from Buyers	Long Chain of Middlemen
Different Currencies	Issue of Balance of Payments
Different National Policies	Difference in Constitutional Policy

2. Independent Monetary Systems: The second distinguishing factor of international trade is the existence of independent monetary systems in different countries giving rise to the need of exchanging one country's currency unit for another at an agreed ratio. The purchase and sale of foreign currency is conducted in the foreign exchange market and the ratio at which different currencies are exchanged is known as the foreign exchange rate.

3. Political Boundaries: The third distinguishing factor of international trade arises from the fact that "the existence of political boundaries carries with it controls and regulations of international trade and payments, in the form of customs duties, quotas, exchange control, foreign trade monopolies, the more subtle measures of control referred to as "administrative protectionism" and so forth, which do not generally exist in the domestic trade area".

4. Greater Geographical Distances: The fourth distinguishing factor of international trade lies in the existence of greater geographical distances and the consequent increases in the transport costs. The fact of distance which renders international exchange costly necessitates a special theory for the determination of international values. International trade, in most cases, involves the hauling of goods over longer distances involving land, air and sea routes through different countries necessitating the use of different modes of transport.

5. Territorial Specialization: International trade takes place basically due to geographical specialization. Every country specializes in the production of goods and services in which it has a specific advantage. For example, India has specific advantage in the production of jute and tea. Therefore, India exports these commodities to U.S. India imports computer processors from U.S. which U.S. can produce at lower cost than India.

6. International Competition: Producers from many countries complete with another to sell their products. Therefore, there is intense competition in international trade. Here the quality, design, packing, price, advertisement, etc., all play a significant role in deciding the winner in the market.

7. Separation of Sellers from Buyers: In international trade, sellers and buyers belong to different countries. They may have no chance of ever meeting one another. Therefore, they have to depend upon middlemen for transactions.

8. Long Chain of Middlemen: The procedure of international trade is very long and complex. It is very difficult for buyers and sellers to perform all the formalities themselves. They require the services of expert middlemen such as, indent houses, forwarding agents, clearing agents, foreign exchange banks, etc.

9. Different Currencies: A critical difference between inter-regional and international trade is the use of different currencies in foreign trade but a common currency in inter-regional trade. So, international trade is limited by the extent of liquidity of foreign exchange while there are no such restrictions in inter-regional trade.

10. Issue of Balance of Payments: The fact that balance of payments should balance the trade between any two countries in the long-run restricts the volume of demand for goods and services produced in the other nation. If the domestic country cannot export equivalent amount of exports, then there is a restriction on the amount of goods and services that it can import also. Such a restriction is absent for inter-regional trade.

11. Different National Policies: Countries may pursue various domestic policies with regard to trade, industry, commerce and so on. So, trade between regions will not be affecting such difference, while those differences matter in international trade. For example, non-tariff barriers regarding environment, child labour, etc., may create problems in the international market. Domestic environmental laws may allow the production process of certain commodities, while they may be rejected in the international market.

12. Difference in Constitutional Policy: The constitution mandates protection of inter-regional trade by preventing any provincial government from framing policies that obstruct trade between regions. On the other hand, there are constitutional provisions that enable the national government to frame policies that protect the domestic industries from external competition and thereby reduce free flow of international goods into domestic economy.

BASIS OF INTERNATIONAL TRADE

Basis of international trade are as follows:

1. Variations in Spatial Distribution of Natural Resources: The main basis of trade is inequalities in the distribution of natural resources bestowed by nature. Some countries possess rich natural resources while others are poor. Countries with a rich resource base are in a position to produce much more than their requirement. Therefore, this surplus goods are exchanged with other countries in which those countries are deficit.

Argentina has plenty of wheat, corn and dairy products which it exports to those countries which are short of it. India is a major producer of tea, mica and jute. It has surplus for others. Thus, it exports these items to other countries of the world where these are required. The United States cannot grow tea, coffee and jute.

As such, it imports these commodities. The Middle East countries are the largest oil producing and oil exporting countries in the world on account of large production and less consumption at home; they have enough surplus for export to other countries. It is, therefore, clear that richness in natural resources and their spatial distributional differences in the world form a basis of international trade.

2. Differences in Economic Development: There are variations in the stage of economic development which necessitate extensive transfer of commodities. **For example,** the U.K. which is in an advanced stage of economic development buys raw materials from Australia, South Africa,

Argentina, etc., where manufacturing industries related to these raw materials have not been developed. Later, the **U.K.** exports finished products made from these raw materials to these very countries.

3. Uneven Distribution of Population in the World: It is an important factor which determines the volume, character and direction of trade. If regions of small population produce more and have some rich mineral resources in comparison to large population size of countries of poor production and resources, they exchange services and labour in place of manufactured and other products with small population size countries.

Commercial grain farming regions produce extensive volumes of wheat but have sparse population at home. As such, they have large wheat surplus for export. Japan exports electronic computers, automobiles, ships, textiles, etc., on account of and mass scale production and little demands of such goods in the country due to less population.

4. Transportation Facilities: Transportation affects international trade tremendously. Transportation may be the use of seas, lakes, rivers, rail roads, etc. With the development of the modes of transportation, international trade has undergone great changes in volume and direction.

5. Nature, Choice and Fashion: Every country has a different pattern of nature, choice and fashion. The American and European women like to wear woollen clothes whereas the Japanese women like to wear silken clothes. At some places, there is a demand for woollen clothes while at others there is a demand for silken clothes. Some people like wearing leather jackets.

The Indian women prefer coloured sarees and bangles. The rice is considered to be a high class dietary item in Thailand, Vietnam, etc. Wheat is the main food crop in Pakistan, Afghanistan, Saudi Arabia, etc. Thus, in order to meet different demands of people of different countries, foreign trade system is helpful and is the only answer.

6. Scientific Progress: It has increased international trade. There has been great progress in transport and communication system due to scientific and technological development. A person can get information about the products and price, etc., off places with the help of telephone, television, fax, etc.

The raw materials and manufactured goods are transported by rail, ships and trucks to distant places. Thus, science and technology have revolutionised international trade. Development of means of transportation and introduction of refrigeration in the ships and rail wagons has facilitated transportation of perishable commodities even too far off markets.

7. War and Peace: For trade, it is imperative that the goods must reach their destination in a secure way. In war days, it becomes difficult to transport commodities safely because the enemy planes and warships try to destroy the merchant ships. This inhibits international trade. Peace is ideal for the growth of international trade, whereas war or insecurity hampers or discourages international trade.

8. Trade Policy: Every country keeps on changing its trade policy. For example, India grants loans to many African countries with the condition that they will have to purchase industrial goods from India. Japan gives loans worth crore of rupees to India with the condition that India shall supply coal or iron ore or mica to Japan. India's trade policy is pro-Russia. Thus, government policies matter a lot in the development of international trade.

9. Political Contacts and Trade Alliances: Political affiliations play an important role in trade alliances. **For example,** CIS carries on trade due to its friendly relations with communist countries. The Islamic countries have given special concessions to the friendly Islamic countries in matters of trade. In Europe, the Benelux countries do not charge taxes on the import and export of goods belonging to their trade allies – Belgium, Luxembourg, Netherlands, etc.

REASONS FOR GOING INTERNATIONAL

There are many factors, which motivate or drive firms to go international, are considered as the major drivers/motives of international trade and may be broadly divided into following groups:

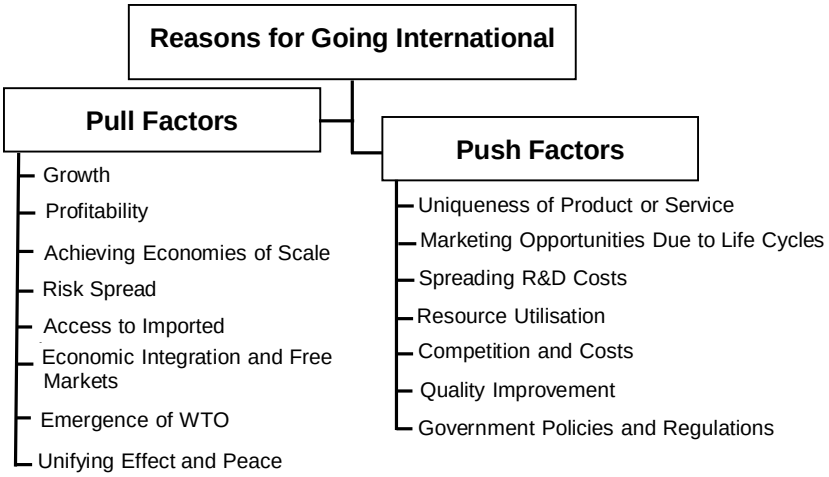


Fig. 1.1

1. Pull Factors: The pull factors, most of which are proactive reasons, are those forces of attraction, which pull the business to the foreign market. In other words, companies are motivated to internationalize because of the attractiveness of the foreign market. Such attractiveness includes, broadly, the relative profitability and growth prospects. The followings are important Pull Factors:

(i) ***Growth:*** Firms enter international markets when the domestic market potential saturates and they are forced to explore alternative marketing opportunities overseas. However, in the context of Indian market, given the size of the Indian market, enormous opportunities for most of the practices exist in the domestic market itself. Therefore, growth is the motive of only a few select companies to internationalize.

(ii) ***Profitability:*** The price differences among markets also serve as an important incentive to internationalize. An important incentive for international business is the profit advantage. International business could be more profitable than the domestic.There are cases of companies which earned more than 100 per cent of the total from foreign markets (in which case the domestic operation, obviously, resulted in loss). Even when international business is less profitable than the domestic, it could increase the total profit.

(iii) ***Achieving Economies of Scale:*** Large-scale production capacities necessitate domestic firms to dispose of their goods in international markets once the domestic markets become

saturated. One of the basic reasons behind the intemationalisation of Great Britain during the Industrial Revolution was domestic market saturation. Large volumes of production to meet international markets will give scale of economies in production. Nations encourage and industries build large facilities.

(iv) ***Risk Spread:*** A company operating in domestic markets is highly vulnerable to economic upheavals in the home market. Overseas markets provide an opportunity to reduce their dependence on one market and spread the market risks.

(v) ***Access to Imported Inputs:*** The national trade policies provide for import of inputs used for export production, which are otherwise restricted. Besides, there are a number of incentive schemes which provide duty exemption or remission on import of inputs for export production, such as advance licensing, duty drawback, duty exemption, export promotion, capital goods scheme. It helps the companies in accessing imported inputs and technical know-how to upgrade their operations and increase their competitiveness.

(vi) ***Economic Integration and Free Markets:*** The growth of liberalisation is opening free markets. There is movement in goods and services from country to country. Companies look for growth opportunities in free markets. **For example,** German chemical companies going international from Germany. Local consumption in Germany is too small.

(vii) ***Emergence of WTO:*** A number of friendly and neighbouring countries enter into trade agreements to develop trade. The World Trade Organisation (WTO) replaced GATT (General Agreement on Tariffs and Trade) in 1994. WTO has 159 members and helps to develop multilateral trade.

(viii) ***Unifying Effect and Peace:*** Two-way business help development activities and economic growth. Business develops long lasting relationships of trust and a feel good factor. All this lead to peace.

2. Push Factors: The push factors refer to the compulsions of the domestic market, like saturation of the market, which prompt companies to internationalise. Most of the push factors are reactive reasons. The followings are important push factors:

(i) ***Uniqueness of Product or Service:*** The products with unique attributes are unlikely to meet any competition in the overseas markets and enjoy enormous opportunities in international markets. **For example,** herbal and medicinal plants, handicrafts, value-added BPO services, and software development at competitive prices provide Indian firms an edge over other countries and smoothen their entry into international markets.

(ii) ***Marketing Opportunities Due to Life Cycles:*** Each market shows a different stage of life cycle for different products, which varies widely across country markets. When a product or service gets saturated in the domestic or an international market, a firm may make use of such challenges and convert them into marketing opportunities by operating into international markets. Strategies to launch new products in the existing markets or identify new markets for existing products may be adopted.

(iii) ***Spreading R&D Costs:*** By way of spreading the potential market size, a firm recovers quickly the costs incurred on research and development. It is especially true for products involving higher costs of R&D, where use of price skimming strategies necessitate faster

recovery of costs incurred, such as software, microprocessors, pharmaceutical products, etc. International markets facilitate speedy recovery of such costs because of the large market size and also due to larger coverage of the right market segments in international markets.

(iv) ***Resource Utilisation:*** New industries are developed where resources are readily and abundantly available. This reduces considerable transport costs of raw materials. This is especially true in case of mineral based industries. **For example,** raw steel capacities now being built in Orissa.

(v) ***Competition and Costs:*** Competition may become a driving force behind internationalisation. The economic liberalisation, ushered in India since 1991, which has increased competition from foreign firms as well as from those within the country, have, however, significantly changed the scene. Many Indian companies are now systematically planning to go international in a big way. Many companies also take an offensive international competitive strategy by way of counter-competition. The strategy of counter-competition is to penetrate the home market of the potential foreign competitor so as to diminish its competitive strength and to protect the domestic market share from foreign penetration.

(vi) ***Quality Improvement:*** Larger markets and improved margins help large investments in quality improvements. These include better equipment training and adopting quality systems. Quality improvement gives larger markets again and again the cycle continues. For example, Caterpillar earth-moving equipment manufacture.

(vii) ***Government Policies and Regulations:*** Government policies and regulations may also motivate internationalisation. There are both positive and negative factors which could cause internationalisation. Many governments offer a number of incentives and other positive support to domestic companies to export and to invest in foreign countries. Similarly, several countries give a lot of importance to import development and foreign investment.

BENEFITS OF INTERNATIONAL TRADE

The benefits of international trade are as follows:

1. Greater Variety of Goods Available for Consumption: Foreign trade brings in different varieties of a particular product from different destinations. This gives consumers a wider array of choices which will not only improve their quality of life but as a whole it will help the country grow.

2. Efficient Allocation and Better Utilisation of Resources: Efficient allocation and better utilisation of resources since countries tend to produce goods in which they have a comparative advantage. When countries produce through comparative advantage, wasteful duplication of resources is prevented. It helps save the environment from harmful gases being leaked into the atmosphere and also provides countries with a better marketing power.

3. Promotes Efficiency in Production: Foreign trade promotes efficiency in production as countries will try to adopt better methods of production to keep costs down in order to remain competitive. Countries that can produce a product at the lowest possible cost will be able to gain larger

share in the market. Therefore an incentive to produce efficiently arises. This will help to increase the standards of the product and consumers will have a good quality product to consume.

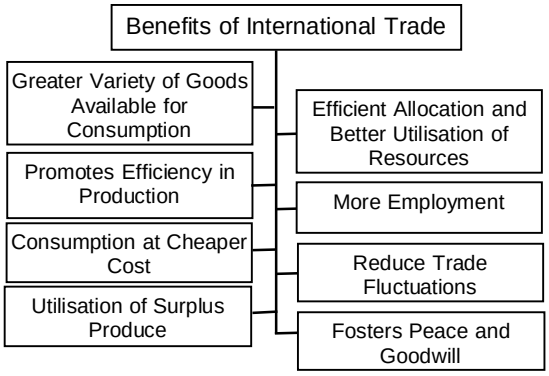


Fig. 1.2

4. More Employment: More employment could be generated as the market for the countries' goods widens through trade. International trade helps generate more employment through the establishment of newer industries to cater to the demands of various countries. This will help countries to bring down their unemployment rates.

5. Consumption at Cheaper Cost: Foreign trade enables a country to consume things which either cannot be produced within its borders or production may cost very high. Therefore, it becomes cheaper to import from other countries through foreign trade.

6. Reduces Trade Fluctuations: By making the size of the market large with large supplies and extensive demand international trade reduces trade fluctuations. The prices of goods tend to remain more stable.

7. Utilisation of Surplus Produce: Foreign trade enables different countries to sell their surplus products to other countries and earn foreign exchange.

8. Fosters Peace and Goodwill: Foreign trade fosters peace, goodwill, and mutual understanding among nations. Economic interdependence of countries often leads to close cultural relationship and thus avoid war between them.

LIMITATIONS OF INTERNATIONAL TRADE

International trade does not always amount to blessings. It has certain limitations also, such as:

1. Rapid Depletion of Exhaustible Natural Resources: It could lead to a more rapid depletion of exhaustible natural resources. As countries begin to increase up their production levels, natural resources tend to get depleted with the time and it could pose a dangerous threat to the future generation.

2. Import of Harmful Goods: Foreign trade may lead to import of harmful goods like cigarettes, drugs, etc., which may harm the health of the residents of the country. **For example,** the people of China suffered greatly through opium imports.

3. It may Exhaust Resources: Foreign trade leads to intensive cultivation of land. Thus, it has the operations of law of diminishing returns in agricultural countries. It also makes a nation poor by giving too much burden over the resources.

4. Overspecialisation: Overspecialisation may be disastrous for a country. A substitute may appear and ruin the economic lives of millions.

5. Danger of Starvation: A country might depend for its food mainly on foreign countries. In times of war, there is a serious danger of starvation for such countries.

6. One Country Gains at the Expense of Other: One of the serious drawbacks of foreign trade is that one country may gain at the expense of other due to certain accidental advantages. **For example,** the Industrial revolution is Great Britain ruined Indian handicrafts during the nineteenth century.

7. May Lead to War: Foreign trade may lead to war different countries compete with each other in finding out new markets and sources of raw material for their industries and frequently come into clash, this was one of the causes of First and Second World War.

8. Language Diversity: Each country has its own language. As foreign trade involves trade between two or more countries, there is diversity of languages. This difference in language creates problem in foreign trade.

DIFFERENCE BETWEEN INTERNATIONAL TRADE AND DOMESTIC TRADE

The following table describes the clear difference between the international trade and domestic trade.

Table 1.2

Basis of Difference	International Trade	Domestic Trade
Scope	Scope of international trade is quite wide. It includes merchandise exports, trade in services, licensing and franchising as well as foreign investments.	Domestic trade pertains to a limited territory. Though the firm has many business establishments in different locations, all the trading activities are inside a single boundary.
Benefits	International trade benefits both the nations and firms.	Domestic trade has lesser benefits when compared to international trade.
Market Fluctuations	Firms conducting trade internationally can withstand these situations and huge losses as their operations are widespread. Though they face losses in one area, they may get profits in other areas. This provides for stabilising during seasonal market fluctuations.	Firms carrying business locally have to face this situation which results in low profits and in some cases losses too.
Political Relations	Foreign trade improves the political relations among the nations which give rise to cross-national cooperation and agreements.	Does not improve political relations globally, and subsequently does not give rise to cross-national cooperation and agreements.

Purvey (Deals in)	Globally operating firms need to follow complicated customs procedures and trade barriers like tariff, etc.	Providing goods and services as a business within a territory is much easier than doing the same globally. Restrictions such as custom procedures do not bother domestic entities.
Sharing of Technology	Foreign trade provides for sharing of the latest technology that is innovated in various firms across the globe.	Does not provide for sharing of technology, only adopts the technology.
Trade Restrictions	Will have to face restrictions in trade practices, licenses and government rules.	In few cases, restrictions exist due to area development, forest, land, etc.
Distance	Long distances and hence more transaction time.	Short distances. Quick business is possible.
Modes of Entry	A firm desirous of entering into international business has several options available to it. These range from exporting/importing to contract manufacturing abroad, licensing and franchising, joint ventures and setting up wholly owned subsidiaries abroad.	Firms going for domestic trade does have the options but not too many as in international business.
Location	MNCs take advantage of location economies wherever cheaper resources available.	No such advantage, once plant is built, it cannot be easily shifted.
Cost Advantage	High volumes cost advantage.	Cost advantage by automation, new methods, etc.
MNCs	MNCs have perfected principles, procedures and practices at international level. MNCs take advantage of location economies wherever cheaper resources available.	No such experience or exposure. Once plant is built, it cannot be easily shifted.

DIFFERENCE BETWEEN INTERNATIONAL FINANCIAL MANAGEMENT AND DOMESTIC FINANCIAL MANAGEMENT

1. International Finance is different from domestic financial management in many aspects and most significant of them is foreign currency exposure. This is dealing with Income and Expenditure transactions in different political, cultural, legal, economical and taxation environment.

2. Domestic Financial Management aims at minimizing the cost of capital while raising funds and try optimizing the returns from investments to create wealth for shareholders.

3. Foreign Exchange risk is an additional risk which a finance manager is required to mitigate with implementable strategies. In the Domestic Finance Management, there is no Foreign Exchange risk as the money dealings are completely in domestic currency only.

4. International Financial Management has to take into account Foreign Currency Exposure on account of receiving income from foreign customers and importing Plant and Machinery from abroad. In the case of Domestic Financial Management, there is no such exposure on account of all buying and selling taking place only inside the country.

5. In International Financial Management, we use derivatives instrument to hedge the risk. But in the case of domestic financial management, we do not use derivatives because there is less risk.

6. Under International Finance, the manager has to deal with different tax structure and different country legal laws. Whereas in Domestic Financial Management, the finance manager have to deal with domestic country legal laws and tax structure.

7. In International Finance domain, the finance manager has to work in Macro Business Environment of different countries but in Domestic Financial Management, the manager has to be aware of local macro business environment of single country.

SCOPE OF INTERNATIONAL FINANCIAL MANAGEMENT

1. Like any finance function, international finance, the finance function of a multinational firm has two functions namely, treasury and control. The treasurer is responsible for financial planning analysis, fund acquisition, investment financing, cash management, investment decision and risk management. On the other hand, controller deals with the functions related to external reporting, tax planning and management, management information system, financial and management accounting, budget planning and control, accounts receivables, etc.

2. For maximizing the returns from investment and to minimize the cost of finance, the firms has to take portfolio decision based on analytical skills required for this purpose. Since the firm has to raise funds from different financial markets of the world, which needs to actively exploit market imperfections and the firm's superior forecasting ability to generate purely financial gains. The complex nature of managing international finance is due to the fact that a wide variety of financial instruments, products, funding options and investment vehicles are available for both reactive and proactive management of corporate finance.

3. Multinational finance is multidisciplinary in nature, while an understanding of economic theories and principles is necessary to estimate and model financial decisions, financial accounting and management accounting help in decision making in financial management at multinational level. Because of changing nature of environment at international level, the knowledge of latest changes in FOREX rates, volatility in capital market, interest rate fluctuations, macro level charges, micro level economic indicators, savings, consumption pattern, interest preference, investment behavior of investors, export and import trends, competition, banking sector performance, inflationary trends, demand and supply conditions, etc. is required by the practitioners of international financial management.

DISTINGUISHED NATURE OF INTERNATIONAL FINANCIAL MANAGEMENT

International Finance is a distinct field of study and certain features set it apart from other fields. The important distinguishing features of international finance from domestic financial management are discussed below:

1. Foreign exchange risk is an understanding of foreign exchange risk which is essential for managers and investors in the modernday environment of unforeseen changes in foreign exchange rates. In a domestic economy, this risk is generally ignored because a single national currency serves as the main medium of exchange within a country. When different national currencies are exchanged for each other, there is a definite risk of volatility in foreign exchange rates.

2. The present International Monetary System set up is characterized by a mix of floating and managed exchange rate policies adopted by each nation keeping in view its interests. In fact, this variability of exchange rates is widely regarded as the most serious international financial problem facing corporate managers and policy makers.

3. At present, the exchange rates among some major currencies such as the U.S. dollar, British pound, Japanese yen and the euro fluctuate in a totally 6 unpredictable manner. Exchange rates have fluctuated since the 1970s after the fixed exchange rates were abandoned. Exchange rate variation affect the profitability of firms and all firms must understand foreign exchange risks in order to anticipate increased competition from imports or to value increased opportunities for exports.

4. Political risk is yet another risk that firms may encounter in international finance is political risk. Political risk ranges from the risk of loss (or gain) from unforeseen government actions or other events of a political character such as acts of terrorism to outright expropriation of assets held by foreigners. MNCs must assess the political risk not only in countries where it is currently doing business but also where it expects to establish subsidiaries. The extreme form of political risk is when the sovereign country changes the 'rules of the game' and the affected parties have no alternatives open to them. For example, in 1992, Enron Development Corporation, a subsidiary of a Houston based energy company, signed a contract to build India's largest power plant. Unfortunately, the project got cancelled in 1995 by the politicians in Maharashtra who argued that India did not require the power plant. The company had spent nearly $ 300 million on the project. The Enron episode highlights the problems involved in enforcing contracts in foreign countries. This, episode highlights the problems involved in enforcing contracts in foreign countries. Thus, political risk associated with international operations is generally greater than that associated with domestic operations and is generally more complicated.

5. Expanded opportunity sets – When firms go global, they also tend to benefit from expanded opportunities which are available now. They can raise funds in capital 7 markets where cost of capital is the lowest. In addition, firms can also gain from greater economies of scale when they operate on a global basis.

6. Market imperfection is the final feature of international finance that distinguishes it from domestic finance is that world markets today are highly imperfect. There are profound differences among nations' laws, tax systems, business practices and general cultural environments. Imperfections in the world financial markets tend to restrict the extent to which investors can diversify their portfolio.

Though there are risks and costs in coping with these market imperfections, they also offer managers of international firms abundant opportunities.

FOREIGN TRADE AND ECONOMIC GROWTH

Introduction

International trade has exerted a profound influence on the economic growth of a country. It has been observed that with the opening up of the economy and liberalization of trade restrictions, the developing countries, especially India and China, have grown over the years.

The issues of international trade and economic growth have gained substantial importance with the introduction of trade liberalization policies in the developing nations across the world. International trade and its impact on economic growth crucially depend on globalization. As far as the impact of international trade on economic growth is concerned, the economists and policy makers of the developed and developing economies are divided into two separate groups.

One group of economists is of the view that international trade has brought about unfavorable changes in the economic and financial scenarios of the developing countries. According to them, the gains from trade have gone mostly to the developed nations of the world. Liberalization of trade policies, reduction of tariffs and globalization have adversely affected the industrial set-ups of the less developed and developing economies. As an aftermath of liberalization, majority of the infant industries in these nations have closed their operations. Many other industries that used to operate under government protection found it very difficult to compete with their global counterparts.

The other group of economists, which speaks in favour of globalization and international trade, come with a brighter view of the international trade and its impact on economic growth of the developing nations. According to them, developing countries, which have followed trade liberalization policies, have experienced all the favourable effects of globalization and international trade. China and India are regarded as the trend-setters in this case.

There is no denying that international trade is beneficial for the countries involved in trade, if practiced properly. International trade opens up the opportunities of global market to the entrepreneurs of the developing nations, International trade also makes the latest technology readily available to the businesses operating in these countries. It results in increased competition both in the domestic and global fronts. To compete with their global counterparts, the domestic entrepreneurs try to be more efficient and this in turn ensures efficient utilization of available resources. Open trade policies also bring in a host of related opportunities for the countries that are involved in international trade.

In conclusion, it can be said that international trade leads to economic growth provided the policy measures and economic infrastructure are accommodative enough to cope with the changes in social and financial scenario that result.

Relationship between Foreign Trade and Economic Growth

International trade and economic growth are two concepts that go together, because international trade contributes to the growth of a country’s economy in several ways. Some of these ways include

the effects of import and export, specialization, increased productivity and improved infrastructure. The export of goods to other countries can contribute to the growth of the exporting country by increasing the earnings of that country.

The national economies of some countries are even dependent on and sustained by their exports. **For example,** some oil-producing countries depend on the income from the export of crude oil and its derivatives to sustain their nations. Some of these countries actually plan their national budgets based on projections or calculations of expected income from the export of oil. Apart from crude oil, other countries also partially base their national budget on the income from items like agricultural products, precious stones and even technology. This represents one way in which international trade and economic growth are linked.

Apart from commodities, the international trade in labour is also an offshoot of globalisation. Immigrants take much-needed skills to countries in which these skills are needed. Most immigrants from less developed nations to countries of highly developed state send money to their country of origin contributing to its economic growth. They also help to increase the growth of the economies of the countries where they live by contributing to productivity. For example, migrant workers often work on farms where they supply labour to help prepare food items for sale locally and internationally. More skilled immigrants like engineers, doctors and nurses contribute to the growth of the economy of their chosen country.

Another factor establishing a link between international trade and economic growth is the increase in productivity. When there is a high demand for a product, the countries that produce such a product will automatically increase production in order to meet up with the demand for the product. This increase translates to more revenue and an improvement in the economy of the country.

A vibrant culture of international trade also contributes to the building of an infrastructural framework in order to sustain the trade. For example, the demand for groundnuts from a country may lead to the building of roads and an improved transportation system to support the production. If the groundnuts are cultivated in farms located in villages that previously had a poor network of roads, the government or other corporate interests might build better roads.

Contribution of Foreign Trade in Economic Growth

Foreign trade plays a vital role in the economic development of a country. Its importance can be judged from the following points:

1. **Specialisation in Production:** Foreign trade leads to specialisation in the production of those goods which a country can produce at lower cost. This situation improves the overall welfare of the people.
2. **Quality Goods at Lower Rates:** If a country cannot produce a specific commodity, then it can import that commodity at lower rates from international market in the presence of foreign trade.
3. **Flow of Capital Goods and Technical Know-how:** In the presence of foreign trade, flow of capital goods and technical know-how take place which increase the rate of economic growth and development of the country.

4. **Removal of Shortage of Goods:** Foreign trade is helpful for the removal of shortage of goods. If there is shortage of any commodity, then that commodity can be imported from the international market which will eliminate shortage of good.
5. **Industrial and Agricultural Development:** Foreign trade brings improvement in industrial and agricultural sectors of the economy. The necessary inputs of industrial and agricultural sector can be imported which will develop both the sectors of the economy.
6. **Discourage the Formation of Monopolies:** Foreign trade discourages the formation of local monopolies. The local producers cannot exploit the consumers because of fear of cheap imports. In the absence of imports, some local firms may create monopoly and charge very high prices.
7. **Quality Importance of Local Products:** The foreign competition helps to improve the quality of local products. If Pakistani Government allows cycles to be improved, then the quality of Pakistani cycles will definitely improve.
8. **Optimum Utilization of Resources:** International trade helps in the optimum utilization of resources. A country specializes in the production of those goods for which its resources are more suitable, and as a result, the resources are properly utilized.
9. **Price Stability:** Foreign trade helps in the price stability of a country. If the price level is very high of a commodity, then that commodity can be imported which will keep price in stable position.
10. **World Peace:** Foreign trade promotes peace in the entire world because in the presence of international trade, people of different countries come close together and they become interdependent.
11. **Increase in National Income:** In the presence of international trade, the resources are properly utilized which increases exports of the country and, as a result, per capita income and national income increases.

CURRENT TRENDS IN INDIA

Economic Growth Trends in Indian Economy

There are the following major economic trends in India:

1. **Foreign Exchange Market:** The Indian rupee led a weekly loss in Asian currencies on increasing speculation that the U.S. will scale back monetary stimulus. The Indian rupee continued its freefall despite the central bank's efforts to prop up the currency. The rupee hit another record low during the week by ending at **65.83** per U.S. dollar on **6** September **2013.**
2. **Exports:** Indian exports to Euro-zone, which constitute around **17%** of the total exports, appear to be impacted due to the decreasing demand from Euro countries. In the first nine months of **2012-13,** a **10%,** contraction in exports has been observed when compared to that over a similar period in the previous year.

3. **Fiscal Environment:** The Government has found it difficult to contain expenditure despite proactive reforms to boost the slowing economy. The Government revised its fiscal consolidation roadmap in October 2012. As per the revised roadmap, the fiscal deficit of the central government will be reduced in a calibrated way from the targeted **5.3%** of **GDP** in **FY 2012-13** to **3.0%** of **GDP** by **FY 2016-17.** The revision proved challenging as the actual fiscal deficit fared at **5.9%.**
4. **Industrial Sector:** The industrial sector, usually more than one-fourth size of the total **GDP,** performed significantly below par this year with growth of mere 1% during the first half of **2016-17** as against **4.6%** in first half of **2016-17.** The under-performing manufacturing sector, particularly the capital goods industries, posed a real challenge for the country.
5. **Agricultural Sector:** In the agricultural sector, good winter crop sowing prospects are expected to overcome the negative effect of a deficient summer crop output. The yearly output is likely to be better than the **2.1%** growth achieved in first half of **2013.** Overall, the year is expected to close at a lower level compared to earlier years.
6. **Services Sector:** A larger concern exists on the services sector which has moderated during 2012. With "trade, hotels, transport, storage and communication" an important sub-sector in services performing the worst, various indicators of service sector activities such as cargo handling, civil aviation and railway freight, etc., suggest further weakening of growth. Additionally, the uncertain global outlook is likely to affect services exports adversely.
7. **Trade Deficit:** At the helm of worsening, CAD for the current year is the burgeoning trade deficit. During the period April to December 2012, both exports (U.S. $214 billion) and imports (U.S. $361 billion) declined. With a sharper drop in exports than imports, the trade deficit has surged to U.S. $147 billion in the first 9 months as against U.S. $137 billion of last year. Major decline in exports growth is an effect of sluggish global demand and an uncertain macro-economic environment.
8. **Balance of Payment:** This statistics show that capital inflows had improved in 2016-17 and in fact that capital inflows have financed the expanding CAD. While net FDI inflows moderated to U.S. $14.7 billion during April-November 2012 (as against U.S. $19.6 billion last year), net FOREX inflows have shown a significant uptrend reaching U.S. $11.2 billion in 2012.
9. **External Debt:** This has witnessed a steep rise in second quarter of 2016-17, reaching U.S. $365 billion from U.S. $345 billion at the start of the financial year.
10. **Inflation and Monetary Conditions:** For most of the period of 2016-17, the Wholesale Price Inflation (WPI) has remained around the mark of 7.5%. It reached as high as 8% in August 2012 and then revised down to 7.2% by December 2017, further moderating to 6.62% in January 2013. Inflation moderation has been faster than expected in the third quarter touching a three year low.
11. **Monetary Policy:** This monetary policy action is expected to result in consequent reduction in the interest rates. However, it remains to be seen if and how much a 25 basis point reduction will encourage banks in passing on a significant benefit to consumers.

BALANCE OF TRADE (BOT)

Introduction

The balance of trade (or net exports, sometimes symbolised as NX) is the difference between the monetary value of exports and imports of output in an economy over a certain period. It is the relationship between a nation's imports and exports. A favourable balance of trade is known as a trade surplus and consists of exporting more than is imported; an unfavourable balance of trade is known as a trade deficit or, informally, a trade gap. The balance of trade is sometimes divided into a goods and services balance.

The balance of trade forms part of the current account, which includes other transactions such as income from the international investment position as well as international aid. If the current account is in surplus, the country's net international asset position increases correspondingly. Equally, a deficit decreases the net international asset position.

The trade balance is identical to the difference between a country's output and its domestic demand (the difference between what goods a country produces and how many goods it buys from abroad; this does not include money spent on foreign stocks, nor does it factor the concept of importing goods to produce for the domestic market).

For a given country, trade balance comprises those products that a country trades on with other countries.

Measuring the balance of trade can be problematic because of problems with recording and collecting data. As an illustration of this problem, when official data for all the world's countries are added up, exports exceed imports by a few per cent; it appears the world is running a positive balance of trade with itself.

This cannot be true, because all transactions involve an equal credit or debit in the account of each nation. The discrepancy is widely believed to be explained by transactions intended to launder money or evade taxes, smuggling and other visibility problems. However, especially for developed countries, accuracy is likely.

According to Benham, "Balance of trade of a country is the relation over a period between the values of her exports and imports of physical goods".

In other words, balance of trade account is an account which records the exports and imports of goods of a country during a given period and shows the difference between the total value of experts of goods and the total value of imports of goods during a given period. Balance of trade can be represented as under:

$Bg = E_g - M_g$

where B_g = balance of trade

E_g = value of exports of goods

M_g = value of imports of goods

Features of BOT

The features of balance of trade are as follows:

1. Balance of Trade highlights the variation between the total exports and imports of a country for a give period of time.
2. It only shows the value of imports and exports and not the services. So, in this sense, it is a narrow concept.
3. Favourable Balance of Trade shows the country's claim from other countries to the extent of difference between the total value of exports and imports of goods.
4. The country's indebtedness is depicted by the unfavourable Balance of Trade.

Types of BOT

Balance of trade may be of three types as follows:

1. **Favourable Balance of Trade:** Balance of trade is said to be favourable when total value of exports of goods of a country exceeds her total value of imports of goods (i.e., when $E_g >$ Mg).
2. **Unfavourable (or Adverse) Balance of Trade:** Balance of trade is said to be unfavourable when total value of imports of goods of a country exceeds her total value of exports of goods (i.e., when $E_g < M_g$).
3. **Equilibrium Balance of Trade:** Balance of trade is said to be in equilibrium when total value of exports of goods of a company is equal to her total value of imports of goods (i.e., $E_g = M_g$).

BOT Deficit

It is the negative difference of the value of goods exported out of a country less the value of goods and services imported into the country. A balance of trade deficit is the official term for negative net exports that occurs when imports exceed exports. A balance of trade deficit is also termed an "unfavourable" balance of trade because it results in a net outflow of monetary payments from the domestic economic to the foreign sector, which tends to be bad for a country. The alternative is a balance of trade surplus in which exports exceed imports.

A balance of trade deficit exists for a country when the value of imports produced by the foreign sector and purchased by the domestic economy is greater than the value of exports produced by the domestic economy and purchased by the foreign sector. In other words, imports exceed exports and net exports are negative.

This is also commonly termed an unfavourable balance of trade because the excess of exports over imports creates a net outflow of monetary payments out of a country. This generates a decrease in aggregate income and associated measures, especially consumption, saving, investment, and tax revenue, which is rightfully considered to be "unfavourable" for the country.

A given country can have an "overall" balance of trade deficit in which imports from the foreign sector exceed exports to the foreign sector. One country can also said to have a balance of trade deficit

with just one other country, in which imports from that country exceed exports to that country. For example, the United States might have an overall balance of trade surplus with the foreign sector, but a balance of trade deficit with China. An overall balance of trade deficit with the foreign sector does not necessarily mean a balance of trade deficit for every other country.

Causes of Balance of Trade Deficit

A negative balance of trade can have many causes like the following:

1. Not enough companies engage in exporting. For example, most big companies in the U.S. do not emphasize the extension of their exports. They prefer delocalizing their production by investing in emerging economies such as China. From there, the products produced at a by far lower cost are imported to the U.S. and Europe at a by far higher margin.
2. A second reason for a country's negative balance of trade may be that its companies are not internationally competitive enough (because of high labour costs, lack of technology, high taxes, inadequate industrial structures, etc.).
3. Another reason may be an over-rating of the country's currency, which makes its products and services too expensive to export, while imports from other countries are relatively low priced.
4. A government's budget deficit may be an important factor leading to a negative balance of trade. For example, the U.S. government, unlike many European governments, supports its budget deficit by borrowing from other countries. This borrowing makes it possible to maintain consumption at high level, which results in a negative balance of trade (and in net imports of capital because of the higher returns of investments).

An international marketer interested in the economic outlook of a potential country market may analyse the country's balance of trade and the government's budget deficit as a percentage of GDP for both short-term and long-term effects.

BALANCE OF PAYMENT (BOP)

Introduction

Balance of payment is a broader term and it includes balance of trade. It is more comprehensive than the balance of trade. Balance of trade refers to the merchandise account of exports and imports only.

Balance of payment refers to the net results that are drawn recording all the visible and invisible items that are imported and exported from the country. Balance of payment, such as, provides a comprehensive statement over the net results of foreign trade and gives a true picture as to where the country stands in the international trade. Balance of payment clearly exposes the economic viability, strength, and capability by correctly measuring its imports and exports, competency in goods and services as well as technical know-how. By services, we mean the services of shipping lines, insurance companies, banking concerns and others. Balance of payment also includes the foreign loan that is either provided by it or accepted from other country or countries.

According to Kindleberger, "Balance of payment is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time".

In other words, the balance of payments is a comprehensive record of economic transactions of the residents of a country with the rest of the world during a given period of time. The aim is to present an account of all receipts and payments on account of goods exported any services rendered by resident of a country and goods imported, services received and capital transferred by residents of the country.

The balance of payments is an accounting statement that summarizes all the economic transactions between residents of the home country and residents of all other countries. It is a measure of all transactions between domestic countries and international countries.

Nature of Balance of Payment

The nature of balance of payments is as follows:

1. **Systematic Record:** It is a systematic record of receipts and payments of a country with other countries.
2. **Fixed Period of Time:** It is a statement of an account pertaining to a given period of time, usually a year.
3. **Comprehensiveness:** It includes all the three items, i.e., visible, invisible and capital transfers. The balance of payments is a comprehensive record of economic transactions of the residents of a country with the rest of the world during a given period of time. The aim is to present an account of all receipts and payments on account of goods exported services rendered and capital by resident of a country and goods imported, services received and capital transferred by residents of the country.
4. **Double Entry System:** Receipts and payments are recorded on the basis of double entry system. The basic convention applied in constructing a balance of payments statement is that every recorded transaction is represented by two entries with equal values. One of these entries is designated a credit with a positive arithmetic sign; the other is designated a debit with a negative sign. In principle, the sum of all credit entries is identical to the sum of all debit entries, and the net balance of all entries in the statement is zero.
5. **Self-balanced:** From the point of view of accounting, double entry system keeps automatically debit and credit sides of the accounts in balance.
6. **Adjustment of Differences:** Whenever there are differences in actual total receipts and payments, need is felt for necessary adjustment.
7. **All Items – Government and Non-government:** Balance of payments includes receipts and payments of all items government and non-govemment.

Components of BOP

The accounting contents or components of balance of payments are:

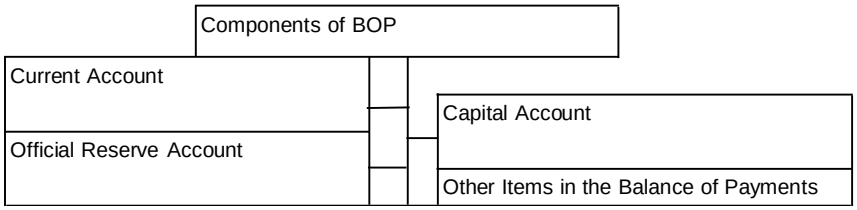


Fig. 1.3

1. Current Account: Current account is typically divided into three sub-categories; the merchandise trade balance, the services balance and the balance on unilateral transfers. Entries in this account are "current" in value as they do not give rise to future claims. A surplus in the current account represents an inflow of funds while a deficit represents an outflow of funds. The capital account can be divided into three categories:

(i) Merchandise: Balance of merchandise trade refers to the balance between exports and imports of tangible goods such as automobiles, computers, machinery and so on. A favourable balance of merchandise trade (surplus) occurs when exports are greater in value than imports. An unfavourable balance of merchandise trade (deficit) occurs when imports exceed exports. Merchandise exports and imports are the largest single component of total international payments for most countries.

(ii) Invisibles: Services represent the second category of the current account. Services include interest payments, shipping and insurance fees, tourism, dividends and military expenditures. These trades in services are sometimes called invisible trade.

(iii) Unilateral Transfers: Unilateral transfers are gifts and grants by both private parties and governments. Private gifts and grants include personal gifts of all kinds and also relief organization shipments. For example, money sent by immigration workers to their families in their native country represents private transfer. Government transfers include money, goods and services sent as aid to other countries.

2. Capital Account: The capital account is an accounting measure of the total domestic currency value of financial transactions between domestic residents and the rest of the world over a period of time. This account consists of loans, investments, and other transfers of financial assets and the creation of liabilities. It includes financial transactions associated with international trade as well as flows associated with portfolio shifts involving the purchase of foreign stocks, bonds and bank deposits.

The capital account can be divided into three categories: direct investment, portfolio investment and other capital flows.

(i) Direct Investment: Direct investment occurs when the investor acquires equity such as purchases of stocks, the acquisition of entire firms, or the establishment of new subsidiaries. Foreign direct investment (FDI) generally takes place when firms tend to take advantage of various market imperfections. Firms also undertake foreign direct investments when the

expected returns from foreign investment exceed the cost of capital, allowing for foreign exchange and political risks. The expected returns from foreign profits can be higher than those from domestic projects due to lower material and labour costs, subsidised financing, investment tax allowances, exclusive access to local markets, etc.

(ii) ***Portfolio Investment:*** Portfolio investments represent sales and purchases of foreign financial assets such as stocks and bonds that do not involve a transfer of management control. A desire for return, safety and liquidity in investments is the same for international and domestic portfolio investors. International portfolio investments have specifically boomed in recent years due to investor's desire to diversify risk globally. Investors generally feel that they can reduce risk more effectively if they diversify their portfolio holdings internationally rather than purely domestically. In addition, investors may also benefit from higher expected returns from some foreign markets.

(iii) ***Capital Flows:*** Capital flows represent the third category of capital account and represent claims with a maturity of less than one year. Such claims include bank deposits, short-term loans, short-term securities, money market investments and so forth. These investments are quite sensitive to both changes in relative interest rates between countries and the anticipated change in the exchange rate. For example, if the interest rates rise in India, with other variables remaining constant, India will experience capital inflows as investors who would like to deposit or invest in India take advantage of the higher interest rate. But if the higher interest rate is accompanied by an expected depreciation of the Indian rupee, capital inflows to India may not materialise.

3. Official Reserve Account: Official reserves are government owned assets. The official reserve account represents only purchases and sales by the central bank of the country (for example, The Reserve Bank of India). The changes in official reserves are necessary to account for the deficit or surplus in the balance of payments. For example, if a country has a BOP deficit, the central bank will have to either run down its official reserve assets such as gold, foreign exchange and SDRs or borrow fresh from foreign central banks. However, if a country has a BOP surplus, its central bank will either acquire additional reserve assets from foreigners or retire some of its foreign debts.

4. Other Items in the Balance of Payments: The remaining items that can not be categorised in to the preceding categories constitute the other items in the balance of payments.

(i) ***Errors and Omissions:*** These take into account the difficulty of accurately recording all the wide variety of transactions that take place in the accounting period. They may arise due to the presence of sampling of transactions rather than recording each individual transaction (e.g., instead of recording each of a thousand exports of lemons, they may multiply an average lemon export figure by thousand), due to dishonesty, i.e., businessmen under reporting sales abroad to avoid taxes, or when smuggling occurs, etc.

(ii) ***Official Reserve Transactions:*** All transactions except those in this category may be termed as autonomous transactions. They are so-called because they are entered into with some independent motive, i.e., not with a view to bring their consequences on the balance of payments or on the exchange rate. In contrast to this, official reserve transactions are carried out by the government and the central banks in pursuit of some international economic policy objective; while keeping an eye on the effect of such transactions on the

BOP and the exchange rate. As a result, such transactions are not autonomous. The first of these items is the change in the domestic country's official reserve assets. These reserves of a country are held in the form of foreign currency or foreign currency securities, gold and Special Drawing Rights (SDR) with the IMF. SDR allows a country to avail of foreign exchange in proportion to the quantum of the country's deposit of its currency with the IMF under the SDR scheme. The changes in the country's reserves must reflect the net value of all other items in the BOP. Reduction in these assets will be used to finance expenditures abroad. Reductions appear as a credit item in the BOP (because their sale causes foreign exchange inflow into the country). An increase in these reserves will appear as a debit because of purchasing assets.

Table 1.3

						Credit	**Debit**	**Net**
(A)	Current Account							
	1.	Merchandise						
		(i)	Exports (on f.o.b. basis)					
		(ii)	Imports (on ci.f. basis)					
	2.	Invisibles (i + ii + iii)						
		(i)	Services					
			(a)	Travel				
			(b)	Transportation				
			(c)	Insurance				
			(d)	Miscellaneous				
		(ii)	Transfers					
			(a)	Official				
			(b)	Private				
		(iii)	Investment Income Total Current Account (1 + 2)					
(B)	Capital Account ^							
	1.	Foreign Investment (i + ii)						
		(i)	In India					
			(a)	Direct				
			(b)	Portfolio				
		(ii)	Abroad					
	2.	Loans (i + ii + iii)						
		(i)	External Assistance					
			(a)	By India				
			(b)	To India				

		(ii)	Commercial Borrowings (MT and LT)					
			(a)	By India				
			(b)	To India				
		(iii)	Short-term					
			(a)	To India				
	3.	Banking Capital (i + ii)						
		(i)	Commercial Banks					
			(a)	Assets				
			(b)	Liabilities				
			(c)	Non-resident Deposits				
		(ii)	Others					
	4.	Rupee Debt Service						
	5.	Other Capital Total Capital Account (1 + 2 + 3 + 4 + 5)						
(C)	Errors and Omissions							
(D)	Overall Balance (A + B + C)							
(E)	Monetary Movements (i + ii)							
	1.	I.M.F.						
	2.	Foreign Exchange Reserves (Increase -/Decrease +)						

Since the balance of payments statement is drawn up in terms of debits and credits based on a system of double-entry book-keeping, if all entries are made correctly, the total debits must equal total credits.

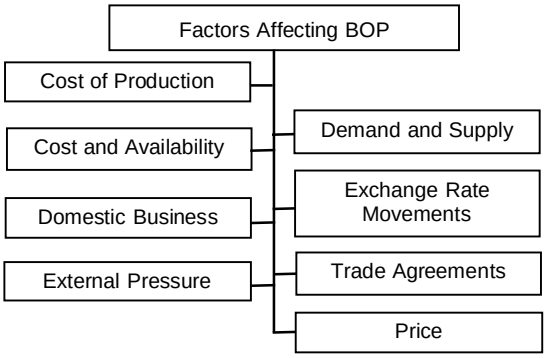
This is because two aspects (debits and credits) of each transaction recorded are equal in amount and appear on the opposite sides of the balance of payments account. In the accounting sense, balance of payments of a country must always balance.

In other words, debit or payment side of the balance of payments accounts of a country represents the total of all the uses made out of the total foreign exchange acquired by a country during the given period, while the credit or the receipt side represents the sources from which this foreign exchange was acquired by this country in the same period. The sides as such necessarily balance.

FACTORS AFFECTING BALANCE OF PAYMENT (BOP)

Following factors affect the balance of payments of the country.

1. **Cost of Production:** The cost of production (land, labour, capital, taxes, incentives, etc.) in the exporting economy ϖϖ those in the importing economy
2. **Demand and Supply:** The demand and supply trend defines the cost of domestic products to be sold in the international market.
3. **Cost and Availability:** The cost and availability of raw materials, intermediate goods and other inputs.



Fig, 1.4

4. **Exchange Rate Movements:** For nations with low exchange rate values, balance of trade tends to remain unfavourable.
5. **Domestic Business:** Sound, domestic policies are required to boost production and international trade. Some countries like the U.S. provide subsidies to local manufacturers for exported goods and services.
6. **Trade Agreements:** Bilateral agreements govern international trade and define the products and their prices in the global context.
7. **External Pressures:** Many countries export items that face heavy competition in international market. This results in market segmentation and low pricing. Countries that are mostly oil exporters or IT hubs tend to generate favourable trade balance due to less competition in the international market. External pressures also work in the form of trade bans. These bans are enforced by either individual countries or international organisations such as the WTO or IMF.
8. **Price:** Prices of goods manufactured at home (influenced by the responsiveness of supply).

Importance of BOP

BOP data may be important for any of the following reasons:

1. **Forecasting:** The BOP helps forecast a country's market potential, especially in the short run. A country experiencing a serious BOP deficit is not likely to import as much as it would if it were running a surplus.
2. **Indicator of Pressure:** The BOP is an important indicator of pressure on a country's foreign exchange rate, and thus on the potential of a firm trading with or investing in that country to experience foreign exchange gains or losses. Changes in the BOP may presage the impositions (or removal) of foreign exchange controls.
3. **Signal of Imposition:** Changes in a country's BOP may also signal the imposition (or removal) of controls over payment of dividends and interest, license fees, royalty fees, or other cash disbursements to foreign firms or investors.
4. **Judging the Stability:** Judging the stability of a floating exchange rate system is easier with BOP as the record of exchanges that take place between nations help to track the accumulation of currencies in the hands of those individuals more willing to hold on to

them and judging the stability of a fixed exchange rate system is also easier with the same record of international exchange. These exchanges again show the extent to which a currency is accumulating in foreign hands, raising questions about the ease of defending the fixed exchange rate in a future crisis.

Disequilibrium in BOP r

The balance of payments of a country is said to be in equilibrium when the demand for foreign exchange is equivalent to the supply of it. The balance of payments is in disequilibrium when there is either a surplus or a deficit in the balance of payments. When there is a deficit in the balance of payments, the demand for foreign exchange exceeds the demand for it.

Though the credit and debit are balanced in the balance of payment account, it may not remain balanced always. Very often, debit exceeds credit or the credit exceeds debit causing an imbalance in the balance of payment account. Such an imbalance is called the disequilibrium. Disequilibrium may take place either in the form of deficit or in the form of surplus.

Disequilibrium of deficit arises when the receipts from the foreigners fall below our payment to foreigners. It arises when the effective demand for foreign exchange of the country exceeds its supply at a given rate of exchange. This is called an 'unfavourable balance'.

Disequilibrium of surplus arises when the receipts of the country exceed its payments. Such a situation arises when the effective demand for foreign exchange is less than its supply. Such a surplus disequilibrium is termed as 'favourable balance'.

Causes of Disequilibrium in Balance of Payments (BOP)

Various causes of disequilibrium in the balance of payments or adverse balance of payments are as follows:

1. Development Schemes: The main reason for adverse balance of payments in the developing countries is the huge investment in development schemes in these countries. The propensity to import of the developing countries increases for want of capital for industrialization. The exports, on the other hand, may not increase because these countries are traditionally primary producing countries. Moreover, the volume of exports may fall because newly created domestic industries may need them. All this leads to structural changes in the balance of payment resulting in structural disequilibrium.

2. Price-Cost Structure: Changes in price-cost structure of export industries affect the volume of exports and create disequilibrium in the balance of payments. Increase in prices due to higher wages, higher cost of raw materials, etc. reduces exports and makes the balance of payments unfavourable.

3. Changes in Foreign Exchange Rates: Changes in the rate of exchange is another cause of disequilibrium in the balance of payments. An increase in the external value of money makes imports cheaper and exports dearer; thus, imports increase and exports fall and balance of payments become unfavourable. Similarly, a reduction in the external value of money leads to a reduction in imports and an increase in exports.

4. Fall in Export Demand: There has been a considerable decline in the export demand for the primary goods of the underdeveloped countries as a result of the large increase in the domestic

production of foodstuffs, raw materials and substitutes in the rich countries. Similarly, the advanced countries also find a fall in their export demand because of loss of colonial markets. However, the deficit in the balance of payment due to the fall in export demand is more persistent in the underdeveloped countries than in the advanced countries.

5. Demonstration Effect: According to Nurkse, the people in the less developed countries tend to follow the consumption patterns of the developed countries. As a result of this demonstration effect, the imports of the less developed countries will increase and create disequilibrium in the balance of payments.

6. International Borrowing and Lending: International borrowing and lending is another reason for the disequilibrium in the balance of payments. The borrowing country tends to have unfavourable balance of payments, while the lending country tends to have favourable balance of payments.

7. Cyclical Fluctuations: Cyclical fluctuations cause cyclical disequilibrium in the balance of payments. During depression, the incomes of the people in foreign countries fall. As a result, the exports of these countries tend to decline which, in turn, produces disequilibrium in the home country's balance of payment.

8. Newly Independent Countries: The newly independent countries, in order to develop international relations, incur huge amounts of expenditure on the establishment of embassies, missions, etc. in other countries. This adversely affects the balance of payments position.

9. Population Explosion: Another important reason for adverse balance of payments in the poor countries is population explosion. Rapid growth of population in countries like India increases imports and decreases the capacity to export.

10. Natural Factors: Natural calamities, such as droughts, floods, etc., adversely affect the production in the country. As a result, the exports fall, the imports increase and the country experiences deficit in its balance.

Types of Disequilibrium in the BOP

The following are the main types of disequilibrium in the balance of payments:

Table 1.4: Types of Disequilibrium

Structural Disequilibrium	Cyclical Disequilibrium
Monetary Disequilibrium	Technological Disequilibrium
Short-run Disequilibrium	Secular or Long-run Disequilibrium

1. Structural Disequilibrium: It takes place due to structural changes in the economy affecting demand and supply relations in commodity and factor market. Structural disequilibrium in balance of payments persists for relatively longer periods; as it is not easy to remove structural imbalance in the economy. Structural disequilibrium is caused by changes in technology, tastes and attitude towards foreign investment, political disturbances, strikes, lockouts, etc. which affect the supply of exports thereby causing structural disequilibrium.

Structural disequilibrium can be further bifurcated into:

(i) Structural Disequilibrium at Goods Level: It occurs when a change in demand or supply of exports or imports alters a previously existing equilibrium, or when a change occurs in the basic circumstances under which income is earned or spent abroad, in both cases without the requisite parallel changes elsewhere in the economy. Suppose the demand for Pakistani handicrafts falls off. The resources engaged in the production of these handicrafts must shift to some other line or the country must restrict imports, otherwise the country will experience a structural disequilibrium.

A deficit arising from a structural change can be filled by increased production or decreased expenditure, which in turn affect international transactions in increased exports or decreased imports. Actually it is not so easy, because the resources are relatively immobile and expenditure not readily compressible. Disinflation or depreciation may be called for to correct a serious disequilibrium.

(ii) Structural Disequilibrium at Factors Level: It results from factor prices which fall to reflect accurately factor endowments, i.e., when factor prices are out of line with factor endowments, distort the structure of production from the allocation of resources which appropriate factor prices would have indicated. If for example, the price of labour is too high, it will be used more sparingly and the country will import goods with a higher labour content. This will lead to unemployment, upsetting the balance in the economy.

Some of the important causes of structural disequilibrium are as follows:

(a) If the foreign demand for a country's products decline due to the discovery of cheaper substitutes abroad, then the country's export will decline causing a deficit.

(b) If the supply position of a country is affected due factors like crop failure, shortage of raw-materials, strikes, and political instability, etc., then there would be the deficit in the balance of payments.

(c) A shift in demand due to the changes in tastes, fashions, and income, etc., would increase or decrease the demand for imported goods causing a disequilibrium in the balance of payments.

(d) Changes in the rate of international capital movements may also cause structural disequilibrium.

(e) A war also results in structural changes which may affect not only goods but also factor of production causing disequilibrium in balance of payments.

2. Cyclical Disequilibrium: When disequilibrium is caused due to the changes in trade cycles, it is termed as cyclical disequilibrium. Cyclical disequilibrium occurs because of two reasons which are as follows:

(i) Two countries may be passing through different paths of business cycle. It is possible that different phases of trade cycles like depression, prosperity, boom, and recession, etc., may disturb terms of trade and cause disequilibrium in balance of payments. For example, during boom period, imports may increase considerably due to increase in-demand for imported goods. During recession and depression, imports may be reduced due to fall in demand on account of reduced income. During recession exports may increase due to fall in price. During boom period, a country may face deficit in

its BOP position on account increase in imports. However, during recession its export may increase, and as such BOP position may show surplus.

(ii) The countries may be following the same path but the income elasticities of demand or price elasticities of demand are different, i.e., the importing countries may face cyclical changes. For example, there may be recession in the importing countries, which in turn would reduce demand for imports. Therefore, the demand for exports will decline and the exporting country may face a trade deficit, which in turn may affect BOP positions.

In short, cyclical fluctuations cause disequilibrium in the balance of payments because of cyclical changes in income, employment, output and price variables. When prices rise during prosperity and fall during a depression, a country which has a highly elastic demand for imports experiences a decline in the value of imports and if it continues its exports further, it will show a surplus in the balance of payments.

3. Monetary Disequilibrium: It takes place on account of inflation or deflation. Due to inflation, the prices of the products in the domestic market rises, and therefore, export items will become expensive. Such a situation may affect the BOP equilibrium. Inflation also results in to increase in money income with the people, which in turn may increase demand for imported goods. As a result imports **may turn** BOP position in disequilibrium.

It arises due to deficient or excess nominal demand for goods and securities and the resulting accumulation or de accumulation of money.

4. Technological Disequilibrium: It is caused by various technological changes involve inventions or innovations of new goods or new technique of production. These technological changes affect the demand for factors and goods.

A technological change will give comparative advantage to the innovating country leading to the increase in exports or a decline in imports. This will create disequilibrium in the balance of payments.

5. Short-Run Disequilibrium: A short-run disequilibrium in a country's balance of payments will be a temporary one, lasting for a short period, which may occur once in a while. When a country borrows or lends internationally, it will have a short-run disequilibrium in its balance of payments, as these loans are usually for a short period or even if they are for a long duration, they are repayable later on; hence the position will be automatically corrected and poses no serious problem. As such a disequilibrium arising from international lending and borrowing activities is perfectly justified. However, a short-run disequilibrium may also emerge if a country's imports exceed its exports in a given year. This will be a temporary one if it occurs once in a way, because later on, the country will be in a position to correct it easily by creating the required credit surplus by exporting more to offset the deficit. But even this type of disequilibrium in the balance of payments is riot justified, because it may pave the way for a long-term disequilibrium. When such disequilibrium (arising from imports exceeding exports or even vice versa) occurs year after year over a long period, it becomes chronic and may seriously affect the country's economy and its international economic relations. A persistent deficit will tend to deplete its foreign exchange reserves and the country may not be able to raise any more loans from foreigners.

Disequilibrium caused on a temporary basis for a short period, say one year is called short-run disequilibrium. Such disequilibrium does not pose a serious threat as it can be overcome within a short run. Such disequilibrium may be caused due to international borrowing and lending. When a country goes for borrowing or lending it leads to short-run disequilibrium. Such disequilibrium is justified as they do not pose a serious threat.

Short-run disequilibrium may also be caused when a country's imports exceeds exports in a particular year. Such disequilibrium is not justified as it has the potentiality to develop in to a crisis in time. The Economic crisis in India in 1990-91 is nothing but the development of short-run disequilibrium. If the short-run disequilibrium is persistent and occurs repeatedly; it may pave the way for long-run disequilibrium.

6. Secular or Long-Run Disequilibrium: It prevails for a long period of time, i.e., when the disequilibrium is persistent and long-run oriented, it is called long-run disequilibrium. The IMF terms such disequilibrium as "Fundamental Disequilibrium".

Long-run or fundamental disequilibrium refers to a persistent deficit or a surplus in the balance of payments of a country. It is also known as secular disequilibrium.

The secular or long-run disequilibrium in BOP occur because of long-run and deep seated changes in an economy as it advances from one stage of growth to another. The current account follows a varying pattern from one state to another. In the initial stages of development, domestic investment exceeds domestic savings and imports exceed exports.

Disequilibrium arises owing to lack of sufficient funds available to finance the import surplus, or the import surplus is not covered by available capital from abroad.

When there is a continuous increase in the stock of gold and foreign exchange reserves. There is a persistent surplus and vice versa. Permanent changes in the conditions of demand and supply of exports and imports cause fundamental disequilibrium. A permanent deficit or surplus may make a country debtor or creditor causing a fundamental disequilibrium.

Then comes a stage when domestic savings tend to exceed domestic investment and exports outrun imports.

Disequilibrium may result, because the long-term capital outflow falls short of the surplus savings or because surplus savings exceed the amount of investment opportunities abroad. At a still later stage, domestic savings tend to equal domestic investment and long-term capital movements are on balance zero. A developing country in its initial stages may import large amount of capital and hence its imports would exceeds exports. When this becomes chronic, there emerges a secular deficit in its balance of payments. Deep rooted dynamic changes like capital formation, innovations, technological advancements, and growth of population, etc., also contribute to fundamental disequilibrium. When there is a series of short-run disequilibrium in a country's balance of payments, ultimately it would lead to fundamental disequilibrium.

METHODS OF CORRECTING DISEQUILIBRIUM IN BALANCE OF PAYMENT

Methods used for correcting disequilibrium in the BOP are as follows:

1. Monetary Policy: Monetary policy may be devised to correct a deficit in the balance of payments of a country. The deficit occurs because of high imports and low exports. This is to be reversed. In this regard, the country may adopt deflationary or dear money policy by raising the bank rate and restricting credit Under deflation, prices fall which makes exports attractive and imports relatively costlier. This eventually leads to a rise in exports and fall in imports.

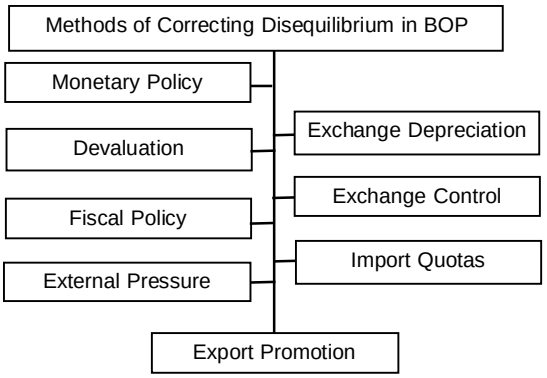


Fig. 1.5

2. Exchange Depreciation: Exchange depreciation means a decline in the rate of exchange of one country ii terms of another. Suppose the Indian rupee exchanges for 30 cents of American currency. If India experience: an adverse balance of payments with regard to America, the Indian demand for American currency (Dollar) will rise. Consequently the price of dollar in terms of rupee will appreciate in its external value. Thus, the rate of exchange of Indian rupee in terms of American dollar may change from Re. l = 30 cents to Re. l = 20 cents. Such depreciation in the value of currency is what is called "exchange depreciation."

3. Devaluation: It is an alternative to exchange depreciation. It is suitable under the present IMF system. Devaluation means official decrease in the external value of a currency in terms of foreign currency or good or SDR.

Suppose 1$ = ?8 and if Indian Government puts it as 1$ = ?10 it means a 25 per cent devaluation of the Indian rupee in terms of the U.S. dollar.

When a country has a persistent deficit in its balance of payments, it may devalue its currency with the permission of the IMF. When a country's currency is devalued, the impact would be relative cheapness of its exports to the foreigners and relative dearness of its imports. Consequently, export will rise and imports decline. This will help removal of the deficits in the balance of payments.

4. Exchange Control: Restrictions on the use of foreign exchange by the central bank is called "exchange control". When exchange control is adopted, all the exporters have to surrender their foreign exchange earnings to the central bank. Under exchange control, the central bank releases foreign exchanges only for essential imports and conserves the rest of the balance. This is the most direct method of curbing imports.

5. Fiscal Policy: Fiscal policy is another method of correcting unfavourable balance of payments. Under budgetary provisions, tariff or import duties may be imposed so that import becomes dearer and the propensity to import is checked. As a result, imports are reduced and the balance of payments becomes favourable.

6. Import Quotas: Fixing of import quotas is another and perhaps a better device used for correcting an adverse balance of payments. Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system deficit is reduced or eliminated and thereby the balance of payments position is improved.

7. Export Promotion: To correct disequilibrium in the balance of payments, it is necessary that exports should be increased. Government may adopt export promotion programmes for this purpose. Export promotion programme includes subsidies, tax concessions to exporters, marketing facilities, incentives for exports, etc.

Difference Between BOT and BOP

The balance of trade (BOT or net exports, sometimes symbolised as NX) is the difference between the monetary value of exports and imports of output in an economy over a certain period. It is the relationship between a nation's imports and exports. A favourable balance of trade is known as a trade surplus and consists of exporting more than is imported; an unfavourable balance of trade is known as a trade deficit or, informally, a trade gap. The balance of trade is sometimes divided into a goods and services balance.

Table 1.5

	Basis of Difference	Balance of Trade	Balance of Payment
1.	Meaning	It refers to the merchandise account of exports and imports only.	BOP is a broader term, it includes Balance of Trade, it encompasses international economic transactions and items such as merchandise trade, services, banking, insurance, capital flows, gold buying and selling, etc.
2.	Nature and Scope	A country may export and import many items, both visible and invisible, balance of trade refers to the visible items only.	It covers the total debits and credits of all items, visible as well as invisible.
3.	Constituents	It is only a partial study of the BOP. It refers to the difference between the value of exports and visible imports. This is what is represented in the trade or merchandise account section of the current account in the BOP statements.	The BOP includes apart from Balance of Trade or merchandise account the invisible account which is again composed of the service sector and gifts and charities account comprising a variety of invisible items, a record of capital account.
4.	In the Accounting Sense	It may be deficit or surplus. Thus, it may be imbalanced.	BOP always balances, since the BOP statement is drawn up in terms of debits and credits based on a system of double entry book-keeping, therefore total debits must equal total credits.

BARRIERS TO INTERNATIONAL TRADE

Introduction

As it is in principle no country permits a totally unregulated flow of goods and services across its borders.Likewise, governments may choose to enable the global competitiveness of their, own domestic Firms. **Protectionism** refers to those government restrictions and incentives that are specifically designed to help a county's domestic firms compete with foreign competitors at home and abroad.

On the other hand **free trade policy** implies absence of any artificial restriction on or obstacle to the freedom of trade of a country with other nations. The rationale for such policies can be economic or non economic in nature. Whenever governments choose to impede the flow of imports and/or encourage the flow of exports, they simultaneously provide direct and/or indirect subsidies for their domestic firms.

Tariffs (taxes on imports/exports), quotas, etc. discourage international trade. These exist to raise revenue for the government or to "protect" domestic industries. Recently, however, governments have been doing more to reduce barriers to trade because they see the benefits of international trade.

A trade barrier is a general term that describes any Government policy or regulation that restricts international trade. The barriers can take many forms, including the following terms that include many restrictions in international trade within multiple countries that import and export any items of trade.

All governments attempts to restrict or support international trade or transfers of resources. This intervention can take the form of controlling the flow of trade and transfer of goods, controlling the transfer of capital flows, or controlling the movement of personnel and technology.

Objectives of International Trade Barriers

Trade barriers often are set-up to ensure that products imported into the country meet safety, legal and quality standards. They also are imposed in an effort to curb unemployment. When governments limit the entry of foreign goods, local companies need not fear threats to their existence. This is particularly useful during recessions, when unemployment and the cost of living are high. Trade barriers also may be imposed for national defence strategies. Countries sometimes use embargoes to force other nations to conform or as an open declaration of war. Objectives of trade barriers are as follows:

1. Protecting Domestic Employment: The levying of tariffs is often highly politicized. The possibility of increased competition from imported goods can threaten domestic industries. These domestic companies may fire workers or shift production abroad to cut costs, which means higher unemployment and a less happy electorate.

The unemployment argument often shifts to domestic industries complaining about cheap foreign labour, and how poor working conditions and lack of regulation allow foreign companies to produce goods more cheaply. In economics, however, countries will continue to produce goods until they no longer have a comparative advantage (not to be confused with an absolute advantage).

2. Infant Industries: The use of tariffs to protect infant industries can be seen by the Import Substitution Industrialization (ISI) strategy employed by many developing nations. The government of a developing economy will levy tariffs on imported goods in industries in which it wants to foster growth. This increases the prices of imported goods and creates a domestic market for domestically produced goods, while protecting those industries from being forced out by more competitive pricing. It decreases unemployment and allows developing countries to shift from agricultural products to finished goods.

3. National Security: Barriers are also employed by developed countries to protect certain industries that are deemed strategically important, such as those supporting national security. Defence industries are often viewed as vital to state interests, and often enjoy significant levels of protection. For example, while both Western Europe and the United States are industrialised, both are very protective of defence-oriented companies.

4. Protect Home Industries from Foreign Competition: Trade barriers are imposed in order to give protection to home industries avoiding completion from other countries. Such competition is harmful and may bring home industries in difficulties. Government has to give support and protection to home industries and for such protection, imports must be discouraged or stopped. This is possible through the creation of different trade barriers and restricting imports.

5. Promote New Industries and R&D Activities: The quality of production is also likely to improve through Research and Development (R&D) activities. Such R&D activities can be undertaken at the company's level, at the industry level and even at the national level. It is type of industrial research activity conducted in the research laboratories.

R&D is a costly and time consuming activity and also requires the services of scientists/exports. Quality improvement, cost reduction, introduction of new product, modification in the existing products and making existing products more useful and agreeable to consumers are some benefits of R&D activities.

6. Conserve Foreign Exchange Reserves: A country has to pay for imports through its foreign exchange reserves. Large-scale imports mean heavy pressure on available reserve of foreign currencies. Such policies will ultimately lead to foreign exchange crisis. On the other hand, foreign exchange will be saved through import substitution and import restriction.

7. Maintain Favourable Balance of Trade and Payments Position: Large-scale imports lead to deficit in the balance of trade and balance of payments. Such deficit is undesirable and puts heavy strain on the available foreign exchange. For removing such deficit, imports should be restricted and exports should be promoted. Trade barriers are useful for reducing imports. They are advocated for reducing deficit in the balance of trade and payment position.

The term balance of trade suggests the difference between exports and imports which may be positive/negative. It is positive when exports made are more than the imports. It is treated as negative when exports are less as compared to imports within a specific period normally one year. Poor and developing countries normally have to face the problems of negative balance of trade.

8. Protect National Economy from Dumping: Foreign countries may try to capture domestic market by offering their goods at very low prices. The purpose is to sell surplus production. Such

techniques of dumping are profitable to reach countries but harms poor countries. To avoid such situation (anti-dumping duties) are imposed. As a result, foreign goods become costly and the adverse effects on home markets are avoided.

9. Hurdle to Exporters: Huge rate of Interest for Export Credit

The rate in India is 11-12% but in China, it is 5.5.%; in Malaysia, it is 6.2%, In Euro area, it is 2.1%, in Taiwan, it is 2.6%,in Thailand, it is 4.6%.

Source: Business Line on "Export Review"

Example:1

Similarly in Japan, India's Pharmaceutical exports have not benefited from tariff reduction under India-Japan CEPA mainly because it is too cumbersome to deal with the Japanese drug regulator. Japan allows duty free import of apparels from India only if all the raw materials used are of either Indian or Japanese origin with an exception of 7 per cent by weight that can be sourced from third countries. No surprise then, that the utilization of India's preferential Trade agreements for export promotion remains very low. On the Contrary, India has not imposed any sourcing restrictions even for sensitive items like textiles while granting unilateral duty free market access to countries like Bangladesh. India's ill-conceived trade pacts have also resulted in inverted duty structure that discourage production and export of value added items.

The recently concluded, transpacific Partnership (TPP) which India did not really try to join could be damaging for its exports. A tighter IPR regime may adversely affect India's export of generic medicines to the TPP countries, the US in particular. TPP will create direct tariff disadvantage for India's apparel exporters who operate on as low as a 6 per cent margin. TPP may lead to investment moving out of India to TPP countries and hurt India's future exports.

Source: Business Line on "Export Review"

Example:2

Vietnam Suspends Indian Groundnut Imports: Nearly 500 containers of Indian groundnut shipments have been stranded at Haiphong Port in Vietnam following the detection of groundnut seed (Caryedon Serratus) in the Consignments. The presence of the beetle has led Vietnam to suspend imports from India on Feb.6th 2016.The Suspension will come in to effect from April 7th if immediate corrective measures are not taken by India. Exporters fear that another 100 odd containers reaching Vietnam by the end of the month, ₹ 120 Crore worth of Groundnut could be held up there.

Source: Business Line on "Agri-Business"

Example: 3

After more than a year of negotiations, Russia has finally agreed to do away with a condition requiring Indian Dairy Companies to own cattle farms to export cheese to the country, making it easier for small companies and Cooperatives. The Russians have, however stuck to their second condition, mandating dairy product exporters to collect milk directly from the farms and not from collection centres. This means that all dairy companies, big and small can now export hard cheese to Russia, even if they do not own cattle, provided they send their own tricks to collect milk from the farms.

Source: Business Line on "Agri-Business"

10. Hurdle to Imports: Due to the sentiments or local Market forces, Free Imports are not being allowed which is posing hindrance to domestic cost of production. Companies of domestic country are not sell products at affordable Prices.

Example: 4

The Kerala Roller Flour Millers Association has requested the Centre to withdraw the import duty on wheat, considering the supply shortage in the wake of adverse weather Conditions. At present, the rate of import duty is 25% of value of imports. It was increased from 10% an year ago. This trend has made Flour Mills' imports of wheat unaffordable and in turn the local cost of production is become very high.

Wheat output during the current season in the year 2016 is expected to fall short due to severe drought and unseasonal rains in growing areas. Since the shortage is expected to be 5 to 6 million tones.It will affect the working of Roller Flour Mills especially in South India.

Source: Business Line " Commodities" Page No.16.

11. Slow Growth in World Trade: During the last nine months 2015, there was the big reduction in India's Merchandise shipments contract by 5%, 12%, 14%, 16%, 21%, 15%, 20%, 16%, 10.3% and 20.7% consecutively. This trend was due to the adverse effect of a fall in crude prices, the competitive devaluation of competing economies' currencies against the dollar and the slower growth of world trade.

The fall in Crude Prices have affected the dollar earnings from export of refined petroleum Products such as diesel and petrol. The slower growth of world trade is an irrefutable reality that is bound to affect India's exports.

Source: Business Line on "Export Review"

12. Regulatory Challenges: International Trade depends upon the regulation of other countries. When there is any change in the law, it might be a positive factor or negative factor to the Exporting or Importing Country.

Example: 1

Recently the Ministry of New and Renewable Energy has requested Ministry of Commerce to allow dumping from China and USA for solar panels and solar accessories. In India, local manufacturers are scarcely available. In order to fight huge pricing in the domestic market, the ministry is in favour of dumping imports which may hurt domestic manufacturing and concept of start-ups in the future.

Source: Business Line Research Bureau Report.

Types of International Trade Barriers

When international trade is concerned it is meant the exchange of goods and/or services. This exchange usually takes place between two parties from different countries or between two countries located anywhere on the globe. Types of international trade barriers are as follows:

If the international trade takes place between two parties, it is known as bilateral trade and if the trade takes place between more than two parties, it is known as multi-lateral trade.

There are basically three types of barriers to international trade that are used by the countries, and they are as follows:

1. ***Tariff Barrier:*** This is barrier is in the form of duties, taxes, quotas etc. Because of this barrier, imports decrease and price of imported products increase which results in the fall in the demand giving boost to domestic products.
2. ***Non-tariff Barrier:*** Usually this type of barrier is imposed by a country on imports so that the quantity of imported items is restricted. Due to this, the availability of the imported item or items is restricted in the domestic market and the price too is very high.
3. ***Voluntary Constraint:*** This is a type of international trade barrier wherein a country voluntarily restricts or stops imports from coming in. This is usually used to limit the competition that domestic industries will face with the coming in of imported goods.

Whenever a country starts international trade with another country, these three barriers to international trade are always taken into account. It has been seen that lower developed countries and developing countries tend to favour these three barriers to international trade as the countries can earn foreign exchange by introducing tariff and non-tariff barrier, the local industries are protected from competition by foreign companies and industries and as less imported goods are available in the country, consumers tend to buy local products giving the local industries a boost.

Tariff Barriers

A tariff is a tax which is levied on goods that move internationally. It is the most common instrument that is used for controlling exports and imports. The tariff which is levied on exports is called export tariff and the one which is levied on imports is called the import tariff. The tariff which is levied on goods that pass through a nation is called transit tariff.

The import tariff is more commonly used than export or transit tariff. This is barrier is in the form of duties, taxes, quotas, etc. Because of this barrier, imports decrease and price of imported products increase which results in the fall in the demand giving boost to domestic products.

The tariff which is collected on per unit basis is called specific duty. For example, the specific duty on import of cars is ₹ 450,000 per car. The tariff which is collected as a percentage of the value of the item is called as ad valorem duty, e.g., ad valorem duty on import of cars in a nation is 10 per cent of the value of the car. The EU, in the mid 1990s, imposed an ad valorem duty of 15 to 20 per cent on import of bananas, up to 2.5 million, from Latin America.

Classification of Tariff

Tariffs may be classified in several ways. The classification scheme used here is based on:

1. Direction: Import and Export Tariffs: Tariffs are often imposed on the basis of the direction of product movements, i.e., on imports or exports, with the latter being the less common one. When export tariffs are levied, they usually apply to an exporting country's scarce resources or raw materials (rather than finished manufactured products).

2. Purpose: Protective and Revenue Tariffs: Tariffs may be classified as protective tariffs and revenue tariffs. This distinction is based on purpose. The purpose of a protective tariff is to protect

home industry, agriculture, and labour against foreign competitors by trying to keep foreign goods out of the country. The purpose of a protective tariff is to protect home industry, agriculture, and labour against foreign competitors by trying to keep foreign goods out of the country.

3. Length: Tariff Surcharge versus Countervailing Duty: Protective tariffs may be further classified according to length of time. A tariff surcharge is a temporary action, whereas a countervailing duty is a permanent surcharge. When Harley-Davidson claimed that it needed time to adjust to Japanese imports, President Reagan felt that it was in the national interest to provide import relief. To protect the local industry, a tariff surcharge was used.

Countervailing duties are imposed on certain imports when products are subsidized by foreign governments. These duties are thus assessed to off-set a special advantage or discount allowed by an exporter's government. Usually, a government provides an export subsidy by rebating certain taws it' goods are exported.

4. Rates: Specific, *Ad valorem,* **and Combined:** How are tax rates applied? To understand the computation, three kinds of tax rates must be distinguished:

(i) ***Specific Duties:*** Specific duties are a fixed or specified amount of money per unit of weight, gauge, or other measure of quantity. Based on a standard physical unit of a product, they are specific rates of so many dollars or cents for a given unit of measure. Product costs or prices are irrelevant in this case. Because the duties are constant for low and high-priced products of the same kind, this method is discriminatory and effective for protection against cheap products due to their lower unit value; i.e., there is a reverse relationship between product value and duty percentage.

(ii) ***Ad Valorem Duties:*** *Ad valorem* duties are duties "according to value". The) are stated as a fixed percentage of the invoice value and applied at a percentage to the dutiable value of the imported goods.

This is the opposite of specific duties since the percentage is fixed but the total duty is not. Based on this method, there is a direct relationship between the total duties collected and the prices of products; i.e., the absolute amount of total duties collected will increase or decrease with the prices of imported products. The strength of this method is that it provides continuous and relative protection against all price levels of a particular product.

(iii) ***Combined Rates:*** Combined rates (or compound duty) are a combination of the specific and ***ad 'valorem*** duties on a single product. They are duties based on both the specific rate and the ***ad valorem*** rate that are applied to an imported product.

One important fact is that the average tariff rates affect the poor the most. After all, working-class consumers spend a large share of their income on the necessities of daily life, and many such necessities are imported. Affluent consumers, in comparison, are not bothered as much by tariffs because these necessities represent only a fraction of what they earn.

5. Distribution Point: Distribution and Consumption Taxes: Some taxes are collected at a particular point of distribution or when purchases and consumption occur. These indirect taxes, frequently adjusted at the border, are of four kinds: single-stage, value-added, cascade, and excise.

(i) ***Single-Stage Taxes:*** Single-stage sales tax is a tax collected at only one point in the manufacturing and distribution chain. This tax is perhaps most common in the USA, where retailers and wholesalers make purchases without paying any taxes by simply showing a sales tax permit. The single-stage sales tax is not collected until products are purchased by final consumers.

(ii) ***Value-Added Tax:*** A Value Added Tax (VAT) is a multi-stage, non-cumulative tax on consumption. It is a national sales tax levied at each stage of the production and distribution system, though only on the value added at that stage. Its important feature is that it credits taxes paid by companies on their material inputs against taxes they must collect on their own sales.

(iii) ***Cascade Taxes:*** Cascade taxes are collected at each point in the manufacturing and distribution chain and are levied on the total value of a product, including taxes borne by the product at earlier stages (i.e., tax on tax). Of the tax systems examined, this appears to be the most severe of all.

(iv) ***Excise Tax:*** An excise tax is a one-time charge levied on the sales of specified products. Alcoholic beverages and cigarettes are good examples. It is also common to levy excise taxes on motor vehicles, petroleum, and consumer durables. Excise taxes account for about 19 per cent of all tax revenues.

These four kinds of indirect taxes are often adjusted at the border. Border taxes can be used to raise prices of imports or lower prices of exports. Prices of imports are raised by charging imported goods with (in addition to customs duties) a tax usually borne by domestic products. For exported products, their export prices become more competitive (i.e., lower) when such products are relieved of the same tax that they are subject to when produced, sold, and consumed domestically.

Non-tariff Barriers

Usually this type of barrier is imposed by a country on imports so that the quantity of imported items is restricted. Due to this, the availability of the imported item or items is restricted in the domestic market and the price too is very high. Types of non-tariff barriers are:

1. Subsidies: A subsidy is a direct payment made by the government to a company in order to make it more competitive nationally or internationally. Subsidy can be in the form of cash grants, low-interest loans, tax benefits, R&D support, government equity participation in the local firms, etc.

The advocates of subsidies point out those subsidies are must for achieving dominant position in certain industries, which does not have a large market and could only support few firms. Secondly, they believe that subsidies are also important in order to overcome the entry barriers. Thirdly, they believe that subsidies help the domestic producers in becoming internationally competitive.

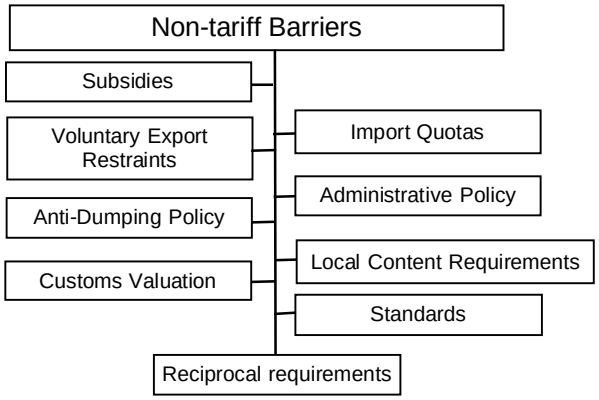


Fig. 1.6

2. Import Quotas: A quota is a quantitative form of restriction imposed on imports and exports. It specifies the amount of quantity that could be imported or exported. Normally, the restriction is enforced by way of issuing licenses. The license specifies the maximum amount of quality that could be improved or exported. For example, in the U.S.A., there is an import quota on cheese; and only those companies could import which possess the license.

Quotas have been negotiated on a country-by-country basis and have been established at different levels.

3. Voluntary export restraints: A variation of import quota is the Voluntary Export Restraint (VER). In VER, the exporting nation, after consultation with the importing nation, voluntarily fixes the quota regarding the maximum amount of quantity which it will be exporting to the concerned nation. The exporting nation agrees to VERs in order to avoid the more strict measures like import quotas, tariffs, etc., which could be applied by the importing nation.

Voluntary export restraints are agreed upon by the importing country and the exporting country. A country that is subject to voluntary export restraints limits the quantity of products it exports to another, primarily because it attempts, by doing so, to avoid more severe, future mandatory import restrictions.

4. Administrative Policy: Apart from the formal ways of interfering in trade, nations resort to intentional administrative policies, which are rules and procedures to be followed, with the objective of discouraging imports and encouraging exports. For example, though Japan boasts of having the lowest, formal, tariff and non-tariff barriers, yet the Netherlands which exports tulip bulbs to all nations of the globe doesn't export it to Japan; the reason being that Japanese custom officials insist on checking every tulip bulb by cutting it vertically down the middle. In the early 1980s, France tried to regulate the import of VCRs from Japan by requiring all VCRs to pass through a small customs entry point which was distantly located and was poorly staffed. The objective was to result in delays in order to keep the Japanese VCRs out of French market.

5. Anti-Dumping Policy: Dumping is defined, as the act of a manufacturer in one country exporting a product to another country at a price which is either below the price it charges in its home market or if it can be proven that there has been a substantial increase of a specific good; dumping large surpluses into a market will substantially lower the market price at will introducing lower than

market priced goods. The term has a negative connotation as advocates of free markets see "dumping" as a form of protectionism.

Anti-dumping action means charging extra import duty on the particular product from the particular exporting country in order to bring its price closer to the "normal value" or to remove the injury to domestic industry in the importing country.

6. Local content requirements: A local content requirement says that some specific fraction of the product be produced locally. Sometimes, this fraction is specified in terms of the value of product and sometimes, in physical terms. The local content requirement clause has been used by both the developed and the developing nations, for different reasons. The developed nations use local content requirement in order to protect employment and local industry.

7. Customs valuation: Normally, when goods enter a nation, the custom officials try to classify and find out the correct value of goods in order to collect the ad valorem duty. This job is quite tedious and difficult, as thousands of categories of products are traded internationally, today. It becomes further complex as, sometimes, exporters and importers misclassify or undervalue their products intentionally or by accident. As a result, when custom officials go for valuation they increase the value and impose penalties for custom valuation violation.

8. Standards: Standards are set for health, welfare, safety, quality, size and measurements in order to create barriers for foreign products. For example, the labeling requirement could ask a company to specify the place of origin. This can create problems for the company, as today, most of the products have mixed origin as they source raw materials, components, designs, etc. from different nations which are scattered all over the globe. Additionally, this requirement could have negative impact on the product as most of the customers prefer product of particular nations only.

9. Reciprocal requirements: The nations use the concept of reciprocal requirements or counter-trade, in order to interfere in the international trade on the grounds of preserving foreign currency reserves or to secure jobs or to secure technology. In reciprocal requirements or counter-trade, the importing nation asks the exporting firm to take payment in terms of goods or to promise to buy merchandise or services in lieu of cash payments.

WTO: WORLD TRADE ORGANISATION

The World Trade Organization (WTO) is an international organization designed by its founders to supervise and liberalize international trade to offer a world trading system. The organization officially commenced on January 1, 1995 under the Marrakech Agreement, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1947. Seventy Six Governments became members of the WTO on its first day.

The World Trade Organisation deals with regulation of trade between participating countries; it provides a framework for negotiating and formalizing trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements which are signed by representatives of member governments and ratified by their parliaments. Most of the issues that the WTO focuses on are derived from previous trade negotiations, especially from the Uruguay Round (1986-1994).

The WTO has 153 members, representing more than 97% of total world trade and 30 observers, most seeking membership. The WTO is governed by a ministerial conference, meeting every two years; a General Council, which implements the conference's policy decisions, and is responsible for day-to-day administration; and a director-general, who is appointed by the Ministerial Conference. The WTO's headquarters is at the Centre William Rappard, Geneva, Switzerland.

Table 1.6: Difference Between GATT and WTO

	GATT	WTO
1.	The main focus of GATT was on trade in goods. Although trade in services was included in Uruguay round, hut no agreement with regard to services was arrived at.	The focus of WTO is on trade in goods and services.
2.	GATT was less powerful and its dispute settlement system was slow and inefficient.	WTO is more powerful and its dispute settlement system is fast, strong and efficient.
3.	In GATf, there was no pre-decided regular time of holding sessions.	In WTO, meet is held after every two years.
4.	GATT had a small secretariat managed by a Director General.	WTO has a large secretariat and huge organizational set up.
5.	TRIPs and TRIMs were not given much emphasis in GATT.	WTO laid special emphasis on TRIPs and TRIMs.

Origin and Rounds of WTO

The need for a world trade body was felt much earlier. The International Trade Organization (ITO) was proposed to be set up along with the World Bank and the IMF on the recommendations of the Bretton Woods Conference in 1944. The ITO was not set-up but in its place GATT was established by the US, UK, and some other countries in 1947. GATT was biased in Favour of the developed countries and was appropriately called the "rich men's club".

The developing countries insisted on setting-up of ITO but opposition to the proposal came from the US. To solve the issue, the UN appointed a committee in 1963; the committee recommended, as a via media, the UNCTAD (United Nations Conference on Trade and Development). UNCTAD came into being in 1964. It could manage to secure some concessions for the developing countries. In the meantime, GATT itself was made progressively liberal in a series of negotiations. In its Uruguay Round of negotiations, WTO was proposed and the proposal became a reality on 1st Jan, 1995.

The Uruguay Round was the 8"1 round of Multilateral Trade Negotiations (MTN) conducted within the framework of the General Agreement on Tariffs and Trade (GATT), spanning from 1986-1994 and embracing 110 countries as "contracting parties". The Round transformed the GATT into the World Trade Organization. The Round came into effect in 1995 and has been implemented over the period to 2000 (2004 in the case of developing country contracting parties) under the administrative direction of the newly created World Trade Organization (WTO).

Table 1.7

	Name (Round)	Date	Outcome
1.	Geneva round	1947	45,000 tariff concessions representing half of world trade.
2.	Annecy round	1949	Modest tariff reductions.
3.	Torquay round	1950-51	25 per cent tariff reductions in relation to 1948 level.
4.	Geneva round	1955-56	Modest tariff reductions.
5.	Dillon round	1961-62	Modest tariff reductions.
6.	Kennedy round	1963-67	Average tariff reduction of 35 per cent of industrial products, only modest reduction for agricultural products, anti-dumping code.
7.	Tokyo round	1973-79	Average tariff reduction of 34 per cent for industrial products. Non-tariff trade barrier code.
8.	Uruguay Round	1986-94	Tariffs and non-tariff measures, rules, services, intellectual property, dispute settlement, creation of WTO, etc.

After the formation of WTO and eighth round of GATT, Ministerial Conferences came in to picture as the topmost decision-making body of the WTO, which usually meets every two years. It brings together all members of the WTO, all of which are countries or customs unions. The Ministerial Conference can take decisions on all matters under any of the multilateral trade agreements.

The inaugural ministerial conference was held in Singapore in 1996. Its primary purpose was to initiate an international effort among global trading nations to overhaul the structure and mechanisms of the General Agreement on Tariffs and Trade (GATT) while preserving the considerable progress and success achieved by that system since its inception in 1948. Disagreements, largely between developed and developing economies, emerged over four issues initiated by this conference; afterwards, these were collectively referred to as the "Singapore issues".

At the Fourth WTO Ministerial Conference held in Doha, Qatar on 9-14 November 2001, Ministers agreed to launch a new round of WTO trade liberalization negotiations. Following on the 1986-1994 Uruguay Round, these negotiations will represent the ninth round since the GATT era. The ninth round of multilateral trade negotiations started in 2001 and continues today. The Doha Round began with a ministerial-level meeting in Doha, Qatar in 2001. The Doha Development Round or Doha Development Agenda (DDA) is the current trade-negotiation round of the World Trade Organization (WTO) which commenced in November 2001. Its objective is to lower trade barriers around the world, which will help facilitate the increase of global trade.

Table 1.8

1.	Singapore Ministerial Conference	1996
2.	Geneva Ministerial Conference	1998
3.	Seattle Ministerial Conference	1999
4.	Doha Ministerial Conference (Doha Round)	2001 to today
5.	Cancun Ministerial Conference	2003
6.	Hong Kong Ministerial Conference	2005
7.	Geneva Ministerial Conference	2009
8.	Geneva Ministerial Conference	2011
9.	Bali (Indonesia) Ministerial Conference	2013

Principles of WTO

WTO works according to the following principles:

1. Trade without Discrimination: This principle covers the following two points:

(i) ***Most-favoured-nation (MFN): Treating other people equally:*** Under the WTO agreements countries cannot normally discriminate between their trading partners. Grant someone a special favour and we have to do the same for all other WTO members. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all its trading partners whether rich or poor, weak or strong.

(ii) ***National Treatment: Treating foreigners and locals equally:*** Imported and locally-produced goods should be treated equally at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents.

2. Freer Trade - gradually, through negotiation: Lowering trade barriers is one of the most obvious means of encouraging trade. The barriers concerned include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively. Opening markets can be beneficial, but it also requires adjustment

The WTO agreements allow countries to introduce changes gradually, through "progressive liberalization".

3. Predictability: through Binding and Transparency: Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future opportunities. The multilateral trading system is an attempt by governments to make the business environment stable and predictable.

4. Promoting fair competition: Many of the other WTO agreements aim to support fair competition - e.g., in agriculture, intellectual property, services. The agreement on government procurement (a "plurilateral" agreement because it is signed by only a few WTO members) extends competition rules to purchases by thousands of government entities in many countries. And so on.

5. Encouraging development and economic reform: The WTO system contributes to development. On the other hand, developing countries need flexibility in the time they take to implement the system's agreements. And the agreements themselves inherit the earlier provisions of GATT that allow for special assistance and trade concessions for developing countries.

Organizational Structure of WTO

1. Ministerial Conference: Ministerial Conference is the highest hierarchical level in the organization structure. All the member countries of WTO are the representatives of the ministerial conference. Ministerial conference has the authority to make decisions on all matters relating to multilateral trade agreements. The ministerial conference meets at least once in two years. Thus the ministerial conference the policy and strategy making body. It gets the policies and strategies implemented and executed by the next level, i.e., General Council. The Ministerial Conference is the

top decision-making body of the World Trade Organization (WTO). It meets at least once in every two years.

2. General Council: General Council is the executive body of the WTO. General Council reports its decisions a activities to the ministerial conference. All the members of the WTO are also the representatives in the General Council. The General Council has other forms like Dispute Settlement Body and Trade Policy Review Body:

(i) Dispute Settlement Body supervises dispute settlement procedures. This body is assisted by the dispute settlement panels and appellate body.

(ii) Trade Policy Review Body reviews trade policies of individual WTO members regularly.

3. Councils: The third level in the hierarchy is councils. There are three councils, viz.,

(i) Council for trade in goods: This council supervises the implementation and functioning of agreements relating to trade in goods.

(ii) Council for trade in services: This council overseas the implementation of all the agreements relating to trade in services.

(iii) Council for trade related aspects of Intellectual Property rights: This council oversees implementations and functioning of all the agreements relating to this area.

4. Committees: Various councils specified earlier, constitute committees for administering the arrangement of Ministerial conference which constituted three committees, viz.:

(i) Committee on Trade and Development: This committee is concerned with the issues concerning developing countries and particularly with least developed countries.

(ii) Committee on Balance of Payments: Some WTO member countries resort to trade restricts measures with a view to cope with their balance of payments problems. Consultations among is countries are arranged by the committee on Balance of Payments.

(iii) Committee on Budget, Finance and Administration: This committee deals with the issues relating the budget, finance and administration of WTO.

5. Management Bodies: Plurilateral agreements of the WTO have their management bodies. The management bodies report to the General Council. Some of the plurilateral agreements having management bodies include: civil aircraft, government procurement; dairy products, bovine-meat, etc.

The organizational structure of the WTO is designed based on four hierarchical levels. The hierarchies from the top to bottom are as follows:

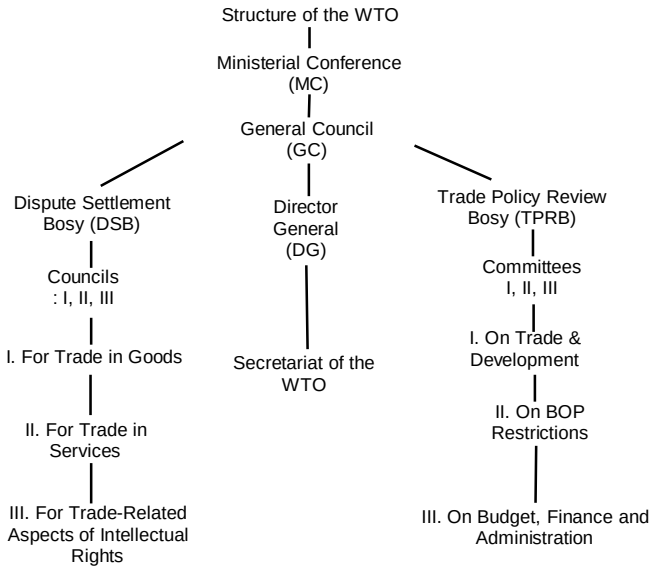


Fig. 1.7

Role and Functions of WTO

WTO performs the following role and functions as discussed below:

1. Helping Developing and Transition Economies: Developing countries make up about three quarter: the total WTO membership. The role of WTO increases as most of these developing countries are in transition phase as they are shifting from planned economic system to market based economic system.

The WTO Secretariat's Training and Technical Cooperation Institute organizes a number of program to train government officials and negotiators. Besides Geneva, these programs also take place in the countries concerned. Various programs are organized jointly with other international organizations. WTO provides data of tariff and trade to developing nations to help them export.

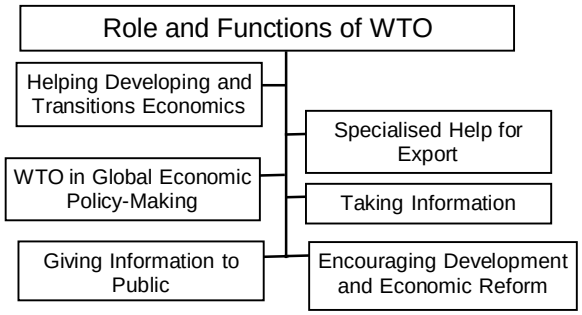


Fig. 1.8

2. Specialized Help for Export: In 1964, the WTO established the International Business Centre to help countries in their exports. It is jointly operated by the WTO and the United Nations. It provides

information and advice on export markets and marketing techniques. It assists in establishing export promotion and marketing services, and in training personnel required for these services.

3. WTO in Global Economic Policy-Making: WTO cooperates with the International Monetary Fund, the World Bank and other multilateral institutions to achieve greater coherence in global economic policymaking. A separate ministerial declaration was adopted at the Marrakesh Ministerial Meeting in April 1994 to underscore this objective.

4. Taking Information: WTO takes regular information from the member countries regarding their policies and tariffs. According to many agreements, the government has to notify the WTO about the modified trade measures like safety standards, technical standards, anti-dumping and countervailing duties, etc. In this way it keeps itself updated regarding developments and it also disseminates information to the member countries, which help them in increasing their exports.

5. Giving Information to Public: It also disseminates information to the public about the developments in WTO through its publication and websites.

6. Encouraging Development and Economic Reform: GATT allows for special assistance and trade concessions for developing countries. WTO agreements give them transition periods to adjust to the more unfamiliar and, perhaps, difficult framework. A ministerial decision adopted at the end of the round says better-off countries should accelerate implementing market access commitments on goods exported by the least-developed countries, and it seeks increased technical assistance for them.

Impact of WTO

The World Trade Organisation (WTO) intends to supervise and liberalise international trade. The global business environment is significantly influenced by the World Trade Organisation (WTO) principles and agreements. Till date, there are various international regulatory authorities operating in the world trade in order to maintain a smooth system of international business. WTO is one of the leading intemational trade regulatory organisations which have so far positive as well as negative impact on international business:

1. Positive Impact of WTO: World Trade Organisation helps member states in various ways and this enables them to reap benefits such as:

(i) ***Promotes Peace within Nations:*** Peace is partly an outcome of two of the most fundamental principles of the trading system helping trade flow smoothly and providing countries with a constructive and fair outlet for dealing with disputes over trade issues. Peace creates international confidence and cooperation that the WTO creates and reinforces.

(ii) ***Disputes are Handled Constructively:*** As trade expands in volume, in the number of products traded and in the number of countries and company trading, there is a greater chance that disputes arise. If this could be left to the member states, the dispute may lead to serious conflict. WTO helps resolve these disputes peacefully and constructively.

(iii) ***Rules Make Life Easier for All:*** WTO is based on rules rather than power and this makes life easier for all trading nations. WTO reduces some inequalities giving smaller countries more voice and at the same time freeing the major powers from the complexity of having to negotiate trade agreements with each of the member states.

(iv) ***Free trade cuts the cost of living:*** Protectionism is expensive, it raises prices, and WTO lowers trade barriers through negotiation and applies the principle of non-discrimination. The result is reduced cost of production (because imports used in production are cheaper) and reduced prices of finished goods and services, and ultimately a lower cost of living.

(v) ***It Provides more choice of products and aualities:*** It gives consumer more choice and a broader range of qualities to choose from.

(vi) ***Trade Raises Income:*** WTO trade barriers are lowered and this increases imports and exports thus earning the country foreign exchange, thereby raising the country's income.

(vii) ***Trade Stimulates Economic Growth:*** With upward trend economic growth, jobs can be created and this can be enhanced by WTO through careful policy-making and powers of freer trade.

(viii) ***Basic principles make life more efficient:*** The basic principles make the system economically more efficient and cut costs. Many benefits of the trading system are as a result of essential principle at the heart of the WTO system and they make life simpler for the enterprises directly involved in International business and for the producers of goods/services. Such principles include nondiscrimination transparency, increased certainty about trading conditions, etc., together they make trading simpler, cutting company costs and increasing confidence in the future and this in turn means more job opportunities better goods and services for consumers.

(ix) ***Governments are shielded from lobbying:*** WTO shields the government from narrow interest. Government is better placed to defend themselves against lobbying from narrow interest groups by focusing on trade-offs that are made in the interests of everyone in the economy.

(x) ***System encourages good governance:*** The WTO system encourages good government. The WTO rules discourage a range of unwise policies and the commitment made to liberalize a sector of trade becomes difficult to reverse. These rules reduce opportunities for corruption.

2. Negative impact of WTO: In spite of having a great importance in cooperating and integrating world trade WTO has negative impact as:

(i) ***Fundamentally undemocratic:*** The policies of the WTO impact all aspects of society and the planet, but it is not a democratic, transparent institution. The WTO rules are written by and for corporations with inside access to the negotiations. For example, the US Trade Representative gets heavy input for negotiations from 17 "Industry Sector Advisory Committees." Citizen input by consumer, environmental, human rights and labour organizations are consistently ignored. Even simple requests for information are denied, and the proceedings are held in secret.

(ii) ***Tramples labour and human rights:*** WTO rules put the "rights" of corporations to profit over human and labour rights. The WTO encourages a 'race to the bottom' in wages by pitting workers against each other rather than promoting internationally recognised labour standards. The WTO has ruled that it is illegal for a government to ban a product based on the way it is produced, such as with child labour. It has also ruled that governments cannot take into account "non commercial values" such as human rights, or the behaviour of

companies that do business with vicious dictatorships such as Burma when making purchasing decisions.

(iii) ***Increasing inequality:*** Free trade is not working for the majority of the world. During the most recent period of rapid growth in global trade and investment (1960 to 1998) inequality worsened both internationally and within countries, the UN Development Program reports that the richest 20 per cent of the world's population consume 86 per cent of the world's resources while the poorest 80 per cent consume just 14 per cent. WTO rules have hastened these trends by opening up countries to foreign investment and thereby making it easier for production to go where the labour is cheapest and most easily exploitable and environmental costs are low.

(iv) ***Hurts poor, small countries in favour of rich powerful nations:*** The WTO supposedly operates on a consensus basis, with equal decision-making power for all. In reality, many important decisions get made in a process whereby poor countries negotiators are not even invited to closed door meetings and then 'agreements' are announced that poor countries didn't even know were being discussed. Many countries do not even have enough trade personnel to participate in all the negotiations or to even have a permanent representative at the WTO. This severely disadvantages poor countries from representing their interests. Likewise, many countries are too poor to defend themselves from WTO challenges from the rich countries, and change their laws rather than pay for their own defence.

(v) ***Undermines local level decision-making and national sovereignty:*** The WTO's "most favored nation" provision requires all WTO member countries to treat each other equally and to treat all corporations from these countries equally regardless of their track record. Local policies aimed at rewarding companies who hire local residents, use domestic materials, or adopt environmentally sound practices are essentially illegal under the WTO. Developing countries are prohibited from creating local laws that developed countries once pursued, such as protecting new, domestic industries until they can be internationally competitive.

(vi) ***Positiveside of WTO in medicine:*** As per the provision mentioned in TRIPS agreement, the concept of compulsory licensing was introduced. Due to it, the inventor of the drug should go for the licensing of patents compulsorily upon the request of Member countries. As a result of it, access to HIV medicines in lower and middle income countries has increased dramatically. In 2003, only 400000 people living with HIV had access to HIV medicines; today the figure is over 15.8 million. It was in fact an outcome of WTO agreement.

(vii) ***Negative side of WTO for textile sector in India:*** According to the WTO's agreement subsidies on export performance is prohibited. However, it provides certain relaxations to developing countries. As per the provisions, when the share of a developing country in global exports touches 3.25 per cent in any product category for two straight years, thereby gaining " export competitiveness", it has to phase out export subsidies for the items eight years from the second year of reaching the target.

Countries like the US and the EU contend that India's Textile and clothing exports first breached the threshold in 2005 and remained above the level in 2006 also and it should therefore end its export subsidies for these items by January 2015. All said and done, it is clear that export-related subsidies

for textile products will have to be replaced latest by 2018. It is time the Government will have to devise suitable option by means of replacing export promotion incentives with Industry promotion incentives. For example, subvention of export credit can be replaced with subvention of working capital.

EXIM (EXPORT-IMPORT) TRADE

Introduction

International or foreign trade is recognized as the most significant determinants of economic development of a country, all over the world. The foreign trade of a country consists of inward (import) and outward (export) movement of goods and services, which results into outflow and inflow of foreign exchange. Thus it is also called EXIM trade.

For providing, regulating and creating necessary environment for its orderly growth, several Acts have been put in place. The foreign trade of India is governed by the *Foreign Trade (Development & Regulation) Act, 1992* and the rules and orders issued there under. Payments for import and export transactions are governed by *Foreign Exchange Management Act, 1999. Customs Act, 1962* governs the physical movement of goods and services through various modes of transportation. To make India a quality producer and exporter of goods and services, apart from projecting such image, an important Act - *Exports (Quality control & inspection) Act, 1963* has been in vogue. Developmental pace of foreign trade is dependent on the Export-Import Policy adopted by the country too. Even the *EXIM* Policy *2002-2007* lays its stress to simplify procedures, sharply, to further reduce transaction costs.

Today's EXIM trade is not only highly competitive but also dynamic. It is a vital part of development strategy and it can be an effective instrument of economic growth, employment generation and poverty alleviation. Market conditions change, almost daily, requiring quick response and more importantly, anticipating of the future requirements.

Export

The term “export” is derived from the conceptual meaning as to ship the goods and services out of the port of a country. The seller of such goods and services is referred to an “exporter” who is based in the country of export whereas the overseas based buyers referred to as an “importer”.

In international trade, “exports” refers to selling goods and services produced in home country to other markets. In economics, an export is any good or commodity, transported from one country to another country in a legitimate fashion, typically for use in trade. Export goods or services are provided to foreign consumers by domestic producers. Export may be defined as to send goods or services across national frontiers for the purpose of selling and realizing foreign exchange. Exporting represents the least commitment on the part of the firm entering a foreign market.

Exporting, of course, is one of the important ways of globalization. With economic liberalization an environment for globalization of Indian exports has been emerging. In a truly globalize environment, the exports will also be global; the sourcing of finance, materials and managerial inputs will be global, based on purely business considerations. In fact, in the early 1950s India’s economic position was much better than those of most countries. Among the developing countries, India had a

relatively broad based industrial structure and significant export market share for several commodities. However, advantage could not be taken of this position due to the absence of an effective export development strategy. India has potential for significantly increasing the exports of many products if appropriate measures are taken. As a matter of fact, in case of number of products several other developing countries which started their exports later than India have gone much ahead of India while India's progress has been slow.

Broadly, the important strategies to increase the export earnings are: increase the average unit value realization; increase the quantity of exports to the existing markets; export new products and develop new markets.

Stages in Export Order Processing

An export order has to be processed to meet the requirements of materials required by the importers. An export order must be processed as expeditiously as possible so that the buyers can receive the materials on time, as per their delivery schedules and also conforming to the specifications stipulated by them. An export has to be processed to meet the requirements of materials required by the importers.

For execution of export order the following steps are follows:

Step 1: Inquiry and offer: The exporter may get an inquiry for exports I through the trade promotion councils or a direct request from the prospective importer from another country. The inquiry will also specify complete details of the goods, e.g., the volume and the value, the grading, catalogues, sizes, weights, the international standardizations certificates, the expected time of delivery and the mode of shipment along with the port of destination, etc.

Step 2: Acceptance and confirmation of purchase order: Once the importer has accepted the offer made to him, he will have to place an order with the exporter. The negotiation if any will take place before placing of a confirmed order by the foreign buyer. He will **have** to send a proforma invoice in triplicate to the buyer and ask him to return two copies duly acknowledged and signed by him so that out of these two signed copies, one copy can be signed by the exporter too and sent back to the importer buyer.

Step 3: Export sales contract: The confirmation and the acceptance of the offer will result into formation of an export contract between the exporter and importer. This contract will carry details on the terms and conditions or the international deal. Although there are no specified rules by any competent authority on the export contracts, but a normal contract will carry details pertaining to details of goods, their quality and quantity, price per unit and the total value of the contract, validity of prices, delivery/shipment periods, packing and forwarding instructions, inspection if needed, terms of payment, insurances and finally documents and certificates needed to fulfil the documentary requirements.

Step 4: Export permissions and licences: There is freedom to export all items unless these items are banned or put on the restrictive list for which a licence will be required from the competent authority. The exporter will have to check if he needs to get the licence issued for the items for which he has received the export order.

Step 5: Managing finances for exports: There are various schemes and finances available for pre-shipment finances. The exporters can check with the banks and export promotion councils of their respective products as to how to avail these financial assistances.

Step 6: Managing production/procurement of goods: Once all formalities have been completed and the exporter has entered into a sales contract with the importer. The exporter has to now ensure he manufactures or procures goods as per the specification given in the export contract.

Step 7: Reserving shipping berth: Though the leading shipping companies announce their schedules in leading media papers and daily shipping intelligence news from time to time but generally the task of booking berth space for cargo is outsourced by shipping companies to the carrying and forwarding agent (C&F agents). These C&F agents work as commission agents and will reserve the shipping space on a commission.

Step 8: Packing and marking: The importer will specify in the export contract about the standards and specifications to be followed for the packing and marking of the goods meant for exports In the absence at any such instructions the standard practices prevailing in the industry will have to be followed. The Bureau ot Indian Standards have specifies certain standards for packing of export items, the exporter can get these details from the bureau.

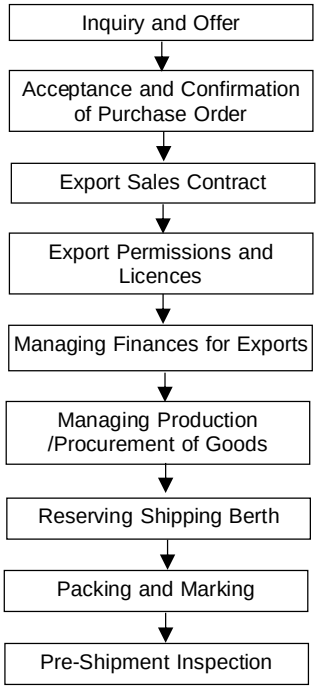


Fig. 1.9

Step 9: Pre-shipment inspection: In order to ensure the exporters from India strictly adhere to ^quality expectations and standards of international trade, the Government of India had introduced the Export Quality Control and Inspection Act in the year 1963. As per this Act certain items meant for exports have been put on compulsory pre-inspection list and these items cannot be exported unless a certificate of pre-inspection nave been obtained from the Export Inspection Council of India based in

New Delhi or from any of their regional offices situated in Mumbai, Kolkata, Chennai, Kochi or Ahmedabad. But exemptions are given under some circumstances.

Benefits of exports

Exports increase the potential for the firms offering, nation's development and helps to reduce risk in following ways:

1. **Market diversification:** By exporting marketers avoid dependency on the domestic market. In times of tough market conditions or a long economic recession, any business may be affected. The best way to avow those types of risks is through market diversification.
2. **Additional source of revenues:** Selling abroad to a reliable distributor for a long period of time will provide us additional steady stream of revenues.
3. **Use of excess production capacity:** Increase production to achieve an efficient level of production while reducing fixed costs.
4. **Leverage on purchasing power:** Increase the negotiation power at the time of purchasing higher volume of raw materials, which will finally be part of the export products.
5. **Business operation stability:** If the business operation is subject to revenue fluctuations due to season factors, exporting to countries with opposite seasons will allow the company to gain stability in its operations.
6. **Product lifecycle extension:** When products reach the maturity stage, many companies replace them with new products investing significant amount of resources in their development. However, exporting them to specific target markets, mature products may still have potential abroad.
7. **Product improvement:** Competing in international markets is an excellent source of learning to gain more competitiveness in the domestic market.
8. **Lower unit costs:** Exports help to put idle production capacity to work. This is generally achieved the more efficient utilization of the existing factory, machines, and staff. Lower unit costs make a product more competitive in the local marketplace as well as in foreign markets, and/or can contribute to the firms overall profitability.
9. **Economies of scale:** Exporting is an excellent way to enjoy pure economies of scale with products that are more "global" in scope and have a wider range of acceptance around the world (in other words, they can be used in other parts of the world without much adaptation).
10. **Minimizing the effect of seasonal fluctuations in Sales:** Being in the Southern Hemisphere, South Africa has seasons opposite to those in the Northern Hemisphere. For companies that sell seasonal goods such as fruit and swimwear or suntan lotion being able to sell these goods in the Northern Hemisphere when the season ends, helps to achieve a longer and more stable sales pattern.
11. **Untapped markets:** A company may have a very unique product that is not yet available elsewhere in the world. In this instance, these untapped markets are likely to drive the

firm's export activities. Other firms may want to take advantage of high-volume purchases in large markets overseas, such as in the U.S., Europe and Asia.

Import

The term "Import" is derived from the conceptual meaning as to bring in the goods and services into the port of a country. The buyer of such goods and services is referred to an "Importer" who is based in the country of import whereas the overseas based seller is referred to as an "Exporter". Thus an import is any good (e.g. a commodity) or service brought in from one country to another country in a legitimate fashion, typically for use in trade. It is a good that is brought in from another" country for sale. Import goods or services are provided to domestic consumers by foreign producers. An import in the receiving country is an export to the sending country.

Imports, along with exports, form the basis of international trade. Import of goods normally requires involvement of the customs authorities in both the country of import and the country of export and are often subject to import quotas, tariffs and trade agreements! When the "imports" are the set of goods and services imported, "Imports" also means the economic value of all goods and services that are imported. The macroeconomic variable I usually stands for the value of these imports over a given period of time, usually one year.

Imports consist of transactions in goods and services (sales, barter, gifts or grants) from non-residents to residents. The exact definition of imports in national accounts includes and excludes specific "borderline" cases. A general delimitation of imports in national accounts is given below:

1. **Import of Goods:** It occurs when there is a change of ownership from a non-resident to a resident; this does not necessarily imply that the good in question physically crosses the frontier. However, in specific cases national accounts impute changes of ownership even though in legal terms no change of ownership takes place (e.g. cross border financial leasing, cross border deliveries between affiliates of the same enterprise, goods crossing the border for significant processing to order or repair). Also smuggled goods must be included in the import measurement.
2. **Imports of Services:** It consists of all services rendered by non-residents to residents. In national accounts any direct purchases by residents outside the economic territory of a country are recorded as imports of services; therefore all expenditure by tourists in the economic territory of another country are considered as part of the imports of services. Also international flows of illegal services must be included.

Import Procedure

When goods are imported from a foreign country, the importer has to follow the procedure prescribed by the government of importing country. Import trade procedure differs from country to country depending upon the existing policy of that country. The general procedure for import trade in India involves the following stages:

Stage 1: Making Trade Enquiry and receiving Proforma Invoice/Quotation offer: The first stage in the import trade is to make trade enquiry from the intending exporters or their agents: An enquiry is a [request by the intending importer to supply the following information:

1. Specification of goods such as quality, size, design, etc.,
2. Unit price,
3. Quantity of goods available,
4. Terms of shipment (FOB, C&F, CIF),
5. Terms of payment (D/P, D/A, Letter of credit),
6. Delivery schedule, and
7. Last date of validity of the offer.

In response to his enquiry, the importer may receive different Performa invoices/quotation offers, for different suppliers. After making a thorough comparison of different offers, the importer should decide about the supplier with whom the import order/indent should be placed.

Stage 2: Obtaining import license: Where the importer wants to import an item for which import license is required, he must first obtain

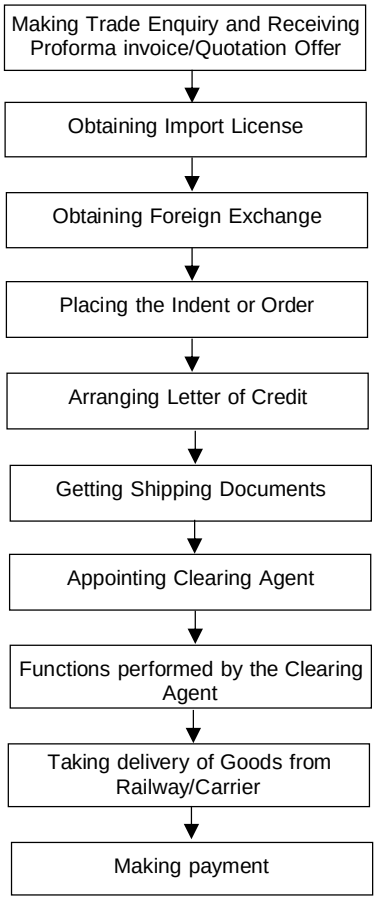


Fig. 1.10

Import license. To obtain an import license, the intending importer makes an application in the prescribed form and submits it to the licensing authority along with the following documents:

1. Treasury receipt for import license fee;
2. Certificate of the value of goods imported by the applicant in the previous year; and
3. Income tax verification certificate from Income tax authorities.

The licensing authority then issues the import license in duplicate after examining the documents and satisfying itself about the claim of the applicant.

Stage 3: Obtaining Foreign Exchange: After obtaining the import license, the intending importer makes an application in the prescribed form under the Foreign Exchange Management Act (FEMA) and submits it to the Exchange Control Department of RBI after getting it forwarded by his exchange bank. The RBI sanctions the release of the amount of foreign exchange to the importers after scrutinizing the application. It may be noted that exchange is released and made available only for a specific transaction for which import order has been placed.

Stage 4: Placing the Indent or Order: After obtaining the import license and requisite amount to foreign exchange, the importer should place the order direcdy or through 'Indent Houses'. An indent is an order sent abroad for the import of goods. An indent house refers to an import agent or import firm which imports goods on behalf of importers.

Stage 5: Arranging Letter of Credit: As per terms of payment if the importer is required to arrange a letter of credit, the importer instructs his bank to issue a letter of credit. Depending upon the deposit or creditworthiness of the importer, the importer's bank may issue a letter of credit. A letter of credit is a document issued by importer's bank on behalf of the importer to authorize the negotiating bank to make payment of the amount stated therein to a party named therein in his order on presentation of documents mentioned in the letter of credit

Stage 6: Getting Shipping Documents: In case of D/A (Document against Acceptance), importer gets the shipping documents on the acceptance of the bill.

In case of D/P (Document against Payment), importer gets the shipping documents on the payment of the bill. In case of letter of credit arrangement, importer gets the shipping documents from his bank.

Stage 7: Appointing Clearing Agent: After getting the shipping documents, the importer who does not want to complete further formalities in this regard himself, appoints clearing agent.

Stage 8: Functions Performed by the Clearing Agent

1. Getting bill of lading enclosed for delivery,
2. Filling-up bill of entry,
3. Payment of dock charges,
4. Getting custom clearance,
5. Taking delivery from the dock,
6. Dispatching goods to importer by rail/road, and Sending advice to the importer.

Stage 9: Taking Delivery of Goods from Railway/Carrier: After receiving the advice from the clearing agent, the importer takes the delivery of goods from railway/carrier surrendering railway receipt/lorry receipt and carries them to his Godown.

Stage 10: Making Payment: The mode of payment for import depends upon the agreement between the importer and the exporter.

1. In case of Documents against Acceptance (D/A Bills), the importer gets the shipping documents on giving the acceptance of bill of exchange and makes the payment on the maturity date.
2. In case of Documents against Payment (D/P Bills), the importer gets the shipping documents on making payment of bill of exchange.
3. In case of letter of credit, the importer gets the shipping documents after payment.

Benefits from Imports

Following are the key benefits associated with importing from foreign markets:

1. Help in development of the economy: Capital goods like machinery and equipment are required for industrial development. Industrial development also depends upon infrastructural facilities like power, transport, etc.

Agriculture also requires machines like tractors, harvesters, etc., for faster growth. Fertilizers, pesticides, etc., play a key role in agricultural development A developing country does not have sufficient resources or know-how to produce such goods or even if it is producing these goods, the production may not be sufficient. This deficiency can be made by importing these goods. Thus, imports can increase the productive capacity of a country.

2. To meet shortages: Imports can fill the gap between domestic demand and domestic supply of essential goods like food, cooking oils, etc". For example, in early years after Independence there was food shortage in India. So large quantities of food grains like wheat and rice were imported. Even now India does not produce vegetable oils enough to meet the requirements. Hence their import continues.

3. Imports for better living standards: The developing countries may not be producing non-essential goods like luxury and semi-luxury items such as television, motorcars, washing machines, etc. The rising income levels in the developing countries create demand for such goods. A country can get these goods from other countries.

4. Improving quality of production: The import of goods may help in improving the quality of domestic production. When faced with competition from foreign goods, the domestic producers try to improve the quality of their products. By doing so, they can effectively compete with foreign producers. For example, import of electronic goods into India has contributed a lot in improving the quality of similar Indian goods.

5. Comparative Advantage Means Lower-Priced Goods: Out of the many benefits of importing goods and raw materials, comparative advantage is the most common reason why companies choose to source products from overseas. Comparative advantage means that the conditions in a foreign market allow for much cheaper production costs, thanks to things like low labour costs, lower tax schemes, etc. If anyone can get the products or materials, he needs it at a cheaper rate, importing is a quick and easy way to cut costs and boost the profit margins.

6. Many Governments actively support Trade Relations and aim to make importing easy for the business: In many developing countries, governments encourage importing by helping local suppliers do business with offshore importers. Depending on the country one can import from where there may be a government agency available to assist the inquiries and make the transaction easier for all parties involved. With official agency oversight, the risks involved in the transaction can be significantly reduced and providing peace of mind throughout the process.

7. Importing Grants access to regionally exclusive resources: Some of the resources may be needed for manufacturing process can only be found in certain parts of the world. This includes everything from raw materials to special technologies. If these ingredients are vital to the production process, importing enables immediate access to primary sources.

8. Various benefits stemming from trade agreements: The various trade agreements negotiated by a country can give the access to unique benefits that make importing easier and more cost-effective. The direct benefits vary by country and are worth researching to find the best possible arrangement for the business. Working with a knowledgeable customs broker is one way to determine which agreements might provide favorable conditions for the business' import;

Procedures for Import and Export

Before actually importing or exporting goods, the goods have to be shared by the customs authorities. Such clearance is normally done in notified customs areas. Customs areas mean all areas of customs station and include any area where imported goods or exported goods kept pending for clearance by the customs authorities.

Customs station means any of the following places which are notified by the Central Government where customs clearances are to be done:

1. Customs port has been defined as port notified by the Central Government as customs port. Under Section 29 of the Customs Act any vessel or ship entering India from a place outside India must land only at a customs port.
2. Inland container depot has been defined as depot notified by the Central Government as inland container depot.
3. Customs airport has been defined as an airport notified by the Central Government as customs airport. An aircraft entering India from a place outside India must land only at a customs airport.
4. Land customs station has been defined as a place notified by the Central Government to be a land customs station. Goods imported by the land route will have to be brought to a land customs station first before being disposed off in any manner. Once goods enter India the land route, they must follow the prescribed route only and reach the prescribed land customs goods to be exported or imported. Thus, though the Central Government notifies a customs area, the actual place within that city or town is approved by the collector.

Procedure to be followed by the Importer

Bill of entry must be filed in the prescribed form by the importer or his authorized agent giving the prescribed details such as name and address of the importer, importer code, name address and license number of the custom house agent, name of vessel, rotation number and date, line number, port of shipment, country of origin, country of consignment, number of bill of lading, description of packages, number of packages, quantity of goods, description of goods, customs tariffs heading, details of exemption from customs duty claimed, invoice number and value. A declaration that the details are true and there is no other document showing contrary information must also be given. The bill of entry may be signed by the importer himself or his custom house agent.

Bill of Entry is of Three Types:

1. Bill of entry for home consumption. It is to be submitted when the imported goods are to be cleared on payment of full duty for consumption of the goods in India. It is white coloured.

2. Bill of entry for warehouses. It is to be submitted when the imported goods are not required immediately by the importer, but they are to be stored in a warehouse without payment of duty under a bond and cleared later when required on payment of duty. This enables the importer to defer payment.

3. Bill of entry for ex-bond clearance. It is used for clearing goods from the warehouse on payment of duty. The goods are classified and valued at the time of clearance from the customs port. Value and classification are not determined on such bill of entry. It is green coloured. The rate of duty payable is that rate which is applicable on the date of removal of goods from the warehouse. If the rate of duty has changed after goods are cleared from custom port, duty assessed in the yellow bill of entry and paid duty payment on green bill of entry will not be the same.

Assessment and clearance. The document details filed by the importer or his authorized agent are checked and assessed by custom authority and then the goods are cleared. The following is the procedure for this:

- The bill of entry submitted by importer is tallied with the import manifest submitted by shipper. If any variance is found between the two, further clarifications for the difference are called for by the customs authorities. The rate of duty payable will be that rate which is prevalent on the date of presentation of bill of entry. The importer or his agent may present bill of entry up to one week before expected date of arrival of the vessel. In such a case duty is payable at the rate applicable on the date of which inward entry is granted and not the date of presentation of shipping bill. However, the rate of foreign exchange will be that rate which was prevalent on the date of submission of bill of entry. This enables the importer to clear the goods quickly.
- On presenting of the bill of entry, date of presentation is noted. The bill of entry is then sent to the appraising department for examination. The examiners carry out physical examination of the goods. Packages are opened and examined on a test check sample basis on the basis of which examination report is prepared. The appraiser classifies the goods, determines the customs value, rate of duty applicable and verifies that the imports do not violate any provision of law. The duty payable is typed by a pin point typewriter. The

importer must pay the amount of duty so determined in cash or by bank draft for clearance of goods. Sometimes, if all documents are in order and the authorities are convinced that there is no violation of any law, the assessment may be done without physically examining the goods.

Provisional Assessment may be done in the following circumstances

- When the customs officer is satisfied that importer or exporter is unable to produce the required document or information.
- It is necessary to carry out chemical or other test of goods.
- When the importer or exporter has produced all documents but the customs officer still feels that further enquiry is required.

In such circumstances, assessment is done on a provisional basis i.e., on a tentative basis. The importer has to pay the duty assessed and may clear the goods. However, he has to execute a bond or furnish warranty or security as required by the custom officer for payment of difference, if any. The surplus amount paid, if any, on final assessment is refunded to him and the shortfall, if any, is to be paid by him. If the imported goods are warehoused after provisional assessment, the customs officer may require the importer to execute bond for twice the difference in duty, if the duty finally assessed is higher.

Sometimes goods are imported in completely knocked down condition, i.e., CKD (e.g., all the components and parts of a car are imported and they are then assembled in India). Such packages comprise several goods, each of which are liable at different rate of duty. In such a case, if the importer is liable to produce satisfactory evidence regarding break-up value of different parts, duty will be charged at different rates applicable on the basis of such break-up. If break-up is not available, the rate of duty for the entire package will be the highest rate applicable among the parts in the package.

Self assessment of bill of entry (Green channel of import). This is a special scheme allowed in certain cases for speedy clearance of imports. As the name suggests, the duty is assessed by the importer himself and voluntarily paid by him. Some of the situations where this scheme has been made applicable are public sector undertakings, government departments, 100% export-oriented units approved by the collector and other importers with a proven identity and clean track record. The following are the main conditions of the scheme:

- Goods should not be subject to any import license or import restriction. They must be goods which fall under the open general list of the RBI.
- They must not fall under any negative list of imports.
- Consignment must be of a single product and not a combination of products.
- Sensitive items are not permitted under this scheme.
- Assessment must not require any bond.
- Assessment should not require original inspection of goods.
- Importer must be regularly importing that item. Bulk imports from manufacturer and test certificate of manufacturer is produced.

Under the scheme, the importer must file bill of entry having green colour band for identification. Bill of entry must be self assessed and must be submitted along with proof of previous clearance of goods.

Export Procedures

Certain procedures have to be followed for the purpose of clearing goods to be exported. Briefly these procedures have been discussed below:

Procedures to be followed by the exporter:

Airway bill of export in case of export by road in the prescribed form containing the prescribed details such as the name of the exporter, consignee, invoice number, details of packing, description of goods, quantity, FOB value, etc. Along with the shipping bill, other documents such as copy of packing list, invoices, export contract, letter of credit, etc. are also to be submitted. Goods have to be assessed for duty even if no duty is payable.

There are four types of shipping bills:

1. Shipping bill for export of goods under claim for duty drawback. This shipping bill is green coloured.
2. Shipping bill for export of dutiable goods. This shipping bill is yellow coloured.
3. Shipping bill for export of duty-free goods. This shipping bill is white coloured.
4. Shipping bill for export of duty-free goods ex-bond, i.e., from bonded warehouse. This shipping bill is pink coloured.

Declaration of Exporter

The exporter must make a declaration in the prescribed form in the following situations:

- In case of exports of goods under claims for drawbacks of duty
- In case of goods under DEEC schemes
- In case of exports of goods in anticipation of issue of advance license or DEEC
- In case of consignment covered by AR-4A (Excise forms) pending weighment at the docks. These forms are excise forms against which a manufacturer/exporter may clear goods from his factory for the purpose of exports without payment of any excise duty
- In case of exporters who have filed shipping bill without certificate from an inspection agency.

Excise Formalities

In case goods are cleared by the manufacturer for export, they are accompanied by Form AR-4 or AR-4A. This form must be submitted to the customs authorities. The custom officer certifies that the goods covered by the form have been exported. This form then has to be submitted to the Maritime Collector for obtaining proof of export.

Exchange Control formalities

The exporter must file copies of GR form prescribed by the Reserve Bank of India (RBI) for the purposes of exchange control with his bankers. Purpose of GR form is to enable RBI to ensure that export proceeds from the export are received in India through proper banking channels only within reasonable time limits.

Inspection reports

Certain goods such as items which are prohibited for export under the Foreign Trade (Development and Regulation) Act, antiques, arms, narcotics, etc. can be exported only after they have been inspected for export, and appropriate permissions from the concerned authorities have been obtained. In such cases, inspection report must also be submitted. The inspection may be done at the exporter's premises or at a customs area.

Let Export Order

After all the above formalities are over, and the customs officer is satisfied that the export does not contravene the provisions of any law and all duties and other dues have been paid, a "Let Export Order" will be made to permit the export.

Procedures have to be followed by the person in-charge of conveyance (shipper):

1. **Entry outwards.** Entry outward is granted by the customs authorities on application made by steamer agents 14 days in advance to enable the exporters to submit shipping bills. This enables speedy completion of customs formalities. Loading of goods on the vessel can start only after entry outwards is granted.
2. **Loading with permission.** Goods for export can be loaded only after the shipping bill or bill of exports duly assessed by the customs officer is handed over by the exporter to the person in-charge of the conveyance. In case of baggage and mail baggage, shipping bill is not necessary but approval of the customs officer is required for loading.
3. **Export manifest or export report.** It must be filed in the prescribed form before departure giving the prescribed details, which are similar to the details required in the import

The export manifest must be accompanied by a declaration that the details specified are true and correct by the person in-charge of the conveyance. This report is not required if the conveyance is carrying only luggage.

How to Export

Introduction

India's Foreign Trade i.e. Exports and Imports are regulated by Foreign Trade Policy notified by Central government in exercise of powers conferred by section 5 of foreign trade (Development and Regulation) Act 1992. Presently Foreign Trade Policy 2015-20 is effective from 1st April, 2015. As per FTD & R act, export is defined as an act of taking out of India any goods by land, sea or air and with proper transaction of money.

Starting Exports

Export in itself is a very wide concept and lot of preparations is required by an exporter before starting an export business. To start export business, the following steps may be followed:

1. **Establishing an Organisation:** To start the export business, first a sole proprietary concern/partnership firm/Company has to be set up as per procedure with an attractive name and logo.
2. **Opening a Bank Account:** A current account with a Bank authorized to deal in Foreign Exchange should be opened.
3. **Obtaining Permanent Account Number (PAN):** It is necessary for every exporter and importer to obtain a PAN from the Income Tax Department.
4. **Obtaining Importer-Exporter code (IEC) number:** An IEC is a 10 digit number which is mandatory for undertaking export/import. Application for obtaining IEC Number can be submitted to Regional authority of DGFT in form ANF 2A along with the documents listed therein.

   Applicants can also apply for e-IEC on the DGFT website (http://dgft.gov.in/). Only one IEC can be obtained against a single PAN.
5. **Registration cum membership certificate (RCMC):** For availing authorization to import/export or any other benefit or concession under FTP 2015-20, as also to avail the services/guidance, exporters are required to obtain RCMC granted by the concerned Export Promotion Councils/FIEO/Commodity Boards/Authorities.
6. **Selection of product:** All items are freely exportable except few items appearing in prohibited/restricted list.

   After studying the trends of export of different products from India proper selection of the product(s) to be exported may be made.
7. **Selection of Markets:** An overseas market should be selected after research covering market size, competition, quality requirements, payment terms etc. Exporters can also evaluate the markets based on the export benefits available for few countries under the FTP. Export promotion agencies, Indian Missions abroad, colleagues, friends, and relatives might be helpful in gathering information.
8. **Finding Buyers:** Participation in trade fairs, buyer seller meets, exhibitions, B2B portals, web browsing are an effective tool to find buyers. EPC's, Indian Missions abroad, overseas chambers of commerce can also be helpful. Creating multilingual Website with product catalogue, price, payment terms and other related information would also help.
9. **Sampling:** Providing customized samples as per the demands of Foreign buyers help in getting export orders. As per FTP 2015-2020, exports of bonafide trade and technical samples of freely exportable items shall be allowed without any limit.
10. **Pricing/Costing:** Product pricing is crucial in getting buyers' attention and promoting sales in view of international competition. The price should be worked out taking into consideration all expenses from sampling to realization of export proceeds on the basis of terms of sale i.e. Free on Board (FOB), Cost, Insurance & Freight (CIF), Cost & Freight

(C&F), etc. Goal of establishing export costing should be to sell maximum quantity at competitive price with maximum profit margin. Preparing an export costing sheet for every export product is advisable.

11. **Negotiation with Buyers:** After determining the buyer's interest in the product, future prospects and continuity in business, demand for giving reasonable allowance/discount in price may be considered.
12. **Covering risks through ECGC:** International trade involves payment risks due to buyer/Country insolvency. These risks can be covered by an appropriate Policy from Export Credit Guarantee Corporation Ltd (ECGC). Where the buyer is placing order without making advance payment or opening letter of Credit, it is advisable to procure credit limit on the foreign buyer from ECGC to protect against risk of non-payment.

Processing an Export Order

1. Confirmation of order: On receiving an export order, it should be examined carefully in respect of items, specification, payment conditions, packaging, delivery schedule, etc. and then the order should be confirmed. Accordingly, the exporter may enter into a formal contract with the overseas buyer.

2. Procurement of Goods: After confirmation of the export order, immediate steps may be taken for procurement/manufacture of the goods meant for export. It should be remembered that the order has been obtained with much efforts and competition so the procurement should also be strictly as per buyer's requirement.

3. Quality Control: In today's competitive era, it is important to be strict quality conscious about the export goods. Some products like food and agriculture, fishery, certain chemicals, etc. are subject to compulsory pre-shipment inspection. Foreign buyers may also lay down their own standards/specifications and insist upon inspection by their own nominated agencies. Maintaining high quality is necessary to sustain in export business.

4. Finance: Exporters are eligible to obtain pre-shipment and post-shipment finance from Commercial Banks at concessional interest rates to complete the export transaction. Packing Credit advance in pre-shipment stage is granted to new exporters against lodgement of L/C or confirmed order for 180 days to meet working capital requirements for purchase of raw material/finished goods, labour expenses, packing, transporting, etc. Normally banks give 75% to 90% advances of the value of the order keeping the balance as margin. Banks adjust the packing credit advance from the proceeds of export bills negotiated, purchased or discounted.

Post Shipment finance is given to exporters normally up to 90% of the Invoice value for normal transit period and in cases of usance export bills upto notional due date. The maximum period for post-shipment advances is 180 days from the date of shipment. Advances granted by banks are adjusted by realization of the sale proceeds of the export bills. In case export bill becomes overdue Banks will charge commercial lending rate of interest.

5. Labeling, Packaging, Packing and Marking: The export goods should be labelled, packaged and packed strictly as per the buyer's specific instructions. Good packaging delivers and presents the goods in top condition and in attractive way. Similarly, good packing helps easy handling, maximum

loading, reducing shipping costs and to ensuring safety and standard of the cargo. Marking such as address, package number, port and place of destination, weight, handling instructions, etc. provides identification and information of cargo packed.

6. Insurance: Marine insurance policy covers risks of loss or damage to the goods during the while the goods are in transit. Generally in CIF contract the exporters arrange the insurance whereas for C&F and FOB contract the buyers obtain insurance policy.

7. Delivery: It is important feature of export and the exporter must adhere the delivery schedule. Planning should be there to let nothing stand in the way of fast and efficient delivery.

8. Customs Procedures: It is necessary to obtain PAN based Business Identification Number (BIN) from the Customs prior to filing of shipping bill for clearance of export good and open a current account in the designated bank for crediting of any drawback amount and the same has to be registered on the system.

In case of Non-EDI, the shipping bills or bills of export are required to be filled in the format as prescribed in the Shipping Bill and Bill of Export (Form) regulations, 1991. An exporter need to apply different forms of shipping bill/bill of export for export of duty free goods, export of dutiable goods and export under drawback etc.

Under EDI System, declarations in prescribed format are to be filed through the Service Centers of Customs. A checklist is generated for verification of data by the exporter/CHA. After verification, the data is submitted to the System by the Service Center operator and the System generates a Shipping Bill Number, which is endorsed on the printed checklist and returned to the exporter/CHA. In most of the cases, a Shipping Bill is processed by the system on the basis of declarations made by the exporters without any human intervention. Where the Appraiser Dock (export) orders for samples to be drawn and tested, the Customs Officer may proceed to draw two samples from the consignment and enter the particulars thereof along with details of the testing agency in the ICES/E system.

Any correction/amendments in the check list generated after filing of declaration can be made at the service center, if the documents have not yet been submitted in the system and the shipping bill number has not been generated. In situations, where corrections are required to be made after the generation of the shipping bill number or after the goods have been brought into the Export Dock, amendments is carried out in the following manners.

1. The goods have not yet been allowed “let export” amendments may be permitted by the Assistant Commissioner (Exports).
2. Where the “Let Export” order has already been given, amendments may be permitted only by the Additional/Joint Commissioner, Custom House, in charge of export section.

In both the cases, after the permission for amendments has been granted, the Assistant Commissioner/Deputy Commissioner (Export) may approve the amendments on the system on behalf of the Additional/Joint Commissioner. Where the print out of the Shipping Bill has already been generated, the exporter may first surrender all copies of the shipping bill to the Dock Appraiser for cancellation before amendment is approved on the system.

9. Customs House Agents: Exporters may avail services of Customs House Agents licensed by the Commissioner of Customs. They are professionals and facilitate work connected with clearance of cargo from Customs.

10. Documentation: FTP 2015-2020 describe the following mandatory documents for import and export.

- Bill of Lading/Airway bill
- Commercial invoice cum packing list
- shipping bill/bill of export/bill of entry (for imports)

(Other documents like certificate of origin, inspection certificate etc may be required as per the case.)

11. Submission of documents to Bank: After shipment, it is obligatory to present the documents to the Bank within 21 days for onward dispatch to the foreign Bank for arranging payment. Documents should be drawn under Collection/Purchase/Negotiation under L/C as the case may be, along with the following documents

- Bill of Exchange
- Letter of Credit (if shipment is under L/C)
- Invoice
- Packing List
- Airway Bill/Bill of Lading
- Declaration under Foreign Exchange
- Certificate of Origin/GSP
- Inspection Certificate, wherever necessary
- Any other document as required in the L/C or by the buyer or statutorily.

12. Realization of Export Proceeds: As per FTP 2015-2020, all export contracts and invoices shall be denominated either in freely convertible currency of Indian rupees, but export proceeds should be realized in freely convertible currency except for export to Iran. Export proceeds should be realized in 9 months.

PRACTICAL CASE STUDIES

Case Study on Car Sales in European Market after BREXIT

Europe is one of the Key markets for the global automotive industry. Yet there have been some events lately which could impact growth in some countries. In early July 2016, the German parliament adopted a purchase incentive program to encourage consumers in to buying electrified cars. In neighboring France, major incentives were announced to decrease pollution. From July1, 2016, Cars and Light Commercial Vehicle made before 1997 will be banned in Paris from 8am to 8pm on week days. There is also an incentive of up to 400 Euros towards part payment of an annual pass for public transport.

In Spain, the eighth edition of the Efficient Vehicle incentive Program which ended on July 31, 2016 has used approximately 83 per cent of its initial budget. This initiative is focused on fuel-efficient vehicles. So what does the future hold for Europe and its Key auto regions? Beginning with France, its economy is expected to continue its journey to recovery with a revised GDP growth of 1.7 per cent in 2016. PWC autofacts anticipates an annual growth of 6.8 per cent to two million new car registrations in 2016. Consumer Confidence in Germany is down 1.6 points in June 2016 which is still better than -6.2 points in March. This is largely due to more positive expectations from the economy over the next 12 months. However, a possible downside risk could come from the BREXIT negotiations now under the way. German suppliers selling components to British manufacturers might need to lower prices at a reaction to decreased purchasing power stemming from currency fluctuations. Keeping this in mind, Germany is forecast to see solid growth of passenger car sales in 2016.

Moving now to the UK, although the society of Motor Manufacturers & Traders speaks of stabilization of the new car market this year, Autofacts has a pessimistic outlook on UK's sales outlook in 2016. Uncertainity is surely the major risk factor in the short term that could undermine consumer/business confidence in the coming months and adversely affect the UK Market. Some companies have already announced deferring investment until the post-Brexit picture becomes clearer. As a result, economic institutes have lowered their UK-GDP outlook and the economy could slip in to a recession by end-2016, consequently, PWC Autofacts anticipates new car sales to fall, resulting in 1.1 per cent fall in annual growth to 2.6 million new car registrations in 2016.

Case Study on Venezuela Economic Crisis

In Venezuela, these days, it is not unusual to see huge gatherings of people jostling with each other in long queues to get inside supermarkets and department stores but only to be welcomed by empty shelves as supplies of even basic goods like food and water have got badly affected as the nation faces its worst economic crisis in several decades. The cash-strapped Venezuelan government has been finding it hard to buy even essential items like medicines that have hit healthcare services hard in the country, thus raising fears that its current political and economic crisis may soon turn in to a potential humanitarian crisis if immediate steps are not taken. Meanwhile, the long lines at the supermarkets and the massive protests against the socialist government of President Nicolas Maduro represent the most dramatic illustration of Venezuela's current political and economic turmoil. Energy experts predict a decline of oil production for Venezuela to 2.25 million barrels a day by the end of this year. Some polls estimate that more than 80% of basic consumer products are now in short supply in Venezuela.

Much of the country's recent lower cost troubles stem from the prolonged global collapse in oil prices over the last two and half years. oil prices after hovering above $100 a barrel in January 2014 came crashing down to below $30 a barrel by January 2016. Although they have recovered some of lost ground to reach around $50 a barrel by June 2016, it is still well below the comfort levels of many oil producing nations including Venezuela. The latest figures from Venezuela's state oil company PDVSA show the average production cost for all its crudes is $18 a barrel, while Toronto-listed Pacific Exploration and Production, Columbia's largest private operator, reported that its production cost including diluents, transportation and taxes averaged $20 to $22 in the third quarter of 2015.The recent oil shock has exposed it to the risk of growing budget deficit and ballooning foreign debt. Its oil

exports revenues have fallen from about $80bn in 2012 to less than $20 bn by 2016 according to Barclays data.

Multiple factors have contributed to the global oil glut and to the collapse in global commodity prices. Among these, the noticeable ones include geo political tensions and retaliations among countries in the Middle East; global competitive pressures among oil producers driven by their struggle to retain market shares and to outperform new aggressive entrants, oil exporters over capacity and Over supply; immediate balances between oil supply and demand due to the global economic slowdown; massive financial speculation in oil and commodities markets and volatile currency markets; market expectations on the Federal Reserve's monetary policy normalization process, the trajectory of the US dollar appreciation and its impact on commodity prices and higher production cost of oil per barrel vis-à-vis the market prices.

The International Monetary Fund(IMF) forecasts that Venezuela will have an unemployment rate of 17% in 2016 and nearly 21% in 2017.The country however could still prevent a potential default, in addition to the benefits of increasing oil prices, through financial assistance from one of its allies such as China, Russia and Iran. Venezuela currently owes about $123 billion to foreign creditors according to estimates from Bank of Americamerill Lynch. One of the major concerns regarding a potential default of Venezuela or its economic meltdown is the extent of impact that this crisis might have on the domestic market, International Markets and its trading Partners. The IMF identifies Venezuela as one of four key countries along with Brazil, Ecuador and Argentina that will cause GDP growth contraction in Latin America and the Caribbean in 2016. Currently, its outlook remains bleak due to hyper inflation(Inflation surged to 181% last year) and deep recession after a big contraction in Economic growth by 4.5% in 2017.

The country is currently experiencing runaway inflation exceeding 200% a year.The IMF predicts that Inflation will be approximately 480% this year and this has shot up to 1642% in 2017.

Source: The Global Analyst-20M-2017-04-01, June 2017 Issue.

Questions

1. Write a note on Inflationary trend of Venezuela.
2. How do you see the dollar depreciation due to hyperinflation?

SUMMARY

International Trade or Foreign Trade is exchange of capital, goods, and services across international borders or territories. In most countries, it represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history, its economic, social, and political importance has been on the rise in recent centuries.

The features of International Trade are mentioned below:

Immobility of factors of production, independent monetary systems, political boundaries, greater geographical distances, territorial specialization,international competition, separation of sellers from buyers, long chain of middlemen, different currencies, issue of balance of payments, different National Policies, difference in Constitutional Policy. Its basis are variations in Spatial Distribution of Natural

Resources, differences in Economic Development, uneven Distribution of population in the world, transportation facilities, nature, choice and fashion, scientific progress, war and peace, trade policy, political contacts and trade alliances.

Benefits of International Trade

The benefits of international trade are as follows:

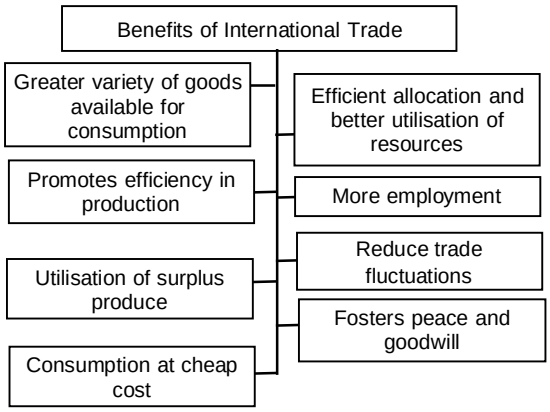


Fig. 1.11

The balance of trade (or net exports, sometimes symbolised as NX) is the difference between the monetary value of exports and imports of output in an economy over a certain period. It is the relationship between a nation's imports and exports. A favourable balance of trade is known as a trade surplus and consists of exporting more than is imported; an unfavourable balance of trade is known as a trade deficit or, informally, a trade gap. The balance of trade is sometimes divided into a goods and services balance. The balance of trade forms part of the current account, which includes other transactions such as income from the international investment position as well as international aid. If the current account is in surplus, the country's net international asset position increases correspondingly. Equally, a deficit decreases the net international asset position.

The trade balance is identical to the difference between a country's output and its domestic demand (the difference between what goods a country produces and how many goods it buys from abroad; this does not include money respent on foreign stocks, nor does it factor the concept of importing goods to produce for the domestic market). For a given country, trade balance comprises those products that a country trades on with other countries.

Measuring the balance of trade can be problematic because of problems with recording and collecting data. As an illustration of this problem, when official data for all the world's countries are added up, exports exceed imports by a few per cent; it appears the world is running a positive balance of trade with itself.

1. Favourable Balance of Trade: Balance of trade is said to be favourable when total value of exports of goods of a country exceeds her total value of imports of goods, (i.e., when $E_g > M_g$).

2. Unfavourable (or Adverse) Balance of Trade: Balance of trade is said to be unfavourable when total value of imports of goods of a country exceeds the total value of exports of goods, (i.e., when $E_g < M_g$).

3. Equilibrium Balance of Trade: Balance of trade is said to be in equilibrium when total value of exports of goods of a company is equal to her total value of imports of goods, (i.e., $E_g = M_g$).

4. Balance of payment is a broader term and it includes balance of trade. It is more comprehensive than the balance of trade. Balance of trade refers to the merchandise account of exports and imports only.

5. Balance of payment refers to the net results that are drawn recording all the visible and invisible items that are imported and exported from the country. Balance of payment, such as, provides a comprehensive statement over the net results of foreign trade and gives a true picture as to where the country stands in the international trade. Balance of payment clearly exposes the economic viability, strength, and capability by correctly measuring its imports and exports, competency in goods and services as well as technical know-how. By services we mean the services of shipping lines, insurance companies banking concerns, and others. Balance of payment also includes the foreign loan that is either provided by it or accepted from other country or countries.

Following are the methods of correcting BOP Disequilibrium

1. Monetary Policy: Monetary policy may be devised to correct a deficit in the balance of payments of a country. The deficit occurs because of high imports and low exports. This is to be reversed. In this regard, the country may adopt deflationary or dear money policy by raising the bank rate and restricting credit Under deflation, prices fall which makes exports attractive and imports relatively costlier. This eventually leads to a rise in exports and fall in imports.

2. Exchange Depreciation: Exchange depreciation means a decline in the rate of exchange of one country ii terms of another. Suppose the Indian rupee exchanges for 30 cents of American currency. If India experience: an adverse balance of payments with regard to America, the Indian demand for American currency (Dollar) will rise. Consequently the price of dollar in terms of rupee will appreciate in its external value. Thus, the rate of exchange of Indian rupee in terms of American dollar may change from Re.l = 30 cents to Re.l = 20 cents. Such depreciation in the value of currency is what is called “exchange depreciation.”

3. Devaluation: It is an alternative to exchange depreciation. It is suitable under the present IMF system. Devaluation means official decrease in the external value of a currency in terms of foreign currency or good or SDR.

Suppose 1$ = ₹ 8 and if Indian Government puts it as 1$ = ₹ 10 it means a 25 per cent devaluation of the Indian rupee in terms of the U.S. dollar.

When a country has a persistent deficit in its balance of payments, it may devalue its currency with the permission of the IMF. When a country’s currency is devalued, the impact would be relative cheapness of its exports to the foreigners and relative deamess of its imports. Consequently, export will rise and imports decline. This will help removal of the deficits in the balance of payments.

4. Exchange Control: Restrictions on the use of foreign exchange by the central bank is called "exchange control". When exchange control is adopted, all the exporters have to surrender their foreign exchange earnings to the central bank. Under exchange control, the central bank releases foreign exchanges only for essential imports and conserves the rest of the balance. This is the most direct method of curbing imports.

5. Fiscal Policy: Fiscal policy is another method of correcting unfavourable balance of payments. Under budgetary provisions, tariff or import duties may be imposed so that import becomes dearer and the propensity to import is checked. As a result, imports are reduced and the balance of payments becomes favourable.

6. Import Quotas: Fixing of import quotas is another and perhaps a better device used for correcting an adverse balance of payments. Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system deficit is reduced or eliminated and thereby the balance of payments position is improved.

7. Export Promotion: To correct disequilibrium in the balance of payments, it is necessary that exports should be increased. Government may adopt export promotion programmes for this purpose. Export promotion programme includes subsidies, tax concessions to exporters, marketing facilities, and incentives for exports. Barriers to international trade are Protecting Domestic employment, infant industries, national security, protect home industries from foreign competition, promote new industries and R&D activities, conserve foreign exchange reserves, maintain favorable balance of trade and payments position, protect national economy from dumping, hurdle to exporters,

Types of International Trade Barriers

Where international trade is concerned it is meant for the exchange of goods and/or services. This exchange usually takes place between two parties from different countries or between two countries located anywhere on the globe. Types of international trade barriers are as follows:

If the international trade takes place between two parties, it is known as bilateral trade and if the trade takes place between more than two parties, it is known as multi-lateral trade.

There are basically three types of barriers to international trade that are used by the countries, and they are as follows:

1. **Tariff Barrier:** This is barrier is in the form of duties, taxes, quotas etc. Because of this barrier, imports decrease and price of imported products increase which results in the fall in the demand giving boost to domestic products.
2. **Non-tariff Barrier:** Usually this type of barrier is imposed by a country on imports so that the quantity of imported items is restricted. Due to this, the availability of the imported item or items is restricted in the domestic market and the price too is very high.
3. **Voluntary Constraint:** This is a type of international trade barrier wherein a country voluntarily restricts or stops imports from coming in. This is usually used to limit the competition that domestic industries will face with the coming in of imported goods.

Whenever a country starts international trade with another country, these three barriers to international trade are always taken into account. It has been seen that lower developed countries and developing countries tend to favour these three barriers to international trade as the countries can earn foreign exchange by introducing tariff and non-tariff barrier, the local industries are protected from competition by foreign companies and industries and as less imported goods are available in the country, consumers tend to buy local products giving the local industries a boost.

REVIEW QUESTIONS

1. Explain the meaning of International Trade? Why are organizational going International.
2. Explain the difference between International Trade and Domestic Trade
3. Explain the difference between International Financial Management and Domestic Financial Management.
4. Discuss the scope and nature of International Financial Management.
5. Discuss the factors affecting Balance of Payment (BOP)
6. How is that Balance Of Payment being corrected? Explain the methods.
7. Elucidate all tariff and non tariff barriers to International Trade.
8. Explain the positive and negative impacts of WTO provisions.

♦ ♦ ♦

2

EXCHANGE RATE SYSTEM

Chapter Outline

- Exchange Rates-An Introduction
- Current Exchange Rate Regime
- Exchange Rate System in India
- Theories of Exchange Rate Determination
- Measuring Exchange Rate Movements
- Practical Case Studies
- Difference between International Financial Management and Domestic Financial Management
- Summary
- Review Questions

EXCHANGE RATES – AN INTRODUCTION

In other words, the rate at which the currencies of two nations are exchanged for each other is called the foreign exchange rate. It is nothing but the value or price of a country's currency expressed in terms of a foreign currency. For example, if 1 U.S. dollar is exchanged for ₹ 10 then foreign exchange rate is. 1 U.S. $ = ₹ 10.

For example, an exchange rate of 102 Japanese yen (JPY, ¥) to the United States dollar (USD, $) means that JPY 102 is worth the same as USD 1. The foreign exchange market is one of the largest markets in the world.

Exchange rates can influence the sourcing of funds for businesses, investment in foreign countries as well as the reporting of financial results. The determination of exchange rates is a complex process that has significant economic impact on imports and exports and in turn job growth. The foreign exchange market plays an important role in the determination of the exchange rates. Individuals can use exchange rates not only for investment decisions, but also for lifestyle choices like tourism, relocation, and buying consumer products.

Determination of Foreign Exchange Rates

The rate of exchange being a price of a national currency in terms of another, is determined in the foreign exchange market in accordance with the general principle of the "theory of value", i.e., by the interaction of the forces of demand and supply. Thus, the rate of exchange in the foreign exchange market will be determined by the interaction between the demand for foreign exchange and the supply of foreign exchange.

The demand function for foreign exchange shows functional relationship between alternative rate of exchange and the corresponding amount of foreign exchange demanded. When the rate of exchange is low, the demand for foreign exchange tends to be high because there will be high inclination to import.

The supply function of foreign exchange represents the functional relationship between the rate of exchange and the amount of foreign exchange supplied. When the rate of exchange is high, more foreign exchange is supplied as there will be more export due to high foreign demand. Equilibrium rate of exchange is determined at a point where demand for foreign exchange equals its supply:

In figure 2.1, OP is the rate of exchange determined at which OM is the demand as well as supply of foreign exchange. Any variation in demand or supply will lead to a variation in the rate of exchange.

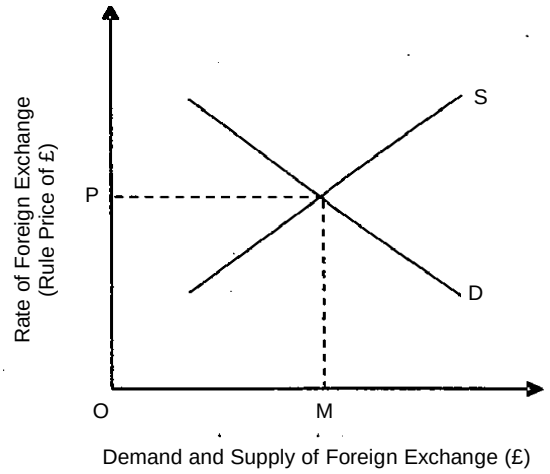


Fig. 2.1

Exchange Rate Equilibrium

As in the commodity market, in the foreign exchange market also there is a normal or equal rate of exchange and there is a market of short-term rate of exchange. The equilibrium rate is the "norm" around which the market rate of exchange oscillates.

The equilibrium or normal rate of exchange is determined differently under different monetary standards. The market rate of exchange will reflect the temporary influence of forces of demand and supply in the foreign exchange market, but it will be oscillating around the normal rate of exchange.

In simple words, however, the equilibrium rate of exchange is the rate of exchange at which the par value of home currency with foreign currency is maintained at a stable level over a long period of time, which means it is neither undervalued nor overvalued.

In short, the exchange rate to be an equilibrium rate must be maintained at par with values of different currencies.

CURRENT EXCHANGE RATE REGIME

An exchange-rate regime is the way an authority manages its currency in relation to other currencies and the foreign exchange market. Between the two limits of fixed and freely floating exchange regimes, there can be several other types of regimes. In their operational objective, it is closely related to monetary policy of the country with both depending on common factors of influence and impact.

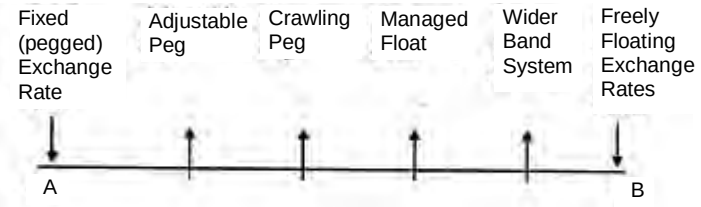


Fig. 2.2: Types of Exchange Rate Regime

The exchange rate regime has a big impact on world trade and financial flows. The volume of such transactions and the speed at which they are growing makes the exchange rate regime a central piece of any national economic policy framework.

In Fig. 2.2, as one moves from point A on the left to point B on the right, both the frequency of intervention by domestic monetary authorities and required level of international reserves tend to be lower.

Under a pure fixed-exchange-rate regime (point A), authorities intervene so that the value of the domestic currency vis-a-vis the currency of another country, say the US Dollar, is maintained at a constant rate. Under a freely floating exchange-rate regime, authorities do not intervene in the market for foreign exchange and there is minimal need for international reserves.

Features of the Current Exchange Rate Regime

The principal features of the current exchange rate regime in India can be briefly stated as follows:

1. The rates of exchange are determined in the market.
2. The freely floating exchange rate regime continues to operate within the framework of exchange control.
3. Current receipts are surrendered (or deposited) to the banking system, which in turn, meets the demand for foreign exchange.
4. RBI can intervene in the market to modulate the volatility and sharp depreciation of the rupee. It effects transactions at a rate of exchange, which could change within a margin of 5 per cent of the prevailing market rate.
5. The US dollar is the principal currency for the RBI transactions.
6. The RBI also announces a Reference Rate based on the quotations of select banks on Bombay at twelve noon every day. The Reference Rate is applicable to SDR transactions and transactions routed through the Asia Clearing Union.

In short, the India rupee has matured to a regime of the floating exchange rate from the earlier versions of a ‘managed float’.

EXCHANGE RATE SYSTEM IN INDIA

India was among the original members of the IMF when it started functioning in 1946. As such, India was obliged to adopt the Bretton Woods system of exchange rate determination. This system is known as the par value system of pegged exchange rate system. Under this system, each member country of the IMF was required to define the value of its currency in terms of gold or the US dollar and maintain (or peg) the market value of its currency within ± per cent of the defined (par) value.

The Bretton Woods system collapsed in 1971. Consequently, the rupee was pegged to Pound Sterling for four years after which it was initially linked to the basket of 14 currencies but later reduced to 5 currencies of India’s major trading partners.

This system continued through the 1980s; through the exchange rate was allowed to fluctuate in a wider margin and to depreciate modestly with a view to maintaining competitiveness. However, the need for adjusting exchange rate became precipitous in the face of external payments crisis of 1991.

As a part of the overall macro-economic stabilization program, the exchange rate of the rupee was devalued in two stages by 18 per cent in terms of the US dollar in July 1991. With that, India entered into a new phase of exchange rate management.

Objectives of Exchange Rate Management

The main objectives of India's exchange rate policy is to ensure that the economic fundamentals are truly reflected in the external value of the rupee.

Subject to this predominant objective, the conduct of exchange policy is guided by the following:

1. Reduce volatility in exchange rates, ensuring that the market correction of exchange rates is effected in an orderly and calibrated manner;
2. Help maintain an adequate level of foreign exchange reserves;
3. Prevent the emergence of destabilization by speculative activities; and
4. Help eliminate market constraints so as to assist the development of a healthy foreign exchange market.

Exchange Rate Reforms

Exchange rate reforms have proceeded gradually beginning with a two- stage cumulative devaluation of rupee by about 20 per cent effected in July 1991. Subsequently, the Liberalised Exchange Rate Management System (LERMS) was introduced in 1992, which was later replaced by the Unified Exchange Rate System (UERS) in 1993. The net result was an effective devaluation of the rupee by around 35 per cent in nominal terms and 25 per cent in real terms between July 1991 and March 1993.

THEORIES OF EXCHANGE RATE DETERMINATION

There are various theoretical explanation advanced in this regard, because the par values and the equilibrium or normal rates of exchange are determined differently under different monetary systems.

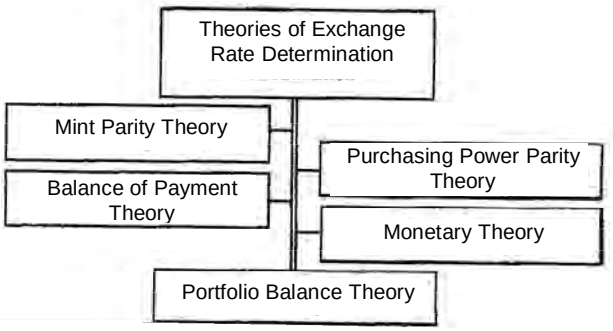


Fig. 2.3

1. Mint Parity Theory: When the currencies of two countries are on a metallic standard (gold or silver), the rate of exchange between them is determined on the basis of party of mint ratios between the currencies of the two countries. Thus, the theory explaining the determination exchange rate between countries which are on the same standard (say, gold coin standard) is known as the Mint Party Theory of foreign exchange rate.

In practice also, before World War I, England and America were simultaneously on a full-fledged gold standard. While gold sovereign (Pound) contained 113.0016 grains of gold; the gold dollar contained 23.2200 grains of gold of standard purity. Since the mint parity is the reciprocity of the gold content ratio between the two currencies, the exchange rate between the American dollar and the British Sovereign (Pound) based on mint parity, was 113.0016/ 23.2200, i.e., 4.8665. That means, the exchange rate £1=4.8665 can be defined as the mint par exchange between the pound and the dollar.

Today, however, the method of determining currency value in terms of gold content or mint parity is obsolete for the obvious reasons that:

1. None of the modern countries in the world is on gold or metallic standard,
2. Free buying and selling of gold inter nationally is not permitted, by various governments and as such it is not possible to fix par value in terms of gold content or mint parity, and
3. Most of the countries' today are on paper standard or Fiat currency system.

The basic principle underlying the purchasing power parity theory is that foreign exchange (foreign money) is demanded by the nationals of a country because it has the power to command goods (purchasing power) in its own country (the foreign country). When the domestic currency of a nation is exchanged for foreign currency, what in fact happens is that domestic purchasing power is exchanged for foreign purchasing power. It follows that the main factor determining the exchange rate is the relative purchasing power of the two currencies and when two currencies are exchanged what is exchanged in fact is the international purchasing power of the two currencies. Thus, the equilibrium rate of exchange should be such that the exchange of currencies would involve the exchange of equal amounts of purchasing power. Hence, it is the parity (equality) of the purchasing power of the currencies which determines the exchange rate. Thus, the theory states that the rate of exchange tends to rest at a point at which there is equality between the respective purchasing power of the currencies. In other words, the rate of exchange between two inconvertible paper currencies tends to approximate the ratio of their purchasing power.

The theory of Purchasing Power Parity postulates that foreign exchange rates should be evaluated by the relative prices of a similar basket of goods between two nations. A possible change in the rate of inflation of a given country should be balanced by the opposite change of country's exchange rate. If prices in the country are surging because of inflation, country's exchange rate should decrease in order to return to parity.

The basket of goods and services includes a sample of all goods and services, which are covered by a country's Gross Domestic Product. Consumer goods and services, services by the government, equipment goods and so on are all included in the basket. Among consumer goods and services are items such as food, drinks, clothing, footwear, tobacco, rents, medical goods and services, water and gas supply, fuel, transport services, recreational and cultural services, education services etc.

The Big Mac Index

A popular example of Purchasing Power Parity is the Big Mac Index by the Economist magazine. A proposed method to forecast exchange rate movements is that the rate between currencies of two countries should adjust in a way that a sample basket of goods and services should cost the same in both currencies. The basket is comprised by one Big Mac burger, sold by the McDonald's fast food chain. The Big Mac PPP exchange rate between two countries is calculated by dividing the cost of a Big Mac in one country in its own currency by the cost of a Big Mac in the other country in its own currency. The resulting value is usually compared with the current exchange rate. In case the value is lower, then the first currency appears to be undervalued in comparison with the second currency. In case the value is higher, then the first currency appears to be overvalued in comparison with the second.

Let us have an example. In July 2008 in the United States a single Big Mac amounted to 3.57 USD, while in the United Kingdom its price was 2.29 GBP. The implied purchasing power parity is calculated as follows: 3.57/2.29 = 1.56. Therefore, the parity was 1.56 USD to 1 GBP. The actual exchange rate (GBP/USD) back then was 2 USD to 1 GBP. Comparing both values we reach the following result: (2.00-1.56)/1.56*100 = 28.20%, or the exchange rate for GBP/USD was overvalued by 28%.

Purchasing Power Parity Index by the Organization for Economic Cooperation and Development (OECD)

The Organization for Economic Cooperation and Development and Eurostat publish a more formal index of Purchasing Power Parity. The latest information about whether a particular currency is undervalued or overvalued against the US dollar is presented on OECD's website (www.oecd.com). Data is shown in the form of a table, containing price levels for major industrialized countries. Every column shows the number of monetary units needed in every country in order to purchase the same sample basket of consumer goods and services.

Limited Application

The theory of Purchasing Power Parity should be applied only for fundamental analysis in a long term. Forces behind Purchasing Power Parity will at some point equalize the purchasing power of currencies. This can occur within 5 to 10 years.

A disadvantage of this theory is that it suggests that goods can be traded without any restraints and it does not take into account any tariffs on imports or taxes. Inflation, interest rate differentials, economic reports, trade flows, political situation are factors, which should also be taken into account when weighing the index of purchasing power parity.

Interest Rate Parity Theory: This theory assumes that if two currencies have different interest rates, this difference will lead to a discount or premium for the exchange rate in order to avoid arbitrage opportunities. We discuss the role of arbitrageurs in the market in our Forex Trading guide.

A simple example may be a situation, where interest rates in the United Kingdom are, say, 2%, while interest rates in Japan are, say, 1%. The sterling will need to depreciate 1% against the Japanese yen so that arbitrage opportunities can be avoided.

The future exchange rate of GBP/JPY is reflected in the forward exchange rate known today. The forward exchange rate of the pound is at a discount, as it purchases lesser amount of Japanese yens in the forward rate than it does in the spot rate. The forward exchange rate of the yen, on the other hand, is at a premium.



Fig 2.4

However, interest rate parity has not shown much proof that it is working recently. Currencies of countries, where interest rates are high, in many cases increase in value, because central banks are determined to cool an overheating economy by raising interest rates, therefore, this influence on currencies is not related to arbitrage.

3. Balance of Payments Theory: According to the Balance of Payments Theory, also known as the Demand and Supply Theory of exchange rate, the foreign exchange rate, under free market conditions, is determined by the demand and supply conditions in the foreign exchange market. Thus, according to this theory, the price of a currency, i.e., the exchange rate is determined in the same way in which the price of any commodity is determined by the free play of the forces of demand and supply.

The value of a currency appreciates when the demand for it increases and depreciates when the demand falls in relation to its supply in the foreign exchange market.

The extent of the demand for the supply of a country's currency in the foreign exchange market depends on its balance of payments position. When the balance of payments is in equilibrium, the supply of and demand for the currency are equal. But when there is a deficit in the balance of payments, the supply of the currency exceeds its demand and causes a fall in the external value of the currency. When there is a surplus, the demand exceeds the supply, and causes a rise in the external value of the currency.

The basics of this theory may be explained on the simplifying assumption that there are only two currencies in the foreign exchange market, say, the Indian Rupee and the US Dollar. As a result, supply of rupees in the exchange market generates an equivalent demand for dollars and vice versa.

Demand for rupees comes from several sources like Indian exports of goods and services, travel by foreigners in India, and inflows of funds on account of gifts, charities, remittances of earnings from abroad, loans and investment, and so on. We should also include inflow of funds in the form of bank deposits, receipts of profits and dividends from abroad, interest on our loans to foreigners and repayment of these loans, and similar other items.

Similarly, all payments made to foreigners generate a supply of rupees (and therefore, a demand for dollars) in the foreign exchange market. Dollars are needed by us to pay for our imports of goods and services, to service our foreign debt and to pay for our travel abroad. We also need dollars for other payments abroad, such as, repatriation of profits and dividends by foreigners, to make foreign

investments, to deposit money with banks outside India; and to give funds in gifts, charities and loans to foreigners, and so on. It is noteworthy that most of the outflows are expected to be responsive (in varying degrees) to changes in the exchange rate, such that the supply of rupees and their dollar-price are positively related, yielding a positively sloped supply curve.

4. Monetary Theory: The monetary theory assumes that PPP holds good, i.e., an increase in the price level results in the depreciation of a country's currency and vice versa. Using this assumption, this theory arrives at a few results that are opposite to that given by the demand-supply approach.

With an increase in the real GNP (the real product) of a country, the real product increases, so do the transactions and the demand for money need to be held for making purchases` Hence, an increase in the real GNP results in an increase in the real money demand. Due to this, lesser money is left for purchase of goods, services, and bonds. With no change in the money supply, this brings down the price levels. With a reduction in the demand for bonds, the bond prices also go down, resulting in an increase in the nominal interest rates. Since this approach assumes PPP to hold well, a reduction in the price levels brings about an appreciation of the currency.

Hence, an increase in the real GNP brings about an appreciation of the currency. This is in contrast with the predictions of the demand-supply theory.

The theory also outlines the correction mechanism in the system. With a fall in the price level, the real money demand stands reduced. At the same time, an increase in the interest rates increases the opportunity cost of holding money, thus reducing the real demand for money. This leaves people with more money to spend on goods and services, thus increasing the price levels. This makes the currency appreciate.

There is another route through which a growth in real GNP affects the exchange rate. An increase in the real GNP increases the real demand for money. As much of this increased demand, as is not satisfied through an increase in the money supply, is satisfied through a current account surplus. This makes the currency appreciate

The effect of an increase in money supply induces people to spend more on goods and bonds. This increases the price levels and reduces the nominal interest rates. The higher price level makes the currency depreciate.

The predictions of the monetary theory can be summarized as follows:

(i) An increase in the real GNP of a country causes its currency to appreciate. It follows that out of two countries, the country having a higher growth in the GNP will see its currency appreciating against the other country's currency.

(ii) An increase in real money demand makes the currency appreciate.

(iii) An increase in nominal interest rates causes the currency to depreciate (as seen in the correction mechanism). This again goes against the predictions of the demand-supply approach.

(iv) An increase in the money supply causes the currency to depreciate.

This theory also analyzes the effects of expected inflation. Expected inflation leads to higher nominal interest rates (since the nominal interest rate includes a premium for inflation). This causes a

depreciation of the currency. The PPP says that inflation causes a currency to depreciate. According to the monetary approach, the effect on the exchange rates is immediate, rather than happening after the inflation takes place.

5. Portfolio Balance Theory: The portfolio balance theory (McKinnon, 1969) suggests that not only the monetary factor but also the holding of financial assets, such as domestic and foreign bonds influences the exchange rate.

This theory suggests that exchange rate is determined by the interaction of real income, interest rates, risk, price level, and wealth. If a change takes place in these variables, the investor re-establishes a desired balance in its portfolio. The re-establishment of the portfolio balance needs some adjustments which, in turn, influence the demand for foreign assets. Any such change influences the exchange rate. For example, a rise in real domestic income or a rise in interest rate abroad leads to a greater demand for foreign bonds. Any rise of demand for foreign currency will result in depreciation of the domestic currency. Again, the legal, political, and economic conditions in a foreign country may be different from those at home. If foreign bonds turn out to be more risky on these grounds, the demand for foreign currency will decrease, in turn appreciating the value of the domestic currency. Similarly, a rising inflation in the foreign country would make foreign bonds risky and the demand for foreign currency will drop and so domestic currency will appreciate. When the exchange rate changes, the above mentioned variables also change leading to a shift in the desired balance in the investment portfolio. Thus, the two-way interaction continues until equilibrium is reached. The equilibrium is, however, short-lived.

MEASURING EXCHANGE RATE MOVEMENTS

An exchange rate measures the value of one currency in units of another currency. A decline in a currency's value is referred to as depreciation, while an increase is referred to as appreciation. Exchange rate movements can be measured differently in different markets.

1. Spot Market
2. Forward Market

Exchange Rate Determination in Spot Market

The exchange rate between two currencies in a floating-rate regime is determined by the interplay of demand and supply forces. The exchange rate between, say, the rupee and the US dollar depends upon the demand for the US dollar and its availability or supply in the Indian foreign exchange market The demand for foreign currency comes from individuals and firms who have to make payments in foreign currency mostly on account of import of goods and services and purchase of securities. The supply of foreign exchange results from the receipt of foreign currency normally on account of export or sale of financial securities to foreign entities.

In figure 2.2 the exchange rate designated by the price of the US dollar (foreign currency) in terms of the rupee, is shown on the vertical axis, and the supply of, and demands for; the US dollar is shown on the horizontal axis. The demand curve slopes downward to the right because the higher the value of the US dollar, the costlier are the Indian imports and the importers curtail the demand for

imports and consequently the demand for foreign currency falls. Similarly, a higher value of the US dollar makes Indian export cheaper and thereby stimulates the demand for export. The- supply of the US dollar increases in the form of export earnings and the supply curve of the US dollar moves upward to the right with a rise in its value. The equilibrium exchange rate is reached where the supply curve intersects the demand curve at Ql. This rate as shown in the figure is 40/US $.

If demand for import rises owing to some factors at home, the demand for the US dollar will rise to D' and intersect the supply at Q2, the exchange rate will then be ₹ 42/US $. But if export rises as a result of decline in the value of the rupee and the supply of the dollar increases to S', the exchange rate will again be ₹ 40AJS $. Quite evidently, the frequent shifts in the demand and supply conditions cause the exchange rate to also adjust frequently to a new equilibrium.

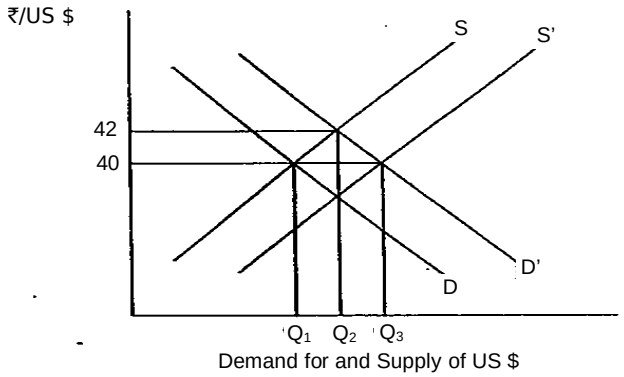


Fig. 2.5: Exchange Rate Determination

Exchange Rate Determination in Forward Market

Forward exchange rate is normally not equal to the spot rate. The size of forward premium or discount depends mainly on the current expectation of future events. Such expectations determine the trend of the future spot rate towards appreciation or depreciation and thereby determine the forward rate that is equal to, or close to, the future spot rate. Suppose, the dollar is expected to depreciate, then holders of dollars will start selling forward. These actions will help depress the forward rate of the dollar. On the contrary, when the dollar is expected to appreciate, the holders will buy it forward and the forward rate will improve.

The determination of exchange rate in a forward market finds an important place in the theory of Interest Rate Parity (IRP).

1. **Covered Interest Arbitrage:** If the forward rate differential is not equal to the interest rate differential, covered interest arbitrage will begin and it will continue till the two differentials become approximately equal. In other words, a positive interest rate differentia! in a country is offset by annualized forward discount. A negative interest rate differential is offset by an annualized forward premium. Finally, the two differentials will be equal. In fact, this is the point where the forward rate is determined.
2. **Uncovered Interest Arbitrage:** When one talks about interest arbitrage, it would be worthwhile to note that interest arbitrage may not be only covered, it may also be

uncovered. However, in an uncovered interest arbitrage, the arbitrageur does not take advantage of the forward market and does not go for any forward contract for reaping profit. Rather the decision behind profit-making depends upon the expectation about the future spot rate, inasmuch as the interest-rate differential between two countries leads to changes in future spot rate.

If interest-rate differential is equal to changes in the future spot rate, uncovered interest parity will exist. This can be represented in the form of an equation: (1 + RA)(l + Ra)=(Se+1 - S)/S

Where Se+1 is the expected future spot rate, and RB are the interest rates in Country A and Country B.

So long as equality is not reached, the arbitrageurs will go for uncovered interest arbitrage and reap profits. Suppose the interest rate on the Indian Treasury bill is 7.0 per cent and that on the UK Treasury bill is 4.0 per cent and so the interest rate differential is 2.88 per cent. If the investor expects a depreciation of 4.0 per cent in the future spot rate of Indian rupee he/she will invest in the UK Treasury bill because a fixed amount of British pound will fetch greater amount of Indian rupee at a future date. This will go on till the two •differentials are equal .This is uncovered interest arbitrage.

Factors Influencing Spot Exchange Rates

1. International Trade: Trade of goods and services between countries is the major reason for the demand and supply of foreign currencies. The value or strength or weakness of a country's currency in terms of other currencies depends on its trade with those countries. If a country's imports are higher, the demand for foreign currency in this country will be high. Higher demand for foreign currency means high value of foreign currency and low value of the domestic currency. This is a typical case for under-developed countries which rely on imports for development needs. The current account balance (deficit or surplus) thus reflects the strength and weakness of the domestic currency.

2. Capital Movements: International investments in the form of Foreign Direct Investment (FDI) and Foreign Institutional Investments (FII) have become the most important factors affecting the exchange rate in today's open world economy. Countries which attract large capital inflows through foreign investments, will witness an appreciation in its domestic currency as its demand rises. Outflow of capital would mean a depreciation of domestic currency.

3. Positivity in Foreign Investors' Investments: When there is positivity in Foreign Investors' choice over the yield which is being offered to them, there will be a scramble to purchase the asset class and thereby there is the scope of huge arrival of foreign cash inflows. At this juncture, there will be a appreciation in domestic currency against foreign currency.

Example:

The Export-Import Bank of India (EXIM Bank) recently raised $1 billion, twice the amount it had originally targeted at decent rates. The total subscription offer even on the upped size was $2.5 billion. The bank's first issue in 2016, under 144 A and Reg.S of the US Securities Act, which allows restricted offering in the US and Unrestricted offering globally saw the 10 year maturity bonds getting a good response in the US. The bonds were issued at a coupon rate of 3.375 per cent which at the current level is around 187.5 basis points over the US treasuries. Whereas the yield on Denmark's 10 year bond is 0.36 per cent. Switzerland is negative -0.45 per cent and Germany's 10 year yield is -0.05

per cent. At this grim scenario, the Indian Exim Bank Bond was subscribed by the US investors almost 61% of the issue.

4. Change in Prices: Domestic inflation or deflation affects the exchange rate by affecting die demand and supply of domestic currency in the foreign exchange market. **For example,** if prices in India go up, making Indian goods costlier, the demand for Indian goods will go down. When exports go down, the demand for rupee will fall, causing depreciation in its exchange value.

5. Speculations: Uncertainties are always there in the financial market. Speculators predict about the future exchange rate based on various happenings in the world, in various countries. Speculators study the various ups and downs of a country and its resilience to international happenings and forecast the possible future exchange rate based on a particular country's economic strengths and weaknesses. If the speculators expect a fall in the value of a currency in the near future, they will sell that currency and start buying: are other currencies that they expect to appreciated. The selling of the former currency will thus increase its supply in the foreign exchange market and bring down its value. The other currency appreciates as its demand increases.

Strength of the Economy: If the economic fundamentals of a country are strong, the exchange rate of its domestic currency remains stable and strong. Fiscal balance, international current balance, international liabilities, foreign exchange reserves, resilience to international trade fluctuations, GDP, inflation rate all are indicators of a country's economic strength.

6. Government Policies: In countries where there is fixed or managed float, the Central Bank becomes an important player in the foreign exchange market. The bank influences the value of the currency by its market operations like buying and selling of bills and currencies. The bank rate also influences the exchange rate by influencing investments and thereby the demand and supply of the domestic currency.

7. Stock Exchange Operations: Stock exchange operations in foreign securities, debentures, stocks and shares, influence the demand and supply of related currencies, thus influencing their exchange rate.

8. Political Factors: Political scenario of the country ultimately decides the strength of the country. Stable efficient government at the centre will encourage positive development in the country, creating investor confidence and a good image in the international market. An economy with a strong, positive image will obviously have a strong domestic currency. This is the reason why speculations rise considerably during the parliament elections, with various predictions of the future government and its policies. In 1998, the Indian rupee depreciated against the dollar due to the American sanctions after India conducted the Pokharan nuclear test.

Value of a currency is thus not a simple result of its demand and supply, but a complex mix of multiple factors influencing the demand and supply. It is a tight rope walk for any country to maintain a strong, stable currency, with policies taking care of conflicting demands like inflation and export promotion welcoming foreign investments and avoiding an appreciation of the domestic currency, all at the same time.

9. Negative Interest Rates: Ten years ago, negative interest rates were a theoretical curiosity that economists would discuss almost as a parlour game. Two years ago, negative interest rates started

as an unconventional step that only a few countries considered. Today it has become the policy of some of the most powerful central banks such as European Central Banks and Bank of Japan. In June 2014, the European Central Banks started paying minus 0.1 per cent on deposits and lowered it further to minus 0.2 per cent in September 2014, while Denmark and Switzerland already had negative Interest rates on February 2015, Sweden joined the fray. Negative Interest rates will suck people's deposit money and arrest inflation. As a result of it, free supply will be controlled and Exchange rate of the currency will be strengthened by arresting frequent fluctuations in the Market.

10. Fall in Exports: It is from the reading of the nominal exchange rate, over January 2015 to March 2016, our country could experience a major fall in exports pact. Due to this impact, the rupee depreciated against the dollar 6.2 per cent whereas the Chinese Yuan fell by only 4.6 per cent.. The currencies of some other countries namely South Africa, Brazil, Russia, Malaysia, Turkey, Canada, the Eurozone depreciated by much more than Indian rupee against US dollar due to the major fall in Exports of these countries.

11. Positive Vibration in International Trade: Lower Trade deficit helped India narrow down the Current Account deficit (CAD) to $0.3 billion in the April- June quarter of 2016-17, significantly lower than $6.1 billion in the year-ago quarter during this time, Indian currency Exchange rate was appreciated by 2.1%. It is quite evident that current Account deficit(CAD) is on the decline whenever the exports data of the country is prevailing over imports data. Positive CAD is good for exchange rate but negative CAD is paving way for depreciation of the domestic currency.

12. Other Countries Currency Devaluation: Domestic countries currency is become weak and less competitive when there is devaluation of competitor countries' currency. There will be direct encouragement to the exporters of the country which is doing devaluation. It will impact adversely the importers who imported products by and large from the country doing devaluation of its currency. Chinese Government yuan devaluation is a clear illustration of how an importing country is suffering. At times US Dollar and Indian rupee had to take up a major plunge . US borrowed more at times of its financial crisis and India found to be a major importer of several products of china particularly electronic goods, toys and certain durable goods.

Example:

Rupee on the Back Foot due to fall in Exports and Selling spree:

Surprisingly the rupee had not benefited very much from the dollar weakness for the past two years since 2014, although other currencies have. This is largely due to foreign money outflow. It was largely due to the chunk of rupee sale by foreign portfolio investors. They sold $2.45 billion worth of Indian equities in early 2016 and correspondingly in debt segment, they sold $844.5million in the same period.

The selling-spree drove the rupee to 68.78 in February 2016, close to its all-time low of 68.85 in August 2013. The rupee was also dragged down by the continuous fall in India's exports since December 2014. In Feb.2016, exports fell 5.6% , in the past 15 months, exports have fallen 21.7?%

Below are the details of Indian Rupee Depreciation against other Currency between 2015 and 2016

Table 2.1

S.No.	Currency	Depreciation (%)
1	US Dollar	-0.85
2	Brazilian Real	-10.28`
3	Rouble	-7.92
4	Yen	-7.72
5	Ringit	-7.38
6	Singapore dollar	-4.49
7	Euro	-3.11
8	Rand	-2.46
9	Yuan	-0.90

Source: Business Line Research Bureau Report

Convertibility of Rupee

Current Account Convertibility

The current regime of the exchange rate has been accompanied by full 'Convertibility on current account with effect from August 20, 1994. Accordingly, several provisions like remittances for service, education, basic travel, gift remittances, donation, and provisions of the Exchange Earners' Foreign Currency Account (EEFCA) were relaxed.

In a further move, announced in 1997, the RBI liberalised the existing regulations in regard to payments for various kinds of feasibility studies, legal services, postal imports and purchases of designs and drawings. With this, India acquired a status called as the IMF Article VIII Status.

By attaining the Article VIII status, India has reached a position by which it can instil confidence among the international investor community, paving the way for further inflow of foreign capital. Further, India is also committed to allowing free outflow of current account payments (like interest) even if there is a serious foreign exchange crisis.

Notwithstanding the above, the government still retains many controls on current account.

Among these, the Following may be Specifically Mentioned

1. Repatriation of export proceeds within six months;
2. Caps on the amounts spent on the purchase of services abroad;
3. Restrictions on the repatriation of interest on rupee debt;
4. Dividend-balancing for FDI in some consumer goods industries;
5. Restrictions on the repatriation of interest on NRI deposits;
6. The rupee is not allowed to be officially used as international means of payment. Indian banks are not permitted to offer two- way quotes to NRIs or-non-resident banks.

With the help of these controls, the governments can significantly alter the flow of foreign exchange and the exchange rate of rupee. Additionally, the RBI can influence the exchange rate through direct purchase and sale of foreign exchange in the market.

Convertibility of Rupee

Convertibility on Capital Account

Drawing on the experience of the past decade and a half, the extent and timing of capital account liberalisation is sequenced with other reforms like strengthening of banking systems, fiscal consolidation, market development and integration, trade liberalization, etc. all of which are in tune with the changing domestic and external economic environment.

A hierarchy is thus established in the sources and types of capital flows. The priority has been to liberalize inflows relative to outflows, but all outflows associated with inflows have been totally freed. Among the type of inflows, FDI is preferred for its stability, while short-term external debt is avoided. A differentiation is made between Corporates, individuals and banks.

For outflows, the hierarchy for liberalization has corporate at the top, followed by financial intermediaries and individuals. Restrictions have been eased for corporate Seeking investments and acquisitions abroad, which strengthen their global presence. Banks and financial intermediaries are considered a source of greater volatility as their assets are relatively illiquid and their liabilities are demandable.

They are thus susceptible to self-fulfilling crisis of confidence leading to contagion effect. In view of this, liberalization for outflows in this sector has been tied to financial sector reforms. For individuals, residents are treated differently from nonresidents, and non-resident Indians are accorded a well-defined intermediate status between residents and non-residents.

Intervention by RBI

The current exchange rate regime, introduced in 1993, the RBI has been, actively intervening in the foreign exchange market with the objective of maintaining the real effective exchange rate (REER) stable.

The RBI uses two types of intervention in this regard:

1. **Direct Intervention:** It refers to purchases and sales in international currency (i.e. US dollars and euro) both on the spot and also in forward markets.
2. **Indirect Intervention:** It refers to the use of reserve requirements and interest rate flexibility to smoothen temporary mismatches between demand and supply of foreign currency.

Intervention by the RBI has raised a question as to whether or not there should be an exchange rate band within, which the central bank should allow the currency to fluctuate. The Tarapore Committee in its report on Capital Account Convertibility had, while suggesting transparency in the exchange rate policy of the central bank, recommended a band within which it would allow the currency to move.

The RBI has been, in contrast, saying that there cannot be such rigidities in exchange rate policy, and, therefore, the bank should have the right to intervene at its discretion. Such interventions are considered necessary till the rupee is made fully convertible

PRACTICAL CASE STUDIES

Case Study on Yuan Devaluation

Last August 2015, financial markets went through a period of extreme turbulence when China decided to peg the value of the Yuan lower against the dollar. There were fears that China was trying to boost its exports by devaluing its currency. The Chinese authorities had then assuaged markets by stating that the intent was to make the Yuan market linked and not to cause a serious decline in the value of the Chinese currency. Eleven months later, the skeptics have been proved that right; the Yuan has depreciated 7 per cent since August 10, 2015. But the Chinese government needs to be lauded for the skilful manner in which it managed this depreciation without ruffling too many feathers. In the initial phase following the market linked of the yuan, when the Chinese currency was closely watched, it appreciated against the dollar from 6.45% to 6.3% by the end of October 2015. But the currency has been consistently sliding since last October 2015 and is down 5.8% since then. It is probable that the Chines government had hoped that it would be able to support the yuan with its large war chest foreign Exchange reserves.

But intervention in the currency market has eroded reserves significantly. Devaluation has helped chine in two ways. One it was able to make the yuan a part of the IMF's SDR basket and two, Chinese exports became more competitive. Reports indicate China's share in global exports increased to 13.8% in 2015 from 12.3% in 2014. This is the highest share any country has enjoyed in the last four decades.

Case Study on BREXIT Issue

An historic vote for Britain to exit the European Union caused significant damage to the European Political and Financial system. It had impacted the world's financial markets including in India.The Brexit Vote blindsided most market analysts and pollsters. Stock Markets of most of the countries were gone in to tailspin. Currency Markets were also in turmoil with Pound Sterling collapsing to a 30 year low against the US dollar. India was not immune to the shock, the Sensex tanked by over 1000 points in early trade and the rupee touched a low of 68.22 against the dollar. They subsequently recovered with the Sensex closing 604 points down and the rupee closed at 67.96.

Most regulators however think that it will be better for the UK and the Global economy if the country continues to remain in EU. The Bank of England (BOE) warned that the outcome of the referendum continues to be the largest immediate risk facing UK financial markets, possible global financial markets. Other Central Bankers, including the Federal Reserve and Bank of Japan concur with the Bank of England.

So what could be the implications of a Brexit on the Indian Currency, Equity and Bond Markets? There is consensus that if Brexit happens, it will take a toll on the British Pound. The UK Treasury, in a dire warning against Britain's exit from the EU has outlined the scenarios that can unfold if the event takes place. The report says that in shock scenario after the Brexit, inflation will spike, Unemployment

will rise, GDP growth will be 3.6 Per cent lower after two years and the Pound can fall around 12 per cent. In the event of severe shock, GDP is expected to be 6 per cent lower and the Pound is expected to lose 15 per cent.

A crash in Pound value will directly result in a sharp appreciation of the rupee against the Pound. The rupee has been strengthening against the Pound since late-August 2015 appreciating from 105 to 96;gaining over 8 per cent. A vote in favour of an exit can take the GBP-INR exchange rate to 90.9; the low recorded in April 2015. While the rupee can appreciate against the pound, the dollar-rupee exchange rate will however be under pressure. This is because the dollar-pound exchange rate has 11.9 per cent weight in the dollar index. If the pound appreciates more than 10 per cent in the turbulence following Brexit, dollar index will gain. Dollar will also move higher due to its safe haven status.

This will result in weakening of the rupee against the dollar. A re test of the 68.89 level against the dollar cannot be ruled out if there is global risk-off trade.

Impact of BREXIT on Indian Farm Exports

The churn would add to Indian exporters' compliance costs as they will have to adhere to two different standards. For Instance, the European Union is the largest importer of India's seafood. So with Brexit, marine exporters will suffer as they would have to adhere to separate sets of safety norms will cost them more. Indian spices, tea, mango, grape and basmati rice are being exported to the UK in large amounts, while there is a separate set of EU regulations governing import of chilli and its products from India. Realisation from tea exports could take a hit as the European Union imports 42 million kilogram of tea, of which 20 million kilogram is shipped to the UK. The possible meltdown of the Pound Sterling will hit Indian farm exports to the UK.

1. What is the root causes of Brexit Issue?
2. What is its Impact on UK Pound sterling and Indian Rupee?
3. What is its Impact on Indian Farm Exports?

Case Study on Currency Appreciation

How was US Dollar able to Gain Appreciation in its Exchange Rate?

Situation:

Gold Prices ended at $1322.7 per ounce, down by 1 per cent last week. Silver and plantation too ended in the red, with the former recording a drop of close to 3 per cent and latter down by 0.9 per cent. The drop in price of precious metals could be attributed to the rally in US dollar. The US dollar index moved to 97.46, up from the previous week's 96.58. The dollar rally was buttressed by a set of strong US data and renewed expectations of rate hike from the Federal reserve before the end of the year. Also with surveys, indicating a slowdown in the UK due to BREXIT,the dollar gained further strength at the cost of sterling. The US manufacturing PMI hit a nine-month high in July. The flash manufacturing PMI hit a nine month high in July. The flash manufacturing PMI rose to 52.9 in July data up from the previous month's reading of 51.3. Analysts had expected the Index to rise to just 51.6.

The existing home sales data in the month of July showed that home sales increased over 1 per cent in June to 5.57 million units, the highest level since February 2007, June 2016 was also the fourth

straight month of increase in the sale of homes. However, the confidence of investors in the yellow metal did not seem to have changed much. In addition to home sales increase, there is the 50% possibility of a rise in Fed Rate hike in March 2017. It is the first time since 2007, US GDP data was increased at around 2.6 per cent in the second quarter of 2016 which was the significant increase from the first quarter's growth of 1.1 per cent

SUMMARY

Features of the Current Exchange Rate Regime

The principal features of the current exchange rate regime in India can be briefly stated as follows:

1. The rates of exchange are determined in the market.
2. The freely floating exchange rate regime continues to operate within the framework of exchange control.
3. Current receipts are surrendered (or deposited) to the banking system, which in turn, meets the demand for foreign exchange.
4. RBI can intervene in the market to modulate the volatility and sharp depreciation of the rupee. It effects transactions at a rate of exchange, which could change within a margin of 5 per cent of the prevailing market rate.
5. The US dollar is the principal currency for the RBI transactions.
6. The RBI also announces a Reference Rate based on the quotations of select banks on Bombay at twelve noon every day. The Reference Rate is applicable to SDR transactions and transactions routed through the Asia Clearing Union.

In short, the India rupee has matured to a regime of the floating exchange rate from the earlier versions of a 'managed float'. Objectives of Exchange Rate Management are

1. Reduce volatility in exchange rates, ensuring that the market correction of exchange rates is effected in an orderly and calibrated manner;
2. Help maintain an adequate level of foreign exchange reserves;
3. Prevent the emergence of destabilisation by speculative activities; and
4. Help eliminate market constraints so as to assist the development of a healthy foreign exchange market.

Mint Parity Theory: When the currencies of two countries are on a metallic standard (gold or silver), the rate of exchange between them is determined on the basis of party of mint ratios between the currencies of the two countries; Interest Rate Parity theory: this theory assumes that if two currencies have different rates, this difference will lead to a discount or premium for the exchange rate in order to avoid arbitrage opportunities. Balance of Payments Theory: According to the Balance of Payments Theory, also known as the Demand and Supply Theory of exchange rate, the foreign exchange rate, under free market conditions, is determined by the demand and supply conditions in the foreign exchange market. Monetary Theory: The monetary theory assumes that PPP holds good, i.e., an increase in the price level results in the depreciation of a country's currency and vice versa. Using

this assumption, this theory arrives at a few results that are opposite to that given by the demand-supply approach. With an increase in the real GNP (the real product) of a country, the real product increases, so do the transactions and the demand for money need to be held for making purchases` Hence, an increase in the real GNP results in an increase in the real money demand. Portfolio Balance Theory: The portfolio balance theory (McKinnon, 1969) suggests that not only the monetary factor but also the holding of financial assets, such as domestic and foreign bonds influences the exchange rate.

This theory suggests that exchange rate is determined by the interaction of real income, interest rates, risk, price level, and wealth. If a change takes place in these variables, the investor re-establishes a desired balance in its portfolio.

REVIEW QUESTIONS

1. Explain in detail the Exchange Rate System in India.
2. Give your comment on Current Exchange Rate Regime.
3. What are the different types of Exchange rates? Explain.
4. Discuss all theories of Exchange Rates.
5. Explain in detail the factors influencing spot Exchange Rates.
6. Short note on
   (i) Current Account Convertibility
   (ii) Capital Account Convertibility

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FOREIGN EXCHANGE MANAGEMENT

Chapter Outline

- History of Exchange Control in India
- Foreign Exchange Management Act 1999
- Foreign Direct Investments in India
- Foreign Trade and Foreign Exchange
- Management of Foreign Exchange
- Functions of Foreign Exchange Department
- Foreign Currency Accounts
- Exchange Rate System under IMF
- Convertibility of Rupee
- Summary
- Review Questions

HISTORY OF EXCHANGE CONTROL IN INDIA

Exchange control was introduced in India on September 3, 1939 on the outbreak of the Second World War by virtue of the emergency powers derived under the financial provisions of the Defence of India Rules, mainly to conserve the non-sterling area currencies and utilise them for essential purposes. In the closing stages of the War, it became clear that control over foreign exchange transactions would have to continue in some form or the other in the post-war period in the interest of making the most prudent use of the foreign exchange resources. It was, therefore, decided to place the control on a statutory basis and the Foreign Exchange Regulation Act of 1947 was enacted.

It was found necessary to continue exchange control introduced during the Second World War on a systematic and long-term basis, in view of the substantial requirements of foreign exchange for the planned developmental efforts undertaken. Over the years, the scope of exchange control in India steadily widened and the regulations became progressively more elaborate with the increasing foreign exchange outlays under successive Five-Year Plans and the relatively inadequate earnings of foreign exchange. Periodically, appraisals and reviews of policies and procedures were undertaken and such modifications made as were warranted by changes in the national policies and priorities, and fluctuations in the level of foreign exchange reserves caused by both national and international economic and other developments. Under these circumstances, the Foreign Exchange Regulation Act, 1973 was passed to replace the Act of 1947. The purpose of the enactment was to consolidate and amend the law regulating certain payments, dealings in foreign exchange and securities, transactions indirectly affecting foreign exchange and the import and export of currency and bullion, for the conservation of the foreign exchange resources of the country and the proper utilisation thereof in the interest of the economic development of the country.

The Foreign Exchange Regulation Act, 1973 (FERA) was reviewed in 1993 and several amendments were enacted as part of the on-going process ot economic liberalisation relating to foreign investments and foreign trade for closer interaction with the world economy. At that stage, the Central Government decided that a further review of the Foreign Exchange Regulation Act would be undertaken in the light of subsequent developments and experience in relation to foreign trade and investment. It was subsequently felt that a better course would be to repeal the existing Foreign Exchange Regulation Act and enact a new legislation. Reserve Bank of India was accordingly asked to undertake a fresh exercise and suggest a new legislation. A Task Force constituted for this purpose submitted its report in 1994 recommending substantial changes in the existing Act.

Significant developments took place after 1993 such as substantial increase in our foreign exchange reserves, growth in foreign trade, rationalisation of tariffs, current account convertibility, liberalisation of Indian investments abroad, increased access to external commercial borrowings by Indian corporates and participation of foreign institutional investors in our stock markets. This needed a change in the outlook of the statute governing the foreign exchange transactions from one of control and conservation to that of encouragement and promotion. The Foreign Exchange Management Act, 1999 was introduced to provide the necessary change.

As per Article 246 of the Constitution of India, the parliament has exclusive power to make laws with respect to any of the matters enumerated in the Union List in the Seventh Schedule. The Foreign

Exchange Management Act, 1999 can be traced to various entries in the Union List. Entry 16 of the Union List deals with foreign jurisdiction. Entry 36 of the Union List deals with Currency, coinage and legal tender;

Foreign exchange. Entry 37 of the Union List deals with foreign loans and Entry 41 of the Union List deals with Trade and commerce with foreign countries; import and export across customs frontiers; definition of customs frontiers.

When a business enterprise imports goods from other countries, exports its products to them or makes investments abroad, it deals in foreign exchange. Foreign exchange means 'foreign currency' and includes deposits, credits and balances payable in any foreign currency; drafts, travellers' cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency; and drafts, traveller's cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency.

The management of foreign exchange is very important in the present day business. This lesson deals with how FEMA facilitates external trade and payments and promotes the orderly development and maintenance of foreign exchange market. The Act has assigned an important role to the Reserve Bank of India (RBI) in the administration of FEMA. The rules, regulations and norms pertaining to several sections of the Act are laid down by the Reserve Bank of India, in consultation with the Central Government.

Introduction

The Foreign Exchange Regulation Act, 1973, which was enacted to consolidate and amend the law in several respects encompassing the experience gained over few decades of implementation of the earlier enactment of 1947, outlived its purpose in the light of the liberalization policies introduced in 1991.

The Foreign Exchange Regulation Act, since then had been reviewed and amendments were made as part of the ongoing process of economic liberalization relating to foreign investment and foreign trade for closer interaction with the world economy. Subsequently, the Central Government decided further review of the Foreign Exchange Regulation Act in the light of developments and experience in relation to foreign trade and investment. It was at that time felt, that a better course would be to repeal the Foreign Exchange Regulation Act and enact a new legislation.

Taking into consideration the developments such as substantial increase in foreign exchanges reserves, growth in foreign trade, rationalization of tariffs, current account convertibility etc., the Foreign Exchange Management Bill, to repeal and replace the Foreign Exchange Regulation Act was introduced in the Lok Sabha. But before the Bill came up for discussion and approval, the Lok Sabha was dissolved. Subsequently, certain modifications were made to the original Bill and a modified Bill was presented and passed by both the Houses of Parliament. The Foreign Exchange Management Act received the assent of the President on 9th December, 1999 and brought into force with effect from 1.6.2000.

Definitions

Section 2 of the Foreign Exchange Management Act defines various terms used in the Act, as given below:

Adjudicating Authority [Section 2(a)]

According to clause (a) of Section 2 'Adjudicating Authority' means an officer authorised under Sub-section (1) of Section 16 for the purposes of adjudication in respect of penalties under Section 13. Section 16 empowers the Central Government, to appoint, by an order published in the Official Gazette, as many officers as it may think fit as the adjudicating authorities for holding an enquiry in the manner prescribed after giving the person alleged to have committed any contravention, an opportunity of being heard.

Appellate Tribunal [Section 2(b)]

'Appellate Tribunal' means Appellate Tribunal for Foreign Exchange to hear appeals against the orders of the adjudicating authorities and Special Directors (Appeals) under the Act.

Authorised Person [Section 2(c)]

The term authorised person is defined to include an authorised dealer, money changer, offshore banking unit or any other person for the time being authorised to deal in foreign exchange or foreign securities.

Capital Account Transaction [Section 2(e)]

'Capital account transaction' has been defined to mean any transaction which alters the assets or liabilities including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of person resident outside India and includes the transactions specified in Sub-section (3) of Section 6 of the Act.

Currency Notes [Section 2(i)]

'Currency Notes' means and includes cash in the form of coins and bank notes. In fact, it means money and such bank notes or other paper money as are authorised by law and circulate from hand to hand as a medium of exchange.

Current Account Transaction [Section 2(j)]

The term current account transaction has been defined to mean a transaction other than a capital account transaction and includes payments due in connection with foreign trade, other current business, services and short term banking and credit facilities in the ordinary course of business; payments due as interest on loan and as net income from investments; remittances for living expenses of parents, spouse and children residing abroad and expenses in connection with foreign travel, education and medical care of parents, spouse and children.

Under the Act freedom has been granted for selling and drawing of foreign exchange to or from an authorized person for undertaking current account transactions. However, the Central Government

has been vested with powers in consultation with Reserve Bank to impose reasonable restrictions on current account transactions. The Central Government has framed Foreign Exchange Management (Current Account Transactions) Rules, 2000 dealing with various aspects of current account transactions.

Foreign Exchange [Section 2(n)]

The term 'foreign exchange has been defined to mean foreign currency and includes deposits, credits, balance payable in foreign currency, drafts, traveller's cheques, letters of credit, bills of exchange expressed or drawn in Indian currency but payable in any foreign currency. Any draft, traveller's cheque, letters of credit or bills of exchange drawn by banks, institutions or persons outside India but payable in Indian currency has also been included in the definition of foreign exchange.

Foreign Security [Section 2(o)]

The term Foreign Security has been defined to mean any security, in the form of shares, stocks, bonds, debentures or any other instrument denominated or expressed in foreign currency and includes securities expressed in foreign currency but where redemption or any form of return such as interest or dividend is payable in Indiacurrency.

Transfer or issue of a foreign security is a capital account transaction within the meaning of Section 6(3)(a) of the Act. The Reserve Bank of India has made Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2000 for regulation, acquisition and transfer of a foreign security by a person resident in India i.e. investment by Indian entities in overseas joint ventures and wholly owned subsidiaries as also investment by a person resident in India in shares and securities issued outside India.

Person [Section 2(u)

The definition of the term 'person includes, an individual, a Hindu Undivided Family, a company, a firm, an association of persons or body of individuals whether incorporated or not; any agency, office or branch owned or controlled by such persons. Even every artificial juridical person not falling within the above definition has been treated as person as per clause (u) of Section 2.

Person Resident in India [Section 2(v)]

The expression 'Person resident in India' has been defined to mean a person residing in India for more than 182 days during the course of the preceding financial year. However, two categories of persons are excluded from the purview of definition.

The first category includes any person who has gone out of India or who stays outside India for or on taking up employment outside India, or for carrying on outside India a business or vocation. The definition also includes person who stays outside India for any other purpose in such circumstances as would indicate his intention to stay outside India for an uncertain period. The second category of persons which have been excluded from the definition of person resident in India include:

A person who has come to stay or stays in India, in either case otherwise than—

(i) for or taking up employment in India; or

(ii) for carrying on in India a business or vocation in India; or

(iii) for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period.

Regulation and Management of Foreign Exchange as per FEMA Act

Chapter II of the Act containing Sections 3-9 deals with Regulation and Management of Foreign Exchange. Section 3 prohibits any person other than an authorised person from dealing in or transferring any foreign exchange or foreign security to any person or making any payment to or for the credit of any person resident outside India in any manner or receiving otherwise through an authorised person any payment by order or on behalf of any person resident outside India in any manner except as provided in the Act, rules or regulations made there under or with the general or special permission of the Reserve Bank of India.

Section 3(d) prohibits a person to enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person, except as otherwise provided in the Act and rules or regulations made thereunder. For this purpose, financial transaction has been defined to mean making any payment to or for the credit of any person or receiving any payment for, by order or on behalf of any person. Financial transaction also includes drawing, issuing or negotiating any bill of exchange or promissory note or transferring any security or acknowledging any debt.

Current Account Transactions

Section 5 of the Act allows any Chapter II of the Act containing Sections 3-9 deals with Regulation and Management of Foreign Exchange. Section 3 prohibits any person other than an authorized person from dealing in or transferring any foreign exchange or foreign security to any person or making any payment to or for the credit of any person resident outside India in any manner or receiving otherwise through an authorized person any payment by order or on behalf of any person resident outside India in any manner except as provided in the Act, rules or regulations made there under or with the general or special permission of the Reserve Bank of India.

Person to sell or draw foreign exchange to or from an authorized person if such sale or withdrawal is a current account transaction as defined under Section 2(j) of the Act. However, the Central Government may, in the public interest and in consultation with the Reserve Bank impose reasonable restrictions for current account transactions. Foreign Exchange Management (Current Account Transactions) Rules, 2000 defines the term ‘Withdrawal as to mean withdrawal of foreign exchange from an authorized person and includes opening of Letter of Credit or use of International Credit Card or International Debit Card or ATM Card or any other thing by whatever name called which has the effect of creating foreign exchange liability.

Current Account Deficit Shrinks to $300 Million in April June Quarter of 2016

Reserve Bank of India said the contraction in the CAD was primarily on account of a lower trade deficit($23.8 billion) than in April-June Q1)period of 2016 but in the corresponding previous year, the

trade deficit was $34.2 billion. This trend was due to the fall in merchandise imports by 11.5 per cent vis-à-vis merchandise exports was declined by 2.1 per cent. This positive trend was leading to a lower trade deficit in April-June quarter of 2016. On the other hand, portfolio investment recorded a net inflow of $2.1 billion in Q1of 2016-17 as against a marginal outflow of 1.5billion in the preceding

Prohibition on Withdrawal of Foreign Exchange for Certain Transactions

Rule 3 prohibits the withdrawal of foreign exchange for the purposes of transactions specified in the Schedule I or a travel to Nepal and/or Bhutan or a transaction with a person resident in Nepal or Bhutan. However, in the case of transaction with a person resident in Nepal and Bhutan, the prohibition may be exempted by RBI subject to such terms and conditions as it may consider necessary. Schedule I to the Rules enumerate the situations in which the withdrawal of foreign exchange is prohibited. These are as follows:

(a) Remittance out of lottery winnings;

(b) Remittance of income from racing/riding etc. or any other hobby;

(c) Remittance for purchase of lottery tickets, banned/prescribed magazine, football pools, sweep stakes etc.

(d) Payment of commission on exports made towards equity investment in joint ventures/wholly owned subsidiaries abroad of Indian Companies.

(e) Payment of Commission on exports under Rupee State Credit Route, except commission upto 10% of invoice value of exports of tea and tobacco.

(f) Payment related to ‘call back service’ of telephone.

(g) Remittance of interest income on funds held in Non-resident Special Rupee Scheme Account.

Prior approval of Government of India for certain transactions

Rule 4 requires prior approval of the Government of India for the transactions as specified in Schedule II. However, this does not apply to the cases where the payment is made out of funds held in Resident Foreign Currency Account (RFC) of the remitter.

Illustration

Mr. Y, a person resident in India, desires to take a life insurance policy from a foreign insurance company, the yearly premium of which is US$ 25, 000.

“Mr. Y , a person resident in India, can take a life insurance policy from a foreign insurance company with a yearly premium of US$25,000(vide-A.P.(dir series) circular no. 76, dated 24/02/2004 issued by RBI). Earlier, as per Rule 4 read with Schedule II to the Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000, payment for securing insurance for health from a company abroad required prior permission of Central Government”.

Prior approval of RBI for certain transactions

Rule 5 requires prior approval of the Reserve Bank in the following cases:

1. Release of exchange exceeding US$ 10,000 or its equivalent in one calendar year, for one or more private visits to any country (except Nepal and Bhutan).
2. Gift remittances exceeding US$ 5,000 per remitter/donor per annum.
3. Donation exceeding US$ 5,000 per remitter/donor per annum.
4. Exchange facilities exceeding US$ 1, 00,000 for persons going abroad for employment.
5. Exchange facilities exceeding US$ 1, 00,000 for emigration or exceeding the amount prescribed by country of emigration.
6. Remittance for maintenance of close relatives abroad—
   (i) exceeding net salary (after deduction of taxes, contribution to provident fund and other deductions) of a person who is resident but not permanently resident in India and:
      (a) is a citizen of a foreign state other than Pakistan;
      (b) is a citizen of India, who is on deputation to the office or branch or subsidiary or a joint venture in India of such foreign company.
   (ii) exceeding US$ 100,000 per year per recipient, in all other cases.

   It has been explained that the item, "a person resident in India on account of his employment or deputation of a specified duration (irrespective of length thereof) or a specific job or assignment the duration of which does not exceed three years, is a resident but not permanently resident."
7. Release of foreign exchange, exceeding US$ 25,000 to a person, irrespective of period of stay, for business travel, or attending a conference or specialised training or maintenance expenses of a patient going abroad for medical treatment or check-up abroad, or for accompanying as attendant to a patient going abroad for medical treatment/check-up.
8. Release of foreign exchange for meeting expenses for medical treatment exceeding US$ 100,000 or its equivalent.
9. Release of exchange for studies abroad exceeding the estimates from the institution abroad or US$ 1,00,000 per academic year whichever is higher.
10. Commission per transaction to agents abroad for sale of residential flats/commercial plots in India exceeding the limits of US$ 25,000 or 5 per cent of the inward remittance, per transaction, whichever is higher.
11. Remittances exceeding US$ 1 million per project for any consultancy services procured from abroad.
13. Remittance exceeding US$ 1,00,000 by an entity in India by way of reimbursement of pre-incorporation expenses.

However, this Rule shall not apply where the payment is made out of funds held in Resident Foreign Currency (RFC) Account of the remitter.

Rule 7 provides that in case of use of International Credit Card for making payment by a person towards meeting expenses while such person is on visit outside India the prior approval of Reserve Bank shall not be required for transactions included in Schedule III.

Vide a circular dated 14th June, 2005, it has been clarified that International Debit Cards can also be used by a resident for drawing cash or making payment to a merchant establishment overseas during his visit abroad for permissible current account transactions and item wise limits as mentioned in the schedules shall be applicable to payment made through use of these cards.

How much foreign exchange is available to a person going abroad on emigration?

A person going abroad on emigration can draw foreign exchange from AD Category I bank and AD Category II up to the amount prescribed by the country of emigration or USD 100,000. He can draw foreign exchange up to USD 100,000 on self- declaration basis from an Authorised Dealer in India This amount is only to meet the incidental expenses in the country of emigration. No amount of foreign exchange can be remitted outside India to become eligible or for earning points or credits for immigration. All such remittances require prior permission of the Reserve Bank. If requirement exceeds USD 100,000, the person requires to obtain the prior approval from the Reserve Bank.

Capital Account Transaction

Section 6 allows capital account transactions subject however to certain conditions. This section empowers the Reserve Bank of India to specify, in consultation with the Central Government, any class or classes of capital account transactions permissible and the limit upto which foreign exchange shall be admissible for such transactions. However, Reserve Bank shall not impose any restrictions on the withdrawal of foreign exchange for payments due on account of amortization of loans or for depreciation of direct investments in the ordinary course of business.

The Reserve Bank of India may, by regulations, prohibit, restrict or regulate the transfer or issue of any foreign security by a person resident in India or by a person resident outside India. Reserve Bank of India may also regulate, prohibit or restrict transfer or issue of any security or foreign security through any branch office, or agency in India of a person resident outside India. Any borrowing or lending in foreign exchange in whatever form or by whatever name called may also be regulated or prohibited by the Reserve Bank. Similarly, RBI may also prohibit or restrict any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India. Deposits between persons resident in India and persons resident outside India may be regulated or prohibited by the Reserve Bank of India. RBI may also regulate the export, import or holding of currency or currency notes. Acquisition or transfer of immovable property other than on lease not exceeding five years in India by person resident in India or a person resident outside India may be prohibited or regulated by the Reserve Bank of India. RBI has also been empowered to prohibit or regulate giving of guarantee or surety in respect of any debt, obligation or other liability incurred by a person resident in India and owed to a person resident outside India or by a person resident outside India. Sub-section (4) allows a person resident in India to hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India, if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India. Similarly, a person resident

outside India is permitted to hold, own, transfer or invest in Indian currency, security, or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.

Reserve Bank of India under Sub-section (6) has been empowered to regulate, prohibit, restrict establishment in India of a branch, office or other place of business by a person resident outside India for carrying on any activity relating to such branch, office or other place of business.

Permissible Capital Account Transactions

Schedule I & II to Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000 classifies the capital account transactions of a person under the following two heads viz.

1. Classes of capital account transactions of persons resident in India.
2. Classes of capital account transactions of persons resident outside India.

Classes of Capital Account Transactions of Persons Resident in India

1. investment by a person resident in India in foreign securities.
2. foreign currency loans raised in India and abroad by a person resident in India;
3. transfer of immovable property outside India by a person resident in India;
4. guarantees issued by a person resident in India in favour of a person resident outside India;
5. export, import and holding of currency/currency notes;
6. loans and overdrafts by a person resident in India from a person resident outside India.
7. taking out of insurance policy by a person resident in India from an insurance company outside India;
8. loans and overdrafts by a person resident in India to a person resident outside India;
9. remittance outside India of capital assets of a person resident in India;
10. sale and purchase of foreign exchange derivatives in India and abroad and commodity derivatives abroad by a person resident in India. However, Notification No. FEMA.165 /2007-RB Dated October 10, 2007 on Foreign Exchange Management (Permissible Capital Account Transactions) (Amendment) Regulations, 2007 provides that subject to the provisions of the Act or the rules or regulations or directions or orders made or issued there under, a resident individual may, draw from an authorized person foreign exchange not exceeding USD 50,000 per financial year with effect from December 20, 2006, USD 100,000 per financial year with effect from May 8, 2007 and USD 2,00,000 per financial year with effect from September 26, 2007, for a capital account transaction specified in Schedule I.

It may be noted that no part of the foreign exchange of USD 50,000 or USD 100,000 or USD 200,000, as the case may be, drawn can be used for remittance directly or indirectly to countries

notified as non-co-operative countries and territories by Financial Action Task Force (FATF) from time to time and communicated by the Reserve Bank of India to all concerned."

Classes of Capital Account Transactions of Persons Resident outside India

1. Investment in India by a person resident outside India, that is to say:
   (a) Issue of security by a body corporate or an entity in India and investment therein by a person resident outside India; and
   (b) Investment by way of contribution by a person resident outside India to the capital of a firm or a proprietorship concern or an association of persons in India.
2. Acquisition and transfer of immovable property in India by a person resident outside India.
3. Guarantee by a person resident outside India in favour of, or on behalf of a person resident in India.
4. Import and export of currency/currency notes into/from India by a person resident outside India.
5. Deposits between a person resident in India and a person resident outside India.
6. Foreign Currency accounts in India of a person resident outside India.
7. Remittance outside India of capital assets in India of a person resident outside India.

Subject to the provisions of the Act, or the rules, or regulations or directions or orders made or issued there under, any person may sell or draw foreign exchange to or from an authorised person for the above mentioned capital account transactions provided the transactions are within the limit, if any, specified in the Regulations relevant to the transaction. However, no person is allowed to undertake or sell or draw foreign exchange to or from an authorised person for any capital account transaction except as provided in the Act, Rules or regulations made there under. Similarly, except as otherwise provided in the Act, no person resident outside India is entitled to make investment in India, in any form, in any company or partnership firm or proprietary concern or any entity whether incorporated or not, which is engaged or proposed to engage in the business of chit funds, or Nidhi company, or in agricultural or plantation activities, or real estate business, or construction of farm houses, or trading in Transferable Development Rights (TDRs). For this purpose real estate business includes development of townships, construction of residential/commercial premises, roads or bridges.

The payment for investment are required to be made by remittance from abroad through normal banking channels or by debit to an account of the investor maintained with an authorised person in India in accordance with the regulation made by the Reserve Bank of India. Every person selling or drawing foreign exchange to or from an authorised person for a capital account transaction is required to furnish to Reserve Bank a declaration within the time specified in the regulations relevant to the transactions.

FOREIGN DIRECT INVESTMENTS IN INDIA

Introduction

Foreign Direct Investment (FDI) is a category of cross border investment made by a resident in one economy (the direct investor) with the objective of establishing a 'lasting interest' in an enterprise (the direct investment enterprise) i.e. resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long term relationship with the direct investment enterprise to ensure the significant degree of influence by the direct investor in the management of the direct investment enterprise. The objectives of direct investment are different from those of portfolio investment whereby investors do not generally expect to influence the management of the enterprise.

Foreign Direct Investment (FDI) in India is undertaken in accordance with the FDI Policy which is formulated and announced by the Government of India. The Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India issues a "Consolidated FDI Policy" on an yearly basis on March 31 of each year (since 2010) elaborating the policy and the process in respect of FDI in India. The latest Consolidated FDI Policy governed by the provisions of the Foreign Exchange Management Act (FEMA), 1999. FEMA Regulations which prescribe amongst other things the mode of investments i.e. issue or acquisition of shares/convertible debentures and preference shares, manner of receipt of funds, pricing guidelines and reporting of the investments to the Reserve Bank

Definitions of FDI Policy

'AD Category-I Bank' means a bank (Scheduled Commercial, State or Urban Cooperative) which are authorized under Section 10(1) of FEMA to undertake all current and capital account transactions according to the directions issued by the RBI from time to time.

'Authorized Bank' means a bank including a co-operative bank (other than an authorized dealer) authorized by the Reserve Bank to maintain an account of a person resident outside India 'Authorized Dealer' means a person authorized as an authorized dealer under subsection (1) of section 10 of FEMA. 'Authorized Person' means an authorized dealer, money changer, offshore banking unit or any other person for the time being authorized under Sub-section (a) of Section 10 of FEMA to deal in foreign exchange or foreign securities.

'Capital' means equity shares; fully, compulsorily & mandatorily convertible preference shares; fully, compulsorily & mandatorily convertible debentures.

Note: Any other type of instruments like warrants, partly paid shares etc. are not considered as capital and cannot be issued to person resident outside India.

'Capital account transaction' means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in sub-section (3) of section 6 of FEMA.

A company is considered as "Controlled" by resident Indian citizens if the resident Indian citizens and Indian companies, which are owned and controlled by resident, Indian citizens, have the power to appoint a majority of its directors in that company.

An entity is considered as 'Controlled' by 'non resident entities', if non-residents have the power to appoint a majority of its directors.

'Depository Receipt' (DR) means a negotiable security issued outside India by a Depository bank, on behalf of an Indian company, which represent the local Rupee denominated equity shares of the company held as deposit by a Custodian bank in India. DRs are traded on Stock Exchanges in the US, Singapore, Luxembourg, etc. DRs listed and traded in the US markets are known as American Depository Receipts (ADRs) and those listed and traded anywhere/elsewhere are known as Global Depository Receipts (GDRs).

'Erstwhile Overseas Corporate Body' (OCB) means a company, partnership firm, society and other corporate body owned directly or indirectly to the extent of at least sixty per cent by non-resident Indian and includes overseas trust in which not less than sixty per cent beneficial interest is held by non-resident Indian directly or indirectly but irrevocably and which was in existence on the date of commencement of the Foreign Exchange Management (Withdrawal of General Permission to Overseas Corporate Bodies (OCBs)) Regulations, 2003 (the Regulations) and immediately prior to such commencement was eligible to undertake transactions pursuant to the general permission granted under the Regulations.

'Foreign Currency Convertible Bonds' (FCCB) means a bond issued by an Indian company expressed in foreign currency, the principal and interest of which is payable in foreign currency. FCCBs are issued in accordance with the Foreign Currency Convertible Bonds and ordinary shares (through depository receipt mechanism) Scheme 1993 and subscribed by a non-resident entity in foreign currency and convertible into ordinary shares of the issuing company in any manner, either in whole, or in part.

Administrative Set-Up

The Central Government has been empowered under Section 46 of the Foreign Exchange Management Act to make rules to carry out the provisions of the Act. Similarly, Section 47 empowers the Reserve Bank to make regulations to carry out the provisions of the Act and the rules made there under. Further, Section 41 provides that the Central Government may, from time to time, give to the Reserve Bank such general or special directions as it thinks fit, and the Reserve Bank shall comply with such directions. Thus, ultimately the Reserve Bank has been charged with the powers as well as the responsibility to administer foreign exchange in India.

AUTHORISED PERSONS

While the Reserve Bank has the authority to administer foreign exchange in India, it is recognised that it cannot do so by itself. Foreign exchange is received or required by a large number of exporters and importers in the country spread over a vast geographical area. It would be impossible: for the Reserve Bank to deal with them individually. Therefore, provision has been made in the Act (Section 10), enabling the Reserve Bank to authorise any person to be known as authorised person to

deal in foreign exchange or in foreign Securities, as an authorised dealer, money changer or off shore banking unit or in any other manner as it deems fit. An authorised person should comply with the general or special directions or orders of the Reserve Bank in all his foreign exchange dealings. Before undertaking any transaction in foreign exchange he should obtain from his customer such declaration and information as to ensure that the provisions of the Act are not violated. Where the authorised person is not satisfied he should refuse in writing to undertake the transaction. If he has a reason to believe that any contravention or evasion of the regulations is contemplated] he should report the matter to Reserve Bank.

Authorised Dealers

Authorised dealers are the banks, financial institutions and other institutions authorised by the Reserve Bank of India to deal in foreign exchange.

An authorised dealer should comply with the directions and instructions of the Reserve Bank given from time to time. While FERA was in force, such directions of standing nature were available in the Exchange Control Manual (latest 1993 edition) issued by the Reserve Bank as amended by its AD (MA Series) circulars. With the coming into effect of the FEMA, the Reserve Bank has issued a series of regulations under the Act. The Reserve Bank has also indicated certain provisions in the Exchange Control Manual which will continue to be effective. Amendments to the extant provisions are now communicated in the form of AP (DIR Series) Circulars.

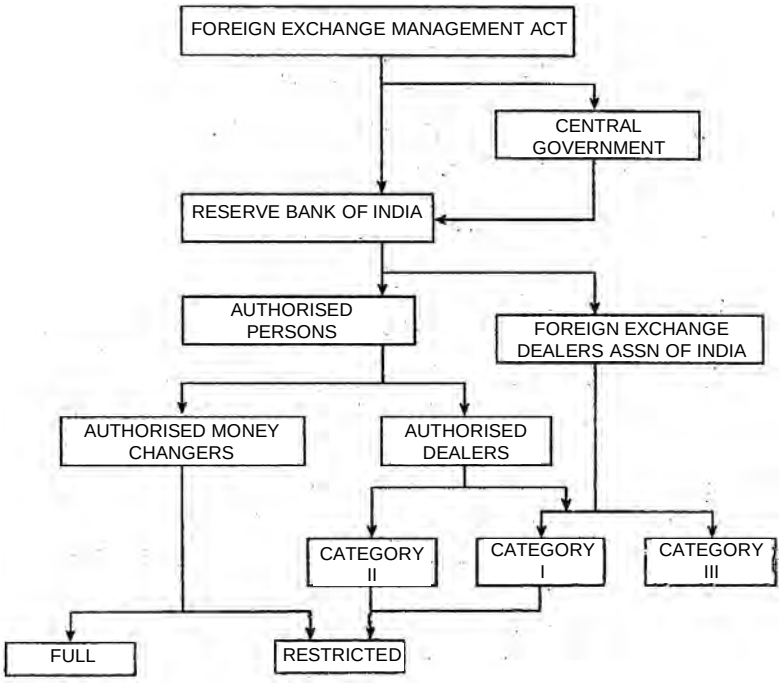


Fig. 3.1: Administration of Foreign Exchange in India

Section 10 of FEMA requires the authorised dealer to obtain declarations and information from the customers as to ensure that the provisions of the Act are not violated. The provision is similar to

the one under FERA. Under FERA regime, Reserve Bank has specified the respective documents to be obtained by authorised dealers for various requirements of the Act. These documents are incorporated in the Exchange Control Manual. Now Reserve Bank has advised the authorised dealers to keep on record any information/documentation on the basis of which the transaction was undertaken for verification by Reserve Bank. Authorised dealers are to devise their own formats for these. Banks continue to use the forms prescribed by Reserve Bank earlier.

With regard to charging of commission, quotation of rates, etc., the authorised dealer should also comply with the rules of Foreign Exchange Dealers Association of India (FEDAT).

Authorised dealers are classified by Reserve Bank into three categories :

Foreign Exchange Dealers' Association of India

FEDAl was established in 1958 as an association of all authorised dealers in India. All authorised dealers of Category I and Category III, currently numbering 89, are its members. It has its quarters at Mumbai and local offices at Bengaluru, Kolkata, Chennai and New Delhi. The affairs of FEDAI are managed by a Managing Committee at the Head Office and respective Local Committees at local offices. The Committees are represented by banks incorporated in India and outside India. The principal functions of FEDAI are :

(a) To frame rules for the conduct of foreign exchange business in India. These rules cover various aspects like hours of business, charges for foreign exchange transactions, quotation of rates to customers, interbank dealings, etc. All authorised dealers have given undertakings to the Reserve Bank to abide by these rules. Provisions of FEDAI rules have been considered at appropriate places in the relevant chapters of this book.

(b) To coordinate with Reserve Bank of India in proper administration of exchange control.

(c) To circulate information likely to be of interest to its members. (Information of international trade received from organisations like the International Chamber of Commerce is passed on to the members. It also acts as a clearing house for exchange of information among members.)

Thus, FEDAI provides a vital link in the administrative set-up of foreign exchange in India. It is the mouthpiece of the authorised dealers, representing their views to the Reserve Bank and other international agencies.

Authorised Money Changers

To provide facilities for encashment of foreign currency for tourists, etc., certain established firms, hotels and other organisations have been permitted to deal in foreign currency notes, coins and travellers cheques subject to directions issued to them from time to time. These firms and organisations are called authorised money changers'. An authorised money changer may be a 'full-fledged money changer' or a 'restricted money changer'.

A full-fledged money changer is authorised by Reserve Bank of India to undertake both purchase of foreign exchange and sale transactions with the public for private and business visits abroad. Departments of posts, urban cooperative banks and others are recognised as full-fledged money changers.

A restricted money changer is authorised only to purchase foreign currency notes, coins and traveller's cheques subject to the condition that all such collections are surrendered by him in turn to an authorised dealer in foreign exchange. The system of approval of restricted money changers by Reserve Bank has been discontinued. Now authorised dealers and full-fledged money changers can enter into agency/franchise agreements with entities for the purpose of carrying on restricted money changing business.

Authorised Dealer—Category I. A major portion of actual dealing in foreign exchange from /I the customers (importers, exporters and others receiving or making personal remittances) is dealt with by such of the banks in India which have been authorised by the Reserve Bank to deal in foreign exchange. These banks are known as Authorised Dealers—Category I. They are authorised to carry out all current account and capital account transactions as permitted by Reserve Bank of India from time to time. Any exporter or importer should route his transactions through authorised dealer—category I.

Authorised Dealer—Category II. They comprise of upgraded full fledged money changers, cooperative banks, regional rural banks and others. They can purchase foreign exchange and sell foreign exchange for private and business visits abroad undertaken by residents, which is the function performed by a full fledged money changer. In addition, they can also execute for residents specified non-trade related current account transactions such as those relating to education, medical expenses, subscriptions, etc.

Authorised Dealer—Category III. They comprise of selected financial and other institutions. They are permitted to carry out transactions incidental to the foreign exchange activities undertaken by them.

Organisation of an Authorised Dealer

Foreign exchange is a highly specialised business and is, therefore, concentrated in selected branches of the bank. In most banks, the decision making is done at the corporate level. The Foreign Exchange Department, also called the International Banking Division or International Division, is headed by a senior executive of the bank. An in depth knowledge of the rules and regulations of foreign exchange business in particular and banking in general and high level of awareness of the happenings in the international economic and political arena is expected from the Executive heading the department. Since foreign exchange business requires quick decisions, the Executive is vested with enough powers to take decisions on most of the situations that would arise in the dealings of the bank. Matters involving very large amounts and those beyond the discretionary powers of the Executive are referred to the Chief Executive of the bank or its Board of Directors.

While policy decisions are taken and foreign exchange resources are managed at the corporate level, the actual dealing with the customers takes place at select branches of the bank authorised to deal in foreign exchange. Such branches are mostly concentrated in metropolitan cities and other places where either import or export trade predominates or inflow of foreign remittances is expected to be high. These branches can, however, function only within the guidelines prescribed by the head office, from time to time.

There may also be an intermediary tier at the Zonal or Regional level. In order to decentralise decision making and reduce the problem of communication from head office to branches spread over the length and breadth of the country, special Departments or Cells have been set up at these levels. They perform some of the functions like advising branches on the exchange rate to be quoted to customers, maintenance of foreign exchange balances abroad, etc.

Banks have also set up at select metropolitan centres special branches dealing exclusively in foreign exchange, designated as Overseas Branches. Besides dealing directly with customers engaged in foreign trade, they also take on the role of special foreign exchange cells at national/zonal levels.

FOREIGN TRADE AND FOREIGN EXCHANGE

International trade refers to trade between the residents of two different countries. Each country functions as a sovereign State with its own set of regulations and currency. The difference in the nationality of the exporter and the importer presents certain peculiar problems in the conduct of international trade and settlement of the transactions arising there from. Important among such problems are:

(i) Different countries have different monetary units;

(ii) Restrictions imposed by countries on import and export of goods;

(iii) Restrictions imposed by nations on payments from and into their countries; and

(iv) Differences in legal practices in different countries.

The existence of national monetary units poses a problem in the settlement of international transactions. The exporter would like to get the payment in the currency of his country. For instance, if Amerex of New York exports machinery to Indimp, Mumbai, the former would like to get the payment in US dollars. Payment in Indian rupees will not serve their purpose because Indian rupee cannot be used as currency in the USA. On the other hand, the importers in India have their savings and borrowings in India in rupees. Thus, the exporter requires payment in the currency of the exporter's country whereas the importer can pay only in the currency of the importer’s country. A need, therefore, arises for conversion of the currency of the importer’s country into that of the exporter's country. Foreign exchange mechanism by which the currency of one country gets converted into the currency of another country.

Exghange Rate

The rate at which one currency is converted into another currency is the rate of exchange between the currencies concerned. In our illustration, if Indian Bank exchanges US dollars for Indian rupees at ₹ 45 a dollar, the exchange rate between rupee and dollar can be expressed as USD ₹ 66.67

The rate of exchange for a currency is known from the quotation in the foreign exchange market, banks operating at a financial centre, and dealing in foreign exchange, constitute the foreign exchange market. As in any commodity or stock market, the rates in the foreign exchange market are determined by the interaction of the forces of demand for and supply of the commodity dealt in, viz., foreign exchange. Since the demand and supply are affected by a number of factors, both fundamental and transitory, the rates keep on changing frequently, and violently too.

MANAGEMENT OF FOREIGN EXCHANGE

Foreign exchange was considered a rare commodity and was subject to strict control in almost all countries of the world till 1970s. Exchange control was the order of the day. Today we talk of exchange management and not exchange control. But the fact is that foreign exchange management from the national point of view is only exchange control or regulation, though in a diluted form.

The term 'exchange control' refers to the control, by the Government or a centralised agency of transactions involving foreign exchange. In a broad sense, any stipulation or regulation which restricts the free play of forces in the foreign exchange market can be termed exercise of exchange control. The rate of exchange under exchange control regime tends to be different from the one that would exist in the absence of such control.

The origin of exchange control can be traced to nineteen-thirties. After the First World War, many countries of Europe found themselves with depleted gold reserves and foreign exchange. They imposed payment restrictions to prevent massive capital withdrawals and instil stability in the domestic economy. Since then exchange control has been adopted by a large number of countries and for different purposes.

With the onset of globalisation and liberalisation beginning at the commencement of 1990s, the tendency throughout the world has been that of relaxing exchange control. Even earlier, some countries like USA proclaimed that they had no exchange control. But the fact is, even today, exchange control exists in all countries, with varying intensity.

FUNCTIONS OF FOREIGN EXCHANGE DEPARTMENT

The Foreign Exchange Department at the Central/Zonal office or the Overseas branch is divided into well-defined sections, each undertaking a specialised activity. Each section is further sub-divided into sub-sections or desks rendering specific tasks. There is no uniformity among banks either in the allocation of the tasks or in the designations of the officers manning the sections and sub-sections. Yet, an attempt is made below to delineate the important functions performed by the foreign exchange department of a bank. These functions are elaborated at appropriate chapters in this book.

1. Financing Exports

The financial needs of the exporter, right from the moment he conceives the project till realises export proceeds, are met by banks. The credit extended to the exporter to procure materials, process them and prepare them for shipment to the importer is known as packing preshipment credit. On shipping the goods the exporter would draw a bill of exchange, with or without a letter of credit, and discount it with the bank. The credit extended to the exporter at shipment is known as post-shipment finance.

Besides financing, the other service rendered by banks to exporters is advising, confirming letter of credit issued in favour of the exporters by their correspondents abroad. Even if the exporter does not require any financial accommodation from the bank, the exchange regulations require to receive the export proceeds only through an authorised dealer. Therefore, the export bills to be collected through a bank. The bank may also execute guarantees on behalf of its existing customers.

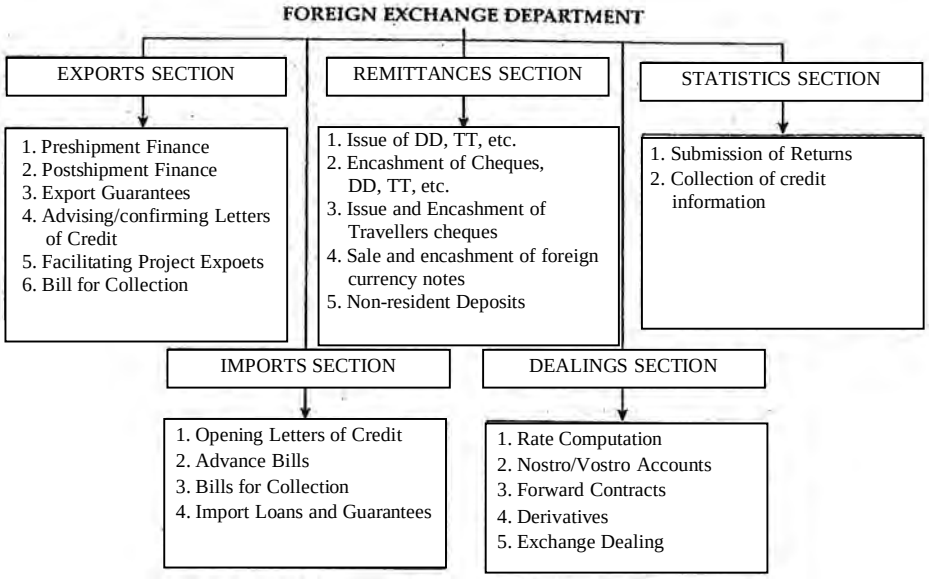


Fig. 3.2: Functions of Foreign Exchange Department

2. Financing Imports

Letters of credit are issued by banks on behalf of their importer-customers. The opening of the let of credit by the bank, whereby it undertakes to make payment to the exporters on shipment, enable the importer to conclude the deal with ease. The importer may be financed by the bank for import. This finance may take any form, cash credit or loans, as the case may be, and against hypothecation or pledge or mortgage of the item imported. The exporter abroad is paid by them in foreign exchange. The bank may issue deferred payment guarantees on behalf of the importer items purchased on long-term credit. The importing of goods into India is subject to the import policy of the Government and exchange regulations of the Reserve Bank. The Bank takes care to that they are adhered to.

3. Remittance Facilities

An importer in India has to pay the overseas exporter. Similarly, an Indian exporter has to receive payment from abroad. A person in India may like to subscribe to a magazine published abroad. Indian who is employed abroad may like to remit funds for maintenance of his family in India Thus, all transactions in foreign exchange ultimately result in either remittance of funds into India. (inward remittance) or remittance of funds from India (outward remittance).

The payment of funds into or from India can be arranged through any of the credit instrument. The instruments employed may include telegraphic transfer, mail transfer, demand draft, foreign traveller's cheques, bill of exchange or any other instrument.

For the benefit of Indians residing abroad, banks open and maintain non-resident accounts.

4. Dealings in Foreign Exchange

Banks buy and sell foreign exchange from and to the public. To carry out this function, banks have to keep sufficient stocks of foreign exchange. These are kept in the form of bank accounts abroad. Banks in India maintain accounts with banks in important financial centres abroad through which all

sales and purchases of foreign exchange are routed. For example, a foreign demand draft Pound-Sterling issued by the bank would be made payable by the bank in London with which maintains an account. On presentation of the draft at London, the bank's account would be debited Bank's dealings in foreign exchange may sometimes necessitate it to sell or buy, to/from other bar in the place or the Reserve Bank, the required foreign currency.

Subject to the rules and regulations of the Reserve Bank and Foreign Exchange Dealers Association of India, banks have to quote rates for foreign exchange to be purchased from and to the customer. Subject to these regulations the rate quoted would depend upon the rates prevailing in interbank or international markets and the bank's margin of profit, etc.

This section of the department is headed by a 'Dealer'. It is the duty of the dealer to see that the bank maintains just adequate balance of each foreign currency and that the rate quoted to the customer is competitive and at the same time profitable to the bank.

5. Furnishing Credit Information

With a network of correspondent relations with banks abroad, a bank in India is in a position to furnish business information to exporters and importers in India. The information may relate to the credit report on the prospective seller/buyer, market conditions, exchange regulations in different countries, etc. The bank is also in a position to advise the customers on such other matters as the currency in which the transaction is to be designated, avoidance of exchange risk, etc.

The department should also furnish periodic information on its dealings to its management and to the Reserve Bank. The information supplied by banks to Reserve Bank is of vital importance and forms the basis of decision-making at the national level.

Thus, the foreign exchange department of a bank renders many useful services to exporters and importers. The bank should keep itself constantly updated and be in touch with the latest trend in international markets.

FOREIGN CURRENCY ACCOUNTS

As stated earlier, to facilitate dealings in foreign exchange, banks maintain accounts with other banks abroad where frequency of transactions is expected. For instance, a bank in India may maintain accounts with banks abroad. Similarly, some foreign banks may maintain accounts with banks in India. When the banks maintain accounts mutually with each other, there may arise confusion as to which account they are referring to in their correspondence. For instance, Indian Bank may maintain an account in Malaysia with Bank of Malaysia and Bank of Malaysia may maintain an account with Indian bank in India. Banks use certain specific terms to identify the accounts to avoid the confusion.

Nostro Account

The term nostro is used by the bank which maintains the account to refer to its account with other bank. For a bank in India nostro account is an account maintained by it with a bank abroad. For example, Indian Bank may maintain an account with Lloyds Bank, London. Obviously, the account would be in Pound Sterling. Similarly, it may have a dollar account with Bank of America, New York. While corresponding with the foreign bank, Indian Bank would refer its account with the former as

nostro account, meaning 'our account with you'. So, for Indian Bank nostro account means the bank account it maintains abroad in foreign currency. All foreign exchange transactions are routed through nostro accounts. For example, if the bank issues a demand draft on London payable in pound-sterling, it would draw on Lloyds Bank, London. When the draft is presented in London the Lloyds Bank will debit the Indian Bank's account with it. Likewise, when a bill drawn on London is given to Indian Bank for purchase or collection, it would send it for collection to Lloyds Bank. Lloyds Bank would collect and credit the account of the Indian bank with the proceeds

Vostro Account

The term vostro is used by the bank with which the account is maintained. A foreign bank may open rupee account with an Indian bank. While corresponding with the foreign bank maintaining an account with it, the Indian bank would refer to the account as 'vostro account' meaning 'your account with us' For example, a bank in Middle East may open an account with an Indian bank and draw drafts on the account. On presentation of drafts, the Indian Bank would pay to the debit of the foreign bank's account with it. For exchange control purposes such accounts are known as 'non - resident bank accounts'.

It should be noted that credit to a non-resident bank account amounts to remittance of foreign currency from India to the country of the bank maintaining the vostro account. Similarly debit to the account amounts to inflow of foreign exchange from the country concerned into India For instance, when an import is made from Sri Lanka, the proceeds may be credited to the vostro account of the Sri Lankan bank with the Indian bank. But for crediting the vostro account, the amount should have been remitted abroad.

EXCHANGE RATE SYSTEMS UNDER IMF

The fixed change rate system, with central place for US dollar, was the exchange rate system officially adopted when the International Monetary Fund was founded. The scheme worked well for few years, but its latent defects were begun to be felt towards the end of 1960s. Since 1970s IMF has much diluted role to play in the exchange rate arrangement of its member countries. Countries are adopting various methods, mostly falling between the extremes of fixed arid floating rates, in managing their exchange systems.

Original Scheme under IMF

The International Monetary Fund was instituted soon after the Second World War with the avowed objective of facilitating smooth running of international trade and betterment of all nations of the world. It was thought that a system of fixed exchange rates would be necessary for the smooth functioning of international finance. The original scheme of the IMF, therefore, provided that

(a) Each member-country should declare the external value of its currency in terms of gold and a currency pegged to gold. Most counties declared values of their currencies in terms of gold and US dollar. This was known, as the 'par value' of the currency.

(b) The value of US dollar was fixed at USD 35 per ounce of fine gold. The USA committed itself to convert dollars into gold at the above official price.

(c) Following the above, the monetary reserves of member-countries came to consist of gold and US dollars. Thus US dollar got the position of a reserve asset.

(d) Each country agreed to maintain the market value of its currency within a margin of 1% of the par value. Where the variation in the market is more than the permitted level, the country should take steps to devalue the currency to correct the position.

(e) Members were free to devalue their currencies. But, if the devaluation exceeded 10% of the par value, approval of the IMF should be obtained. The IMF might approve it or advise a lower rate. However, it had no power to reject the proposal.

(f) The IMF granted short-term financial assistance to its members to tide over their temporary balance of payments problems. For chronic problems the members were expected to use permanent solutions like devaluation.

Working of the System

For the smooth running of the system, the major industrialized countries, other than the USA, endeavored to keep exchange rate changes to the minimum and maintain a common price level for tradable goods. Since other countries were endeavoring to maintain the exchange rate, USA had to remain passive in foreign exchange markets so as to lend support to such efforts. On the other hand, it had to follow a monetary policy that could provide a stable price level for tradable goods. Europe and Japan found it convenient to rely upon the USA to supply a stable price environment, and support US dollar as unit of account and means of settlement of international transactions.

The system provided a distinct advantage to the USA, viz., USA gains. It means that USA could obtain goods and services from abroad by merely printing US dollar, so long as the other countries were willing to accept dollar as the key currency. The acceptance of dollar depended on the confidence the other countries had that their US dollar reserves could be used for settlement of their international debts or that they could convert their reserves into gold. This aspect proved to be both a strength and weakness of the system. It was a strength because dollar became a reserve asset, in addition to gold, providing additional base for creation of money supply to keep pace with increase' in international trade. It was a weakness in the sense, the system depended excessively on a single currency. This dependence ultimately brought the fall of the system.

Collapse of the System

For about two decades the system worked smoothly. Slowly during the late sixties, the deficiencies of the system began to surface themselves up. One of the major difficulties was that the growth of means of settlement of international debts (international liquidity) did not keep pace with the increase in the volume of international trade. Many countries began to experience balance of payments problems. The reason can be attributed to the fact that increase in international liquidity depended upon the availability of gold. The supply of gold did not increase because its official price was fixed at USD 35 per ounce. With inflation and increased cost of mining, many countries found it uneconomical to mine gold.

The other reason was the undue importance given to a single currency, viz., the US dollar. As early as 1960, Robert Triffin pointed out the paradox in the situation, which has come to be known as

the Triffin paradox or Triffin dilemma. As we have seen, the system depended on the countries which had got trading in the US dollar. To facilitate other countries to accumulate reserves, USA has to run deficits in its balance of payments. So long as deficit was moderate, the system could well work. However, when every country began accumulating as much dollars as possible, which means huge deficits in US balance of payments, the dollar could not hold its value in the foreign exchange markets. If the faith in the dollar was lost due to pressure in the market and if only a portion of the balance outside was required to be converted into gold the Federal Reserve System of the US would have collapsed because the gold reserve constituted only a little portion of the dollar balance abroad.

The events in 1960s followed the predictions. The USA experienced heavy deficits in the balance of payments. The supply of dollars in the foreign exchange markets increased to greater extent leading to sharp fall in the value of dollar in the market. The speculative forces further complicated the issue rendering it difficult to maintain the exchange value of dollars. As a corrective measure the USA was advised to devalue its currency. But the USA did not heed to the advice because it thought the prestige enjoyed by the dollar as a reserve currency would thereby suffer. Further it was thought that devaluation of the dollar would affect many other countries which had accumulated huge dollar balances. Instead of resorting to devaluation the USA took a unilateral and unexpected step on August 15,1971. The convertibility of dollar into gold was suspended and further a surcharge of 10% was imposed on imports into the USA. These measures completely destabilized the exchange markets. Some major countries like Japan and West Germany took steps to rescue the dollar purchasing it in huge amounts. This action could not, however, stabilize the exchange mark. Therefore, some western countries decided to float their currencies in exchange markets.

CONVERTIBILITY OF RUPEE

In the present context, convertibility of a currency refers to its convertibility into a foreign currency as desired by its holder. The currency is fully convertible if the holder can convert it into any other currency at rates determined by the forces of demand and supply and without any interference from the government. The convertibility therefore involves two aspects:

(i) The rate of exchange should be determined by the market and not by the regulatory authority and thus the holder does not incur any loss on conversion; and

(ii) There should not be any quantitative restrictions on the repatriation of the currency.

Earlier the exchange rate of rupee was subject to the condition that the rate quoted by a bank to its customer should not be worse than the rate based on RBI rate. Rupee was made partially convertible when dual exchange rate was introduced and 60% of the remittance into India was converted at the market determined rates. Now the value of rupee is fully determined by the market forces. Thus rupee now fulfils the first condition of convertibility, viz., the exchange rate should be determined by market forces.

A currency is converted to effect remittances, either from the country or into the country from abroad. Remittances are broadly classified into two categories:

(i) those on current account and

(ii) those on capital account. This classification is based on the current and capital accounts in the balance of payments. Remittances on current account represent transactions relating to trade in goods and services. For such remittances, no reverse flow of funds in the future is anticipated. Remittances on capital account relates to investments, loans, etc. These represent the external debt of the country and reverse flow in the form of interest/dividend and repatriation of capital is expected.

Current Account Convertibility

Rupee is now fully convertible on current account fulfilling also the second condition for convertibility, viz., no quantitative ceiling on remittances abroad, through subject to certain regulations. As a part of liberalisation of foreign exchange transactions, the Reserve Bank has enhanced the discretionary powers for authorised dealers for making various remittances abroad. The limits on remittances for various purposes like travel, studies, medical treatments, gifts, services, etc. have become indicative. In certain cases authorised dealers themselves can permit remittance beyond the indicated limits. In certain other cases, the requests for remittances over the limits shall be referred to Reserve Bank, who will favourably consider the request.

As an affirmation of the convertibility of rupee on current account, with effect from August 20, 1994, India moved over to Article VIII status in the IMF. IMF members accepting the obligations of Article VIII undertake to refrain from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in discriminatory currency arrangements or multiple currency practices without IMF approval.

Capital Account Convertibility

The next logical step in the direction is the convertibility of rupee on capital account. In his Budget Speech for 1997-98, the Union Finance Minister described capital account convertibility as the cherished goal of the government. As a follow-up measure, the Reserve Bank of India appointed in February 1997 a committee on Capital Account Convertibility (CAC) under the Chairmanship of

Sri S.S. Tarapore, then Deputy Governor of Reserve Bank. The committee submitted its report on May 30,1997.

Benefits of CAC

The Committee has put forward the following as the advantages flowing from CAC:

(i) It makes available a large capital stock to supplement domestic resources and thereby enables the economy to register higher growth, reduce the cost of capital and improve access to international financial markets.

(ii) It allows residents to hold-an internationally diversified portfolio which reduces the vulnerability of income streams and wealth to domestic stocks, lower funding costs for borrowers and prospects of higher yields for savers.

(iii) Allocative efficiency improves as a result of financial integration arising from CAC. This can stimulate innovation and improve productivity.

(iv) It provides impetus for domestic tax regimes to rationalise and converge to international tax structures. This removes inducements for domestic agents towards evasion and capital flight.

(v) The capital controls turn progressively ineffective, costly and even distortive. On the other hand, an open account would bring the weakness of the Indian financial system under a sharper focus. It would impose a strong discipline upon the financial system and expedite the early rectification of infirmities in the system and lead to deepening of markets to enable the distribution of risks.

International Experience

The Committee made a survey of the international experience in capital account convertibility. The countries which initiated the move to CAC on the basis of strong fundamentals were able to modulate the pace of instituting CAC without undertaking large and dramatic shift in a stance of macro-economic policies. Also, these countries were less vulnerable to backtracking and the reimposition of controls. Countries with weak initial conditions were constrained to adopt drastic macro-economic policies to facilitate the move to CAC.

The following are considered important preconditions for CAC:

(i) A strong balance of payments position.

(ii) The strengthening of the financial system.

(iii) Fiscal consolidation.

(iv) Conduct of an appropriate exchange rate policy.

In the implementation of CAC, restriction on inflows and related outflows by non-residents and residents, corporates and non-banks usually received preferential treatment, followed by banks and individuals. Some restriction on capital inflows were imposed during the transition period.

Preconditions for CAC in India

The Committee stipulated preconditions in three important areas for implementation of CAC. They are:

Fiscal Consolidation. The ratio of Centre's gross fiscal deficit to gross domestic production to be reduced from a budgeted 4.5% in 1997-98 to 4% in 1998-99 and further to 3.5% in 1999-2000, accompanied by a reduction in the States deficit.

Mandated Inflation Rate. The inflation for the three-year period (1997-2000) should be an average of 3-5 per cent. .

Strengthening of Financial System. Interest rates should be fully deregulated in 1997-98. The average effective CRR should be reduced to 8% in 1997-98,6% in 1998-99 and further to 3% in 1999-

2000. Gross non-performing assets to be brought down to 12% in 1997-98, 9% in 1998-99 and 5% in 1999-2000.

Implementation, CAC was implemented in three phases over three years: Phase 1—1997-98, Phase 11-1998-99 and Phase III-1999-2000! The implementation of measures contemplated for each phase was based on a careful and continuous monitoring of the preconditions.

Exchange Rate Policy. On the exchange rate policy, the Reserve Bank should have a monitoring band of 5% around the neutral Real Effective Exchange Rate (REER). (REER is the exchange rate for the currency adjusted for inflation rate differential.) Reserve Bank should ordinarily intervene as and when the REER is outside the band.

Adequacy of Reserves. The following four indicators should be for evaluating the adequacy of reserves:

(i) Reserves should not be less than six months of imports.

(ii) Reserves should not be less than three months of imports plus 50% of debt service payments plus one month's exports and imports.

(iii) The short term debt and portfolio stock should be lowered to 60%. (iv) The net foreign exchange assets to currency ratio should be prescribed by law at not less than 40 per cent.

Narrow Banks. The weak banks should be converted into 'narrow banks' and the incremental resources of these narrow banks should be deployed only in Government securities.

Risks of Convertibility

Those who oppose convertibility offer the following arguments against its implementations:

(a) Credit rating institutions will play a vital role in decision making by the investors. The changed view of these institutions or changes in the interest/exchange rates may have a destabilising effect on the portfolio flows.

(b) It exposes banks' liabilities and assets to more price and exchange risks. The effect of increased volatility of exchange rate will be felt on the banks' open foreign currency positions.

(c) Banks may supplement their domestic deposit base with borrowings from off-shore markets. The volatility in interest and exchange rates can be dangerous to weak and fragile banks.

(d) Fluctuation in interest rate may affect the cost of borrowing for .emerging markets and alter the relative attractiveness of investing in these markets. Real exchange rate volatility may cause currency and maturity mismatches, creating large losses forhank borrowers.

(e) Due to increased competition, the margins for the banks may be reduced.

Implementation in INR

India is already moving towards capital convertibility; though not at the speed envisaged by the Committee. The recent Asian currency crisis has moderated the tone of the staunch advocates of CAC. The Reserve Bank and the Government are progressively relaxing the conditions attached to such

areas as investments abroad, investments into India and maintenance of foreign currency, accounts by banks. Thus India is cautiously moving towards convertibility of its currency on capital account.

Provisions under FEMA. The Foreign Exchange Management Act, 1999, which came into force with effect from June 2000, continues restrictions on capital account transactions. Section 6(2) provides that the Reserve Bank may, in consultation with the Central Government specify the permissible classes of capital account transactions and the limit up to which foreign exchange shall admissible for such transactions. Only such transactions which are permitted under specific or general permission of the Reserve Bank can be carried out. Thus rupee remains only partially convertible for capital account transactions.

Committee on Fuller Capital Account Convertibility

The Reserve Bank of India appointed in March 2006 a committee to set out the Roadmap Towards Fuller Capital Account convertibility under the chairmanship of Shri S.S. Tarapore. The committee submitted its report in August 2006. It favours the move towards full capital convertibility to be achieved by 2011, to be implemented in three phases. Among others, the Committee has recommended further liberalisation on remittances, freeing of capital markets for non-residents, abolition of tax benefits for NRIs on deposits, review of double taxation treaties, prohibition of investment through Participatory Notes by foreign institutional investors, increasing limits to banks for borrowing from external markets and increasing external commercial borrowing limits.

NRI Investments Issues and Remedy

Indian people living abroad face many issues while investing, especially in the US and it is not at all hassle-free process for them. In the US, most of the registered mutual fund companies who have operations in India do not generally accept investments made by Indians who are presently living in the US as they have to maintain a cap on the number of non-resident investors they can take.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of the US requires the fund managers to register with the regulator and follow their rules if the fund managers are handling more than 15 US based investors account. This means that if the fund house acquires more than 15 NRIs, then they have to get registered with the regulator and follow their rules. So, to avoid this, many fund houses do not generally accept investments from NRIs. Such NRI can invest in the Indian markets via US based mutual funds which are India-specific.

According to the FEMA (Foreign Exchange Management Act) 1999, an NRI is a person resident outside India who is either a citizen of India or a person of Indian Origin. After understanding the above fact, now the question arises how to get started with investing. It is important to take a note that all the investments that an NRI makes must be in Indian Rupee. Hence for the purpose, NRI needs to open either Non Resident External account (NRE) account or NRO (Non Resident Ordinary Rupee) account or FCNR (Foreign Currency Non Resident) account with an Indian Bank. If you wish the money that you invested along with gains to be repatriated to your account of residence, then you should open an NRE account. If the investor wishes that the investment that you are making must not get repatriated to your country of residence, then you should open an NRO account and if you wish to hold funds in a foreign currency, then you should open an FCNR account. There are ways through

which once can invest. First, the investment amount can be directly debited from your NRE or NRO account. Second, NRI needs to give rupee cheque or draft from your NRE or NRO account.

If investment is made through Cheque or draft, then NRI must attach FIRC (Foreign Inward Remittance Certificate) which is a proof that the payment is received by the individual from outside the country in a foreign currency or a letter issued by a bank confirming the source of funds along with the application of funds. When it comes to redemptions after the maturity of deposits, all the redeemed amounts will be payable in rupees only. The payment is directly credited to the NRI investor's account. When investments along with its appreciation and dividend earnings are fully repatriable only in the case of NRE and FCNR accounts. In the case of NRO account, only the appreciation on investments is repatriable and not the principal amount.If India has double taxation avoidance treaty with NRI's country of residence, the NRI has to pay the difference between the tax rate of India and tax rate of the country where NRI resides. For example, if India has ADTT (Avoidance of Double Taxation Treaty) with USA, if NRI resides in USA wherein short-term capital gain tax is 30% but in India the same is 15%, NRI has to 7.5% tax to India and 7.5% tax to USA. Total tax payment obligation is 15% on the part of NRI investor.

SUMMARY

When a business enterprise imports goods from other countries, exports its products to them or makes investments abroad, it deals in foreign exchange. Foreign exchange means 'foreign currency' and includes deposits, credits and balances payable in any foreign currency; drafts, traveller's cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency; and drafts, traveller's cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency.

The management of foreign exchange is very important in the present day business. This lesson deals with how FEMA facilitates external trade and payments and promotes the orderly development and maintenance of foreign exchange market. The Act has assigned an important role to the Reserve Bank of India (RBI) in the administration of FEMA. The rules, regulations and norms pertaining to several sections of the Act are laid down by the Reserve Bank of India, in consultation with the Central Government. The term 'foreign exchange has been defined to mean foreign currency and includes deposits, credits, balance payable in foreign currency, drafts, traveller's cheques, letters of credit, bills of exchange expressed or drawn in Indian currency but payable in any foreign currency. Any draft, traveller's cheque, letters of credit or bills of exchange drawn by banks, institutions or persons outside India but payable in Indian currency has also been included in the definition of foreign exchange.

Chapter II of the Foreign Exchange Management Act containing Sections 3-9 deals with Regulation and Management of Foreign Exchange. Section 3 prohibits any person other than an authorized person from dealing in or transferring any foreign exchange or foreign security to any person or making any payment to or for the credit of any person resident outside India in any manner or receiving otherwise through an authorized person any payment by order or on behalf of any person resident outside India in any manner except as provided in the Act, rules or regulations made there under or with the general or special permission of the Reserve Bank of India. Current account

Transaction means a person is to sell or draw foreign exchange to or from an authorized person if such sale or withdrawal is a current account transaction as defined under Section 2(j) of the Act. However, the Central Government may, in the public interest and in consultation with the Reserve Bank impose reasonable restrictions for current account transactions. Foreign Exchange Management (Current Account Transactions) Rules, 2000 defines the term 'Drawal as to mean drawal of foreign exchange from an authorised person and includes opening of Letter of Credit or use of International Credit Card or International Debit Card or ATM Card or any other thing by whatever name called which has the effect of creating foreign exchange liability.

'Capital account transaction' has been defined to mean any transaction which alters the assets or liabilities including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of person resident outside India and includes the transactions specified in Sub-section (3) of Section 6 of the Act.

Current Account Convertibility: Rupee is now fully convertible on current account fulfilling also the second condition for convertibility, viz., no quantitative ceiling on remittances abroad, through subject to certain regulations. As a part of liberalisation of foreign exchange transactions, the Reserve Bank has enhanced the discretionary powers for authorised dealers for making various remittances abroad. The limits on remittances for various purposes like travel, studies, medical treatments, gifts, services, etc. have become indicative. In certain cases authorised dealers themselves can permit remittance beyond the indicated limits. In certain other cases, the requests for remittances over the limits shall be referred to Reserve Bank, who will favourably consider the request.

Capital Account Convertibility: The next logical step in the direction is the convertibility of rupee on capital account. In his Budget Speech for 1997-98, the Union Finance Minister described capital account convertibility as the cherished goal of the government. As a follow-up measure, the Reserve Bank of India appointed in February 1997 a committee on Capital Account Convertibility (CAC) under the Chairmanship of Sri S.S. Tarapore, then Deputy Governor of Reserve Bank. The committee submitted its report on May 30,1997. It makes available a large capital stock to supplement domestic resources and thereby enables the economy to register higher growth, reduce the cost of capital and improve access to international financial markets. Its benefits are mentioned below:

1. It allows residents to hold-an internationally diversified portfolio which reduces the vulnerability of income streams and wealth to domestic stocks, lower funding costs for borrowers and prospects of higher yields for savers.
2. Allocative efficiency improves as a result of financial integration arising from CAC. This can stimulate innovation and improve productivity.
3. It provides impetus for domestic tax regimes to rationalise and converge to international tax structures. This removes inducements for domestic agents towards evasion and capital flight.
4. The capital controls turn progressively ineffective, costly and even distortive. On the other hand, an open account would bring the weakness of the Indian financial system under a sharper focus. It would impose a strong discipline upon the financial system and expedite the early rectification of infirmities in the system and lead to widening/deepening of markets to enable the spreading/distribution of risks.

REVIEW QUESTIONS

1. Define Foreign Exchange
2. Explain in detail the regulation and Management of Foreign Exchange as Per FEMA Act.
3. Explain in detail the functions of Foreign Exchange Department
4. What are the two different types of Foreign Currency accounts
5. Explain in detail the Exchange Rate system under IMF.
6. What are the issues and remedies available for NRI Investments?

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4

FOREIGN EXCHANGE MARKETS

Chapter Outline

- Foreign Exchange Market – An Overview
- Feature of Foreign Exchange Market
- Settlement of Transactions
- Transaction in Markets
- Forward Rates in Instrumental Markets
- Factors Determining Spot Exchange Rates
- Summary
- Review Questions

FOREIGN EXCHANGE MARKET-AN OVERVIEW

The foreign exchange market (forex, FX, or currency market) is a global decentralized market for the trading of currencies. This includes all aspects of buying, selling and exchanging currencies at current or determined prices. In terms of volume of trading, it is by far the largest market in the world, followed by the Credit market. The main participants in this market are the larger international banks. Financial centres around the world function as anchors of trading between a wide range of multiple types of buyers and sellers around the clock, with the exception of weekends. The foreign exchange market does not determine the relative values of different currencies, but sets the current market price of the value of one currency as demanded against another.

The foreign exchange market works through financial institutions, and it operates on several levels. Behind the scenes banks turn to a smaller number of financial firms known as "dealers", who are actively involved in large quantities of foreign exchange trading. Most foreign exchange dealers are banks, so this behind-the-scenes market is sometimes called the "interbank market", although a few insurance companies and other kinds of financial firms are involved. Trades between foreign exchange dealers can be very large, involving hundreds of millions of dollars. Because of the sovereignty issue when involving two currencies, forex has little (if any) supervisory entity regulating its actions.

The foreign exchange market assists international trade and investments by enabling currency conversion. For example, it permits a business in the United States to import goods from European Union member states, especially Eurozone members, and pay Euros, even though its income is in United States dollars. It also supports direct speculation and evaluation relative to the value of currencies, and the carry trade, speculation based on the interest rate differential between two currencies.

In a typical foreign exchange transaction, a party purchases some quantity of one currency by paying with some quantity of another currency. The modern foreign exchange market began forming during the 1970s after three decades of government restrictions on foreign exchange transactions (the Bretton Woods system of monetary management established the rules for commercial and financial relations among the world's major industrial states after World War II), when countries gradually switched to floating exchange rates from the previous exchange rate regime, which remained fixed as per the Bretton Woods system.

The foreign exchange market is unique because of the following characteristics:

- its huge trading volume representing the largest asset class in the world leading to high liquidity;
- its geographical dispersion;
- its continuous operation: 24 hours a day except weekends, i.e., trading from 22:00 GMT on Sunday (Sydney) until 22:00 GMT Friday (New York);
- the variety of factors that affect exchange rates;
- the low margins of relative profit compared with other markets of fixed income; and
- the use of leverage to enhance profit and loss margins and with respect to account size.

As such, it has been referred to as the market closest to the ideal of perfect competition, notwithstanding currency intervention by central banks. According to the Bank for International Settlements, the preliminary global results from the 2016 Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets Activity show that trading in foreign exchange markets averaged $5.1 trillion per day in April 2016. This is down from $5.4 trillion in April 2013 but up from $4.0 trillion in April 2010. Foreign exchange swaps were the most actively traded instruments in April 2016, at $2.4 trillion per day, followed by spot trading at $1.7 trillion. According to the Bank for International Settlements as of April 2016, average daily turnover in global foreign exchange markets is estimated at $5.09 trillion, a decline of approximately 5% from the $5.355 trillion daily volume as of April 2013. Some firms specializing on the foreign exchange market had put the average daily turnover in excess of US$4 trillion. The $5.09 trillion break-down is as follows:

$1.654 trillion in spot transactions

$700 billion in outright forwards

$2.383 trillion in foreign exchange swaps

$96 billion currency swaps

$254 billion in options and other products

Market participants also unlike a stock market, the foreign exchange market are divided into levels of access. At the top is the interbank foreign exchange market which is made up of the largest commercial banks and securities dealers within the interbank market, spreads, which are the difference between the bids and ask prices, are razor sharp and not known to players outside the inner circle. The difference between the bid and ask prices widens (for example from 0 to 1pip to 1–2 pips for currencies such as the EUR) as you go down the levels of access. This is due to volume. If a trader can guarantee large numbers of transactions for large amounts, they can demand a smaller difference between the bid and ask price, which is referred to as a better spread. The levels of access that make up the foreign exchange market are determined by the size of the "line" (the amount of money with which they are trading). The top-tier interbank market accounts for 51% of all transactions. From there, smaller banks, followed by large multi-national corporations (which need to hedge risk and pay employees in different countries), large hedge funds, and even some of the retail market makers. According to Galati and Melvin, "Pension funds, insurance companies, mutual funds, and other institutional investors have played an increasingly important role in financial markets in general, and in FX markets in particular, since the early 2000s." (2004) In addition, he notes, "Hedge funds have grown markedly over the 2001–2004 period in terms of both number and overall size". Central banks also participate in the foreign exchange market to align currencies to their economic needs.

Commercial Companies

An important part of the foreign exchange market comes from the financial activities of companies seeking foreign exchange to pay for goods or services. Commercial companies often trade fairly small amounts compared to those of banks or speculators, and their trades often have little short-term impact on market rates. Nevertheless, trade flows are an important factor in the long-term direction of a currency's exchange rate. Some multinational corporations (MNCs) can have an

unpredictable impact when very large positions are covered due to exposures that are not widely known by other market participants.

Central Banks

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. Nevertheless, the effectiveness of central bank "stabilizing speculation" is doubtful because central banks do not go bankrupt if they make large losses, like other traders would. There is also no convincing evidence that they actually make a profit from trading.

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 the behavior of their currency. Fixing exchange rates reflect the real value of equilibrium in the market. Banks, dealers and traders use fixing rates as a market trend indicator.

The mere expectation or rumor of a central bank foreign exchange intervention might be enough to stabilize a currency. However, aggressive intervention might be used several times each year in countries with a currency float regime. Central banks do not always achieve their objectives. The combined resources of the market can easily overwhelm any central bank. Several scenarios of this nature were seen in the 1992–93 European Exchange Rate Mechanism collapse and in more recent times in Asia.

Investment Management Firms

Investment management 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. For example, an investment manager bearing an international equity portfolio needs to purchase and sell several pairs of foreign currencies to pay for foreign securities purchases.

Some investment management firms also have more speculative specialist currency overlay operations which manage clients' currency exposures with the aim of generating profits as well as limiting risk. While the number of this type of specialist firms is quite small, many have a large value of assets under management and can therefore generate large trades.

Retail Foreign Exchange Traders

Individual retail speculative traders constitute a growing segment of this market with the advent of retail foreign exchange trading, both in size and importance. Currently, they participate indirectly through brokers or banks. Retail brokers, while largely controlled and regulated in the USA by the Commodity Futures Trading Commission and National Futures Association, have previously been subjected to periodic foreign Exchange fraud. To deal with the issue, in 2010 the NFA required its members that deal in the Forex markets to register as such (i.e., Forex CTA instead of a CTA). Those NFA members that would traditionally be subject to minimum net capital requirements, FCMs and IBs,

are subject to greater minimum net capital requirements if they deal in Forex. A number of the foreign exchange brokers operate from the UK under Financial Services Authority regulations where foreign exchange trading using margin is part of the wider over-the-counter derivatives trading industry that includes contracts for difference and financial spread betting.

There are two main types of retail FX brokers offering the opportunity for speculative currency trading: *brokers* and *dealers* or *market makers. Brokers* serve as an agent of the customer in the broader FX market, by seeking the best price in the market for a retail order and dealing on behalf of the retail customer. They charge a commission or "mark-up" in addition to the price obtained in the market. Dealers or market makers, by contrast, typically act as principals in the transaction versus the retail customer, and quote a price they are willing to deal at.

Non-bank Foreign Exchange Companies

Non-bank foreign exchange companies offer currency exchange and international payments to private individuals and companies. These are also known as "foreign exchange brokers" but are distinct in that they do not offer speculative trading but rather currency exchange with payments (i.e., there is usually a physical delivery of currency to a bank account).

It is estimated that in the UK, 14% of currency transfers/payments are made via Foreign Exchange Companies. These companies' selling point is usually that they will offer better exchange rates or cheaper payments than the customer" bank. These companies differ from Money Transfer/Remittance Companies in that they generally offer higher-value services. The volume of transactions done through Foreign Exchange Companies in India amounts to about USD 2 billion per day. This does not compete favorably with any well-developed foreign exchange market of international repute, but with the entry of online Foreign Exchange Companies such as FXKART, Book My Forex, BuyForex and others, the market is steadily growing. Around 25% of currency transfers/payments in India are made via non-bank Foreign Exchange Companies. Most of these companies use the USP of better exchange rates than the banks. They are regulated by FEDAI and any transaction in foreign Exchange is governed by the Foreign Exchange Management Act, 1999 (FEMA).

Money Transfer/Remittance Companies and Bureaux De Change

Money transfer/remittance companies perform high-volume low-value transfers generally by economic migrants back to their home country. In 2007, the Aite Group estimated that there were $369 billion of remittances (an increase of 8% on the previous year). The four largest markets (India, China, Mexico and the Philippines) receive $95 billion. The largest and best known provider is Western Union with 345,000 agents globally, followed by UAE Exchange-Bureax De Change or currency transfer companies provide low value foreign exchange services for travelers. These are typically located at airports and stations or at tourist locations and allow physical notes to be exchanged from one currency to another. They access the foreign exchange markets via banks or non-bank foreign exchange companies.

Market Size and Liquidity

The foreign exchange market is the most liquid financial market in the world. Traders include governments and central banks, commercial banks, other institutional investors and financial institutions, currency speculators, other commercial corporations, and individuals. The average daily turnover in the global foreign exchange and related markets is continuously [citation needed] growing. According to the 2010 Triennial Central Bank Survey, coordinated by the Bank for International Settlements, average daily turnover was US$3.98 trillion in April 2010 (compared to $1.7 trillion in 1998). Of this $3.98 trillion, $1.5 trillion was spot transactions and $2.5 trillion was traded in outright forwards, swaps, and other derivatives.

In April 2010, trading in the United Kingdom accounted for 36.7% of the total, making it by far the most important centre for foreign exchange trading in the world. Trading in the United States accounted for 17.9 per cent and Japan accounted for 6.2 per cent. In April 2013, for the first time, Singapore surpassed Japan in average daily foreign-exchange trading volume with $383 billion per day. So the order became: United Kingdom (41 per cent), United States (19%), Singapore (5.7 per cent), Japan (5.6 per cent) and Hong Kong (4.1 per cent) turn over of exchange-traded foreign exchange futures and options has grown rapidly in recent years, reaching $166 billion in April 2010 (double the turnover recorded in April 2007). As of April 2016, exchange-traded currency derivatives represent 2 per cent of OTC foreign exchange turnover. Foreign exchange futures contracts were introduced in 1972 at the Chicago Mercantile Exchange and are actively traded compared to most other futures contracts.

Most developed countries permit the trading of derivative products (like futures and options on futures) on their exchanges. All these developed countries already have fully convertible capital accounts. Some governments of emerging markets do not allow foreign exchange derivative products on their exchanges because they have capital controls. The use of derivatives is growing in many emerging economies. Countries such as South Korea, South Africa, and India have established currency futures exchanges, despite having some capital controls.

Foreign exchange trading increased by 20% between April 2007 and April 2010, and has more than doubled since 2004. The increase in turnover is due to a number of factors: the growing importance of foreign exchange as an asset class, the increased trading activity of high-frequency traders, and the emergence of retail investors as an important market segment. The growth of electronic execution and the diverse selection of execution venues has lowered transaction costs, increased market liquidity, and attracted greater participation from many customer types. In particular, electronic trading via online portals has made it easier for retail traders to trade in the foreign exchange market. By 2010, retail trading is estimated to account for up to 10% of spot turnover, or $150 billion per day (see below: Retail foreign exchange traders).

Foreign exchange is traded in an over-the-counter market where brokers/dealers negotiate directly with one another, so there is no central exchange or clearing house. The biggest geographic trading centre is the United Kingdom, primarily London, which according to The City UK estimates increased its share of global turnover in traditional transactions from 34.6 per cent in April 2007 to 36.7 per cent in April 2010. Due to London's dominance in the market, a particular currency's quoted price is usually the London market price. For instance, when the International Monetary Fund

calculates the value of its special drawing rights every day, they use the London market prices at noon that day.

Foreign Exchange Market Turnover

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Table showing the value of Currency distribution of global foreign exchange market turnover

Rank	Currency	Symbol/ISO4217 Code	%daily Share(April 2017)
1	USA Dollar	USD	87.6%
2	Euro	EUR	31.4%
3	Japanese Yen	JPY	21.6%
4	Pound sterling	GBP	12.8%
5	Australian Dollar	AUD	6.9%
6	Canadian Dollar	CAD	5.1%
7	Swiss franc	CHF	4.8%
8	Chinese yuan	CNY	4.00%
9	Swedish Krona	SEK	2.2%
10	New Zealand dollar	NZD	2.1%
11	Mexican Peso	MXN	1.9%
12	Singapore Dollar	SGD	1.8%
13	Hong Kong Dollar	HKD	1.7%
14	Norwegian Krone	NOK	1.7%
15	South Korean Won	KRW	1.7%

16	Turkish Lira	TRY	1.4%
17	Russian Ruble	RUB	1.1%
18	Indian Rupee	INR	1.1%
19	Brazilan Real	BRL	1.0%
20	South African Rand	ZAR	1.0%

There is no unified or centrally cleared market for the majority of trades, and there is very little cross-border regulation. Due to the over-the-counter (OTC) nature of currency markets, there are rather a number of interconnected marketplaces, where different currencies instruments are traded. This implies that there is not a single exchange rate but rather a number of different rates (prices), depending on what bank or market maker is trading, and where it is. In practice, the rates are quite close due to arbitrage. Due to London's dominance in the market, a particular currency's quoted price is usually the London market price. Major trading exchanges include Electronic Broking Services (EBS) and Thomson Reuters Dealing, while major banks also offer trading systems. A joint venture of the Chicago Mercantile Exchange and Reuters, called FX market space opened in 2007 and aspired but failed to the role of a central market clearing mechanism. Main trading centers are London and New York City, though Tokyo, Hong Kong and Singapore are all important centers as well. Banks throughout the world participate. Currency trading happens continuously throughout the day; as the Asian trading session ends, the European session begins, followed by the North American session and then back to the Asian session.

Fluctuations in exchange rates are usually caused by actual monetary flows as well as by expectations of changes in monetary flows. These are caused by changes in gross domestic product (GDP) growth, inflation (purchasing power parity theory), interest rates (Interest Rate parity, Domestic Fisher effect, and International Fisher effect), budget and trade deficits or surpluses, large cross-border M&A deals and other macroeconomic conditions. Major news is released publicly, often on scheduled dates; so many people have access to the same news at the same time. However, the large banks have an important advantage; they can see their customers' order flow.

On the Spot market, according to the 2016 Triennial Survey, the most heavily traded bilateral currency pairs were:

- EURUSD: 23.0%
- USDJPY: 17.7%
- GBPUSD: 9.2%

The U.S. currency was involved in 87.6% of transactions, followed by the euro (31.3%), the yen (21.6%), and sterling (12.8%). Volume percentages for all individual currencies should add up to 200%, as each transaction involves two currencies.

Trading in the euro has grown considerably since the currency's creation in January 1999, and how long the foreign exchange market will remain dollar-centered is open to debate. Until recently, trading the euro versus a non-European currency ZZZ would have usually involved two trades: EURUSD and USDZZZ. The exception to this is EURJPY, which is an established traded currency pair in the interbank spot market.

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History of Foreign Exchange Trading

- Currency and exchange were important elements of trade in the ancient world, enabling people to buy and sell items like food, pottery and raw materials. If a Greek coin held more gold than an Egyptian coin due to its size or content, then a merchant could barter fewer Greek gold coins for more Egyptian ones, or for more material goods. This is why, at some point in their history, most world currencies in circulation today had a value fixed to a specific quantity of a recognized standard like silver and gold.

Medieval and later

- During the 15th century, the family members were required to open banks at foreign locations in order to exchange currencies to act on behalf of textile merchants To facilitate trade, the bank created the nostro (from Italian, this translates to "ours") account book which contained two columned entries showing amounts of foreign and local currencies; information pertaining to the keeping of an account with a foreign bank During the 17th (or 18th) century, Amsterdam maintained an active Forex market In 1704, foreign exchange took place between agents acting in the interests of the Kingdom of England and the Country of Holland.

Early Modern

- Alex, Brown & Sons traded foreign currencies around 1850 and was a leading currency trader in the USA In 1880, J.M. do Espírito Santo de Silva applied for and was given permission to engage in a foreign exchange trading business.
- The year 1880 is considered by at least one source to be the beginning of modern foreign exchange: the gold standard began in that year.
- Prior to the First World War, there was a much more limited control of international trade. Motivated by the onset of war, countries abandoned the gold standard monetary system.

Modern to Post-modern

- From 1899 to 1913, holdings of countries' foreign exchange increased at an annual rate of 10.8%, while holdings of gold increased at an annual rate of 6.3% between 1903 and 1913.
- At the end of 1913, nearly half of the world's foreign exchange was conducted using the pound sterling. The number of foreign banks operating within the boundaries of London increased from 3 in 1860, to 71 in 1913. In 1902, there were just two London foreign exchange brokers At the start of the 20th century, a trade in currencies was most active in Paris, New York City and Berlin; Britain remained largely uninvolved until 1914. Between 1919 and 1922, the number of foreign exchange brokers in London increased to 17; and in 1924, there were 40 firms operating for the purposes of exchange.

- During the 1920s, the Kleinwort family were known as the leaders of the foreign exchange market, while Japheth, Montagu & Co. and Seligman still warrant recognition as significant FX traders The trade in London began to resemble its modern manifestation. By 1928, Forex trade was integral to the financial functioning of the city. Continental exchange controls, plus other factors in Europe and Latin America, Latin America hampered any attempt at wholesale prosperity from trade for those of 1930s London citizens

After World War

- In 1944, the Bretton Woods Accord was signed, allowing currencies to fluctuate within a range of ±1% from the currency's par exchange rate In Japan, the Foreign Exchange Bank Law was introduced in 1954. As a result, the Bank of Tokyo became the centre of foreign exchange by September 1954. Between 1954 and 1959, Japanese law was changed to allow foreign exchange dealings in many more Western currencies.
- U.S. President, Richard Nixon is credited with ending the Bretton Woods Accord and fixed rates of exchange, eventually resulting in a free-floating currency system. After the Accord ended in 1971, the Smithsonian Agreement allowed rates to fluctuate by up to ±2%. In 1961–62, the volume of foreign operations by the U.S. Federal Reserve was relatively low. Those involved in controlling exchange rates found the boundaries of the Agreement were not realistic and so ceased this, in March 1973, when sometime afterward none of the major currencies were maintained with a capacity for conversion to gold, organizations relied instead on reserves of currency From 1970 to 1973, the volume of trading in the market increased three-fold At some time (according to *Gandolfo* during February–March 1973) some of the markets were "split", and a two-tier currency market was subsequently introduced, with dual currency rates. This was abolished in March 1974.

Strategies Adopted for Boosting Currency Trading in India

1. Shifting to Onshore Trading from offshore trading: The RBI had been quite concerned about the subdued volumes and low participation in currency market. The rupee is traded in the Interbank OTC market and on the stock exchanges as exchange traded futures and options. But many foreign investors prefer to trade the rupee in offshore financial centers such as Singapore or Luxembourg. Since the RBI does not have any control on the movement of the currency in these offshore markets, It was feared that the currency would be exposed to volatility if offshore rupee trading increases. Strong linkage between offshore and onshore price of the rupee is another reason why the Central Bank wants the currency trading to shift onshore.

2. Allowing to take up additional currency position in Onshore Trading: RBI has allowed investors to take up $ 5million of currency position in onshore trading itself in addition to the $30 million. This extra limit is however available only to those already having outstanding positions of $30 million.

3. Increasing exposure to foreign investors: The exposure limit of foreign investors in exchange traded currency derivatives was increased to $15 million in 2015 from $10 Million.

4. Adding new Currency pairs: Three new Cross –Currency pairs-euro-dollar, pound-dollar and dollar-yen were also introduced in 2015.

5. Extension of Trading Time: The Regulators are now seriously considering to increase the trading time on Indian exchanges to enable traders to make the most of the developments that take place between 5pm and 11pm. Extending the trading time will be another booster for liquidity in currency markets.

6. Positivity in Non Trade Cash flows due to offering High Interest Rates

Example:

The Export-Import Bank of India (EXIM Bank) recently raised $1 billion, twice the amount it had originally targeted at decent rates. The total subscription offer even on the upped size was $2.5 billion. The bank's first issue in 2016, under 144 A and Reg.S of the US Securities Act, which allows restricted offering in the US and Unrestricted offering globally saw the 10 year maturity bonds getting a good response in the US. The bonds were issued at a coupon rate of 3.375 per cent which at the current level is around 187.5 basis points over the US treasuries. Whereas the yield on Denmark's 10 year bond is 0.36 per cent. Switzerland is negative -0.45 per cent and Germany's 10 year yield is -0.05 per cent. At this grim scenario, the Indian Exim Bank Bond was subscribed by the US investors almost 61 per cent of the issue.

FEATURES OF FOREIGN EXCHANGE MARKET

Foreign exchange market is the largest financial market in the world. It has its own special features with respect to the way it is organised, the participants in the market and the method by which the transactions are settled.

Salient Features

The salient features of foreign exchange market are seen in its location, size, hours of operations, efficiency and composition of currencies traded.

Location

Foreign exchange market is described as an OTC (Over the Counter) market as there is no physical place where the participants meet to execute the deals, as we see in the case of stock exchange. It is more an informal arrangement among the banks and brokers operating in a financial centre purchasing and selling currencies, connected to each. other by telecommunication like telex, telephone and a satellite communication network, SWIFT, the term foreign exchange market is used to refer to the wholesale segment of the market, where the dealings take place among the banks. The retail segment refers to the dealings that take place between banks and their customers. The retail segment is situated at a large number of places. The retail market can be considered the counters of the foreign exchange market.

The leading foreign exchange market in India is Mumbai. Kolkata, Chennai and Delhi are other centres accounting for bulk of the exchange dealings in India. The policy of Reserve Bank has been to decentralise exchange operations and develop more broad-based exchange markets. As a result of the efforts of Reserve Bank, Kochi, Bengaluru, Ahmedabad and Goa have emerged as new centres of foreign exchange market.

24-Hours Market

The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Major markets are situated in Sydney Tokyo, Hong Kong Singapore, Bahrain, Zurich, Frankfurt, Paris, Brussels, Amsterdam, London, New York, Montreal, Toronto, Chicago, San Francisco and Los Angeles. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning 24 hours of the day. However, a specific market will function only during the business hours. Some of the banks having international network and having centralised control of funds management may keep their foreign exchange department in the key centre open throughout i keep up with developments at other centres during their normal working hours.

In India, the market is open for the time the banks are open for their regular banking business. No transactions take place on Saturdays.

Efficiency

Developments in communication have largely contributed to the efficiency of the market participants keep abreast of current happenings by access to such services like Dow Jones Telera and Reuter. Any significant development in any market is almost instantaneously received by the other market situated at a far off place and thus has global impact. This makes the foreign exchange market very efficient.

Currencies Traded

In most markets US dollar is the principle currency, viz., the currency used to denominate international transactions. US dollar is involved as one of the currencies in 85% of the transactions followed b Euro (39%), Japanese Yen (19%) and Pound-sterling (13%). Most traded pairs of currencies are US Euro (28%), USD/JPY (14%) and USD/GBP (9%).

Participants

The participants in the foreign exchange, market comprise:

1. corporates;
2. commercial banks;
3. exchange brokers; and
4. central banks.

1. Corporates

The business houses, international investors, and multinational corporations may operate in the market to meet their genuine trade or investment requirements. They may also buy or sell currencies with a view to speculate or trade in currencies to the extent permitted by the exchange regulations. They operate by placing orders with the commercial banks. The deals between banks and their clients form the retail segment of foreign exchange market.

In India, the Foreign Exchange Management (Possession and Retention of Foreign Currency) Regulations, 2000 permit retention by resident of foreign currency up to USD 2,000. Foreign Currency Management (Realisation, Repatriation and Surrender of Foreign Exchange) Regulations, 2000 requires a resident in India who receives foreign exchange to surrender it to an authorised dealer:

(a) Within seven days of receipt in case of receipt by way of remuneration, settlement of lawful obligations, income on assets held abroad, inheritance, settlement or gift; and

(b) Within ninety days in all other cases.

Any person who acquired foreign exchange but could not use it for the purpose or for any other permitted purpose is-required to surrender the unutilised foreign exchange to an authorised dealer within sixty days from the date of acquisition. In case the foreign exchange was acquired for travel abroad, the unspent foreign exchange should be surrendered within ninety days from the date of return to India when the foreign exchange is in the form of foreign currency notes and coins and within 180 days in case of traveller's cheques.

Similarly, if a resident require foreign exchange for an approved purpose he should obtain it from an authorised dealer.

2. Commercial Banks

Commercial banks are the major players in the market. They buy and sell currencies for their clients. They may also operate on their own. When a bank enters a market to correct excess or sale or purchase .position in a foreign currency arising from its various deals with its customers, it is said to do a cover operation. Such transactions constitute hardly 5% of the total transactions done by a large bank. A major portion of the volume is accounted by trading in currencies indulged by the bank to t from exchange movements. For transactions involving large volumes banks may deal directly among themselves. For smaller transactions the intermediation of foreign exchange brokers may be sought.

3. Exchange Brokers

Exchange brokers facilitate deal between banks. In the absence of exchange brokers, banks have to contact each other for quotes. If there are 150 banks at a centre, for obtaining the best quote for a single currency, a dealer may have to contact 149 banks. Exchange brokers ensure that the most, favourable quotation is obtained and at low cost in terms of time and money. The bank may leave, with the broker the limit up to which and the rate at which it wishes to buy or sell the foreign currency concerned. From the indents from other banks the broker will be able to match the requirements of both. The names of the counterparties are revealed to the banks only when the death is acceptable to them. Till then anonymity is maintained. Exchange brokers tend to specialise certain exotic currencies, but they also handle all major currencies.

In India banks may deal directly or through recognised exchange brokers. Accredited exchange brokers are permitted to contract exchange business on behalf of authorised dealers in foreign exchange only upon the understanding that they will conform to the rates, rules and conditions laid down by the FEDAI. All contracts must bear the clause "Subject to the Rules and Regulations of the Foreign Exchange Dealers. Association of India".

4. Central Bank

Central bank may intervene in the market to influence the exchange rate and change it from that would result only from private supplies and demands. The central bank may transact in the market on its own for the above purpose. Or, it may do so on behalf of the government when it buys or s bonds and settles other transactions which may involve foreign exchange payments and receipts.

In India, authorised dealers have recourse to Reserve Bank to sell/buy US dollars to the extent the latter is prepared to transact in the currency at the given point of time. Reserve Bank will not ordinarily buy/sell any other currency from/to authorised dealers. The contract can be entered into on any working day of the dealing room of Reserve Bank. No transaction is entered into on Saturdays. The value date for spot as well as forward delivery should be in conformity with the national and international practice in this regard.

Reserve Bank of India does not enter into the market in the ordinary course. Where the exchange rates are moving in a detrimental way due to speculative forces, the Reserve Bank may intervene in the market either directly or through the State Bank of India.

Purpose of Transacting

Based on the purpose of their participation, the users of foreign exchange market can be classify as (a) hedgers, (b) speculators, and (c) arbitrageurs.

(a) Hedgers

Hedgers are those who have an exposure to a risk and resort to foreign exchange market as a means of covering their position. Hedging is the method of entering into an opposite position in the market to that of the position held in a currency, so that ultimately the position becomes zero. For instance an exporter who has a receivable in dollars due six months hence can hedge his position by entering into a forward exchange contract with his bank to sell dollars. The positive position in dollar under receivables is offset by the sale made under the forward contract. His overall position in dollars becomes zero.

How frequently and in what circumstances a hedger resorts to foreign exchange market depends upon his risk preference. A treasurer who is risk averse may seek cover in the market for every exposure. He will do so irrespective of the expectations about the exchange rate to prevail on the due date. On the other hand, a treasurer with a risk appetite looks not only at the risk, but also desirability of keeping his position so as to earn opportunity profits from exchange rate movements. He weighs the cost of hedging with losses likely to be incurred by keeping the position open. He also measures the profits likely to be earned when the position is kept open. He resorts to hedging only when the benefits expected from covering the position are greater than the cost.

(b) Speculators

Speculators enter into deals with the expectation of making profit out of such transactions. A speculator watches the market carefully and makes his own estimates of the future movement in the rates. Based on his estimates he makes moves in the market and hopes to gain from the ultimate results. For instance, if the speculator calculates that the dollar will, appreciate in future, he will accumulate dollars at the current rate with the intention of selling them at a higher price later. When a speculator

feels strongly that the market will behave differently from the general sentiments, he perceives an opportunity for profits by taking appropriate position in the currency concerned. This urge to make money and attitude towards taking risks makes a speculator an ideal person to act as sellers of the financial products in the foreign exchange market.

Speculators as a class are risk-takers. They are the cause for both volatility and efficiency of the market. As a result of the speculative activities, the market may show excessive reaction to the events and often the rates may overshoot. The cumulative wisdom of the speculators who do not react in the same way enables the market to discount all the information and function efficiently.

(c) Arbitrageurs

Arbitrageurs are a careful lot who keep constant vigil on the market, across products and locations, to identify temporary imperfections and convert such opportunities into riskless profits. In the pure form of arbitraging, the operator:

(a) has no investment; and

(b) simultaneously buys and sells in different markets and/or for different periods which ensures riskless profits to him.

Suppose that an arbitrageur finds that dollar is quoted differently in two markets, say Singapore and London. He can buy from the market quoting dollar cheaper and sell it in the market where it is quoted high. The difference realised, less the transaction cost, will be his profit. Similar actions by a large number of arbitrageurs will increase the demand for dollar where it is quoted low and push up the- price. In the market where the price rules high, supply will increase due to the action of the arbitrageurs and consequently the price will fall. Thus the arbitrage possibility will be only momentary and prices in the market will be soon restored to a level where arbitraging is not possible.

SETTLEMENT OF TRANSACTIONS

Foreign exchange markets make extensive use of the latest developments in telecommunications for transmitting as well settling foreign exchange transactions. Banks use the exclusive network SWIFT to communicate messages and settle the transactions at electronic clearing houses such as CHIPS at New York.

SWIFT. SWIFT is a acronym for Society for Worldwide Interbank Financial Telecommunication, a co-operative society owned by about 250 banks in Europe and North America and registered as a co-operative society in Brussels, Belgium. It is a communications network for international financial market transactions linking effectively more than 25,000 financial institutions throughout the world who have been allotted bank identifier codes. The messages are transmitted from country to country via central-interconnected operating centres located in Brussels, Amsterdam and Culpeper, Virginia. The member-countries are connected to the centres through regional processors in each country. The local banks in each country reach the regional processors through the national networks.

The SWIFT system enables the member-banks to transact among themselves quickly. The international payments, (ii) statements, and (iii) other messages connected with international banking. Transmission of messages takes place within seconds and, therefore, this method is economical as well

as time saving. Selected banks in India have become members of SWIFT. The regional processing centre is situated at Mumbai.

The SWIFT Provides Following Advantages for the Local Banking Community

1. Provides a reliable (time tested) method of sending and receiving messages from a number of banks in a large number of locations around the world.
2. Reliability and accuracy are further enhanced by the built-in authentication facilities, which have only to be exchanged with each counterparty before they can be activated for further communications.
3. Message-relay is instantaneous enabling the counterparty to respond immediately,' prevented by time differences.
4. Access is available to a vast number of banks globally for launching new crossborder initiatives.
5. Since communication in SWIFT is to be done using structure formats for various banking transactions, the matter to be conveyed will be very clear and there will not be any ambiguity of any sort for the receiver to revert for clarifications. This is mainly be the formats are used all over the world on a standardised basis for conducting all types banking transactions. This makes the responses and execution very efficient receiving bank's end thereby contributing immensely to quality service being provided to customers of both banks (sending arid receiving).
6. Usage of SWIFT structure formats for message transmission to counterparties will entail the generation of local banks' internal records using at least minimum level of automation This will accelerate the local banks' internal automation activities, since for maxi utilisation of SWIFT a significant internal automation level is required.

CHIPS. CHIPS stands for Clearing House Interbank Payment System. It is an electronic pay system owned by 12 private commercial banks constituting the New York Clearing Association. CHIPS began its operations in 1971 and has grown to be the world's largest pasystem. Foreign exchange and Euro-dollar transactions are settled through CHIPS. It provide mechanism for settlement every day of payment and receipts of numerous dollar transactions a member-banks at New York, without the need for physical exchange of cheques/funds for each transaction.

The functioning of CHIPS arrangement is explained below with an hypothetical transaction Bank of India, maintaining a dollar account with Amex Bank, New York, sells USD 1 million to CanaraBank,, maintaining dollar account with CitiBank. Fig. 4.1 explains how settlement for the transaction is done.

1. Bank of India intimates Amex Bank through SWIFT to debit its account and transfer 1 million to CitiBank for credit of current account of Canara Bank.
2. Amex Bank debits the account of Bank of India with USD 1 million and sends the equiv of electronic cheque to CHIPS for crediting the account of CitiBank. The transfer is effected the Same day.

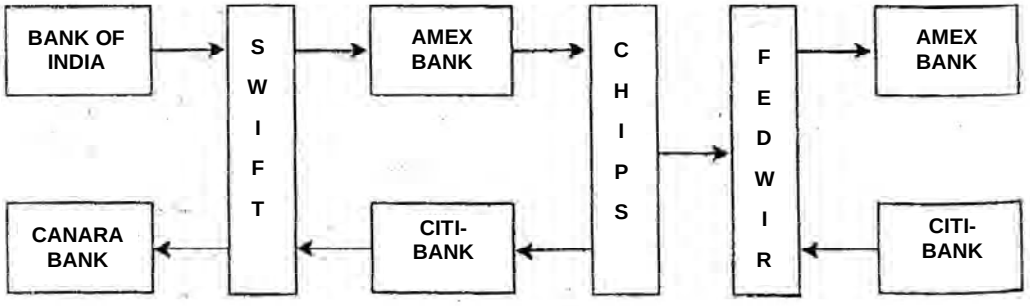


Fig. 4.1: Settlement of Transaction through CHIPS

3. Numerous such transactions are reported to CHIPS by member-banks and transfer effected at CHIPS. By about 4.30 p.m. eastern time, the net position of each member is arrived at and funds made available at Fed wire for use by the bank concerned by 6.00 p.m. eastern time.
4. Citi Bank which receives the credit intimates Canara Bank through SWIFT.

It may be noted that settlement of transactions in the New York foreign exchange market takes place in two stages. First, clearance at CHIPS and arriving at the net position for each bank. Second, transfer of Fedfunds for the net position. The real balances are held by banks only with Federal Reserve Banks (Fed funds) and the transaction is complete only when Fed funds are transferred. CHIPS helps in expediting the reconciliation and reducing the number of entries that pass through Fed wire.

CHAPS. CHAPS is an arrangement similar to CHIPS that exists in London. CHAPS stands for Clearing House Automated Payment System.

Fedwire. The transactions at New York foreign exchange market ultimately get settled through Fedwire. It is a communication network that links the computers of about 7,000 banks to the computers of Federal Reserve Banks. The Fedwire funds transfer system operated by the Federal Reserve Bank are used primarily for domestic payments, bank to bank and third party transfers such as interbank overnight funds sales and purchases and settlement transactions. Corporate-to-corporate payments can also be made, but they should be effected through banks. Fed guarantees settlement on all payments sent to receivers even if the sender fails.

TRANSACTIONS IN INTERBANK MARKETS

Purchase and Sale Transactions

Foreign exchange market is a market where currencies are traded. Any trading has two aspects (i) purchase, and (ii) sale. A trader has to purchase goods from his suppliers which he sells to his .customers. The peculiarity of foreign exchange market is that the same person can be the buyer as as seller in the commodity, viz., the foreign currency. In the deal between one bank and another bank, it is essential to understand the implication of the words purchase and sale. What is purchase le for the counterparty. Similarly, what is currency for one party may be the commodity (foreign Tency) for the other party. The standard practice in the market is to interpret the transaction from the perspective of

the market maker (quoting bank) who is the price maker. Thus two points need to be constantly kept in mind while talking of a foreign exchange transaction:

(i) The transaction is always talked of from the quoting bank's point of view; and

(ii) The item referred to is the foreign currency.

Therefore, when we say a purchase, we imply that

(a) The quoting bank has purchased; and

(b) It has purchased foreign currency.

Similarly, when we say a sale, we imply that

(a) The quoting bank has sold; and

(b) It has sold foreign currency.

In a purchase transaction the quoting bank acquires foreign currency and parts with home currency. In a sale transaction the quoting bank parts with foreign currency and acquires home currency.

Where both the currencies transacted are foreign currencies, for instance, when Japanese Yen exchanged for US dollars in Mumbai market, the interpretation as to which currency is purchased or sold is not provided by the above definition. The case of these cross currency transactions are explained later under American and European quotations.

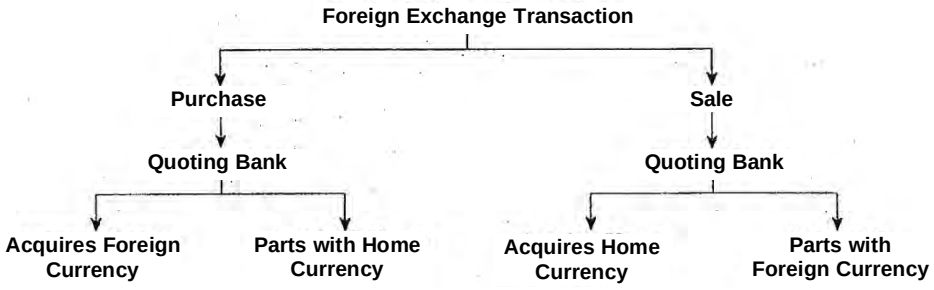


Fig. 4.2: Sale and Purchase Transactions

Types of Forex Transactions

The transactions in inter-bank market may fall under any of the following categories:

(a) spot transactions;

(b) forward transactions;

(c) swap transactions;

(d) non-deliverable forwards.

Spot Transactions

The transaction where the exchange of currencies takes place two days after the date of the contra is known as the spot transaction. For instance, if the contract is made on Monday, the delivery shout; take place on Wednesday. If Wednesday is a holiday, the delivery will take place on the next day, i.e., Thursday, The date on which the currencies are to be exchanged is the value date. Both the currencies

involved are paid on the same day so that there is no loss of interest to either of the parties for instance, if Canara Bank buys US dollars from SBI at Mumbai, the rupee payment will be made Mumbai through the accounts maintained by both the banks with Reserve Bank. US dollar payment will be made at New York, by the correspondent of SBI paying to the correspondent bank Canara Bank account. Both the rupee payment by Canara Bank and dollar payment will take place on the same value date.

When no qualifications are added, a transaction in the interbank market is a spot transaction. But funds may be required urgently by a bank in which case it may require early settlement. In this case it may ask for a special quotation for delivery the same day or the next day.

Where the agreement to buy and sell is agreed upon and executed on the same date, transaction is known as cash or ready transaction. It is also known as value today.

A transaction in which the currencies to be exchanged the next day of the transaction is know. As value tomorrow or torn transaction.

Forward Transactions

The transaction in which the exchange of currencies takes place at a specified future date, subsequent to the spot date, is known as a forward transaction or outright forward transaction. The forward transaction can be for delivery one, two or three months, etc. A forward contract for delivery one month means the exchange of currencies will take place after one month from the date of contract. A forward contract for delivery two months means the exchange of currencies will take place after two months, and so on. The date for forward contract will be calculated from the spot date. For instance, 1 month forward contract entered into on 22nd March will fall due on 24th April. If it is a holiday, the contract will be due on the next working day. As an exception to this rule, if the next day of such due date runs into the next month, the due date is advanced to the preceding day and not the succeeding day.

Swap Transactions

A swap transaction is a deal between the same counterparties in which the same currency for same value is purchased and sold for different maturities. For instance, Dena Bank and IDBI Bank agree under which Dena Bank buys USD 5 million spot and sells it forward for 2 months. The difference between the spot price and forward price is equivalent to the forward margin discussed in the next section. Therefore, the forward margin is also known as swap points. The swap deal may also involve two forwards like purchase of 3 months forward and sale of 6 months forward. The need and mechanism of swap transactions is discussed in detail in the chapter on Exchange Dealings.

Non-deliverable Forwards

This instrument was developed in 1990s. Under non-deliverable forwards actual delivery of forward contract does not take place. On the due date, the spot rate for the currency concerned is compared with the forward rate agreed under the contract and the difference is settled. The market exists for emerging currencies for which ready market may not exist. The markets concerned also exhibit disparities in interest rates and exchange rates offering arbitraging possibilities. The settlement is invariably done in US dollars.

Quotations in Interbank Markets

The big banks in the market are known as market makers, as they are willing to buy or sell foreign currencies at the rates quoted by them up to any extent. Depending upon its resources, a bank maybe a market maker in one or few major currencies. When a banker approaches the market maker, it would not reveal its intention to buy or sell the currency. This is done in order to get a fair price from the market maker.

Two-way Quotation

Typically, the quotation in the interbank market is a two-way quotation. It means, the rate quoted by the market maker will indicate two prices, one at which it is willing to buy the foreign currency, and the other at which it is willing to sell the foreign currency. For example, a Mumbai bank may quote its rate for US dollar as under:

USD 1 = ₹ 46.1525/1650

More often the rate would be quoted as 1525/1650 since the players in the market are expected to know the 'big number', i.e., ₹ 46. In the given quotation, one rate is ₹ 46.1525 per dollar and other rate is ₹ 46.1650 per dollar.

The buying rate is also known as the bid rate or ask rate and the selling rate as the offer rate. The difference between these rates is the gross profit for the bank and is known as the 'spread'.

Direct and Indirect Quotation

The quotation in the foreign exchange market may be made in either of the two ways. For instance, the rupee-dollar rate may be quoted in Mumbai as USD 1 = ₹ 46.1525/1650. Or it may also be quoted as ₹100 = USD 2.1662/1667.

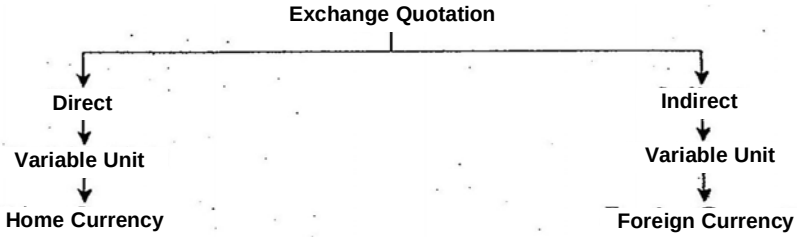


Fig. 4.3: Direct and Indirect Quotations

Direct Quotation

It will be obvious that in the first quotation the quoting bank will be willing to buy dollars at ₹ 46.1525 and sell dollars at ₹ 46.1650. If one dollar and bought and sold, the bank makes a great profit of ₹ 0.0125. In a foreign exchange quotation, the foreign currency is the commodity that being bought and sold. The exchange quotation which gives the price for the foreign currency terms of the domestic currency is known as direct quotation. In a *direct quotation,* the unit of foreign currency is kept constant and change in price is indicated by change in the number of i of the domestic currency equivalent to one foreign currency. For instance, US dollar quoted at ₹ may be quoted at ₹ 46 or ₹ 49 as may be warranted. Direct quotation is also known as *currency quotation.*

The Maxim—Buy Low; Sell High. The prime motive of any trader is to make profit. He earns profit by purchasing the commodity at a lower price and selling it at a higher price. In forex exchange too, the bank buys the foreign currency at a lesser price and sells it at a higher price For instance he may buy US dollar at ₹ 48 and sell at ₹ 48.10. Thus, in direct quotation the principle adopted by the bank *is to buy at a lower price and sell at a higher price.* This principle is stated in form of a maxim: *'Buy Low; Sell High'.*

In India, Direct Quotation was prevalent till 1966. After devaluation of rupee in 1966, following the practice in London exchange market, indirect quotation was adopted. Effective from 2nd August 1993, India has switched over to direct method of quotation.

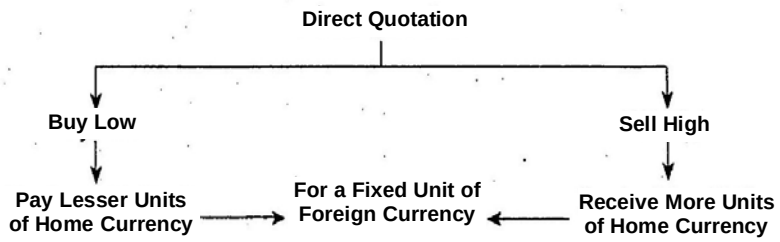


Fig 4.4: Direct Quotation - Buy Low; Sell High

• Indirect Quotation

The other way of quoting in the foreign exchange is: ₹ 100 = USD 2.1662/1667.

This type of quotation at Mumbai gives the quantity of foreign currency per unit of domestic currency and is known as indirect quotation. In this case, the quoting bank will receive USD 2.1667 per ₹ 100 while buying dollars and give away USD 2.1662 per ₹ 100 while selling dollars. In indirect quotation, the unit of domestic currency is kept constant and the change in the price of the currency is indicated by varying units of the foreign currency for fixed sum of domestic currency. Indirect quotation is also known as foreign currency quotation or simply currency quotation.

The Maxim—Buy High; Sell Low. Let,us suppose the statement is to be with respect to the quantity that a trader purchases and sells of the variation in price. For a fixed amount of investment, he would acquire more units of the commodity when he purchases and for the same amount he would part with lesser units of the commodity when he sells. Taking an orange vendor as example, if for ₹ 100 he gets 50 oranges from his supplier and for the same amount of ₹ 100 he sells 40 oranges, he would make profit.

The same principle can be applied to a foreign exchange quotation. In indirect quotation, it is the commodity of the trade, viz., the foreign currency, which is varying in accordance with the change in exchange rates. For a fixed unit of home currency, the bank would like to acquire more units of foreign currency while buying and part with lesser units of foreign currency while selling. For example, for ₹ 100, the bank may quote a selling rate of USD 2.3000 and buying rate of USD 2.3100. The difference between USD 2.31 CO and USD 2.3000 is the bank's margin of profit. The position is summed up in the maxim—Buy High; Sell Low.

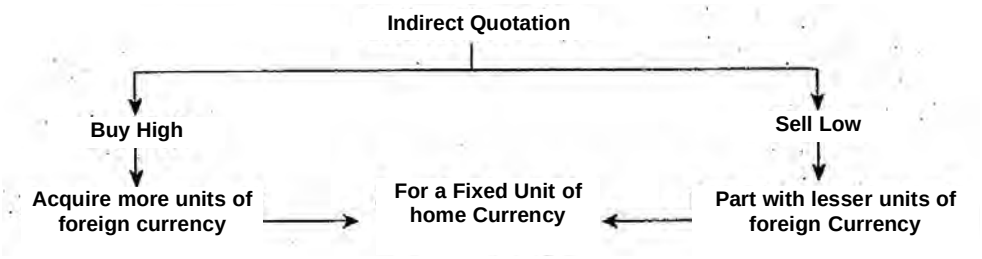


Fig. 4.5: Indirect Quotation - Buy High; Sell Low

American and European Quotation

Interpretation of quotations as direct and indirect is not convenient when the market quotes rates for two currencies neither of which is the domestic currency. To avoid multiple quotations, international markets adopt the US dollar as the standard currency and exchange rates are quoted terms of or against this currency. Based on the fact, whether the exchange rate is in terms of or against US dollar, the quotation is termed as American or European quotation. The quotation is in American terms when the rate is expressed as so many units of US dollar per unit of foreign currency. It is in European terms when the quotation is the number of foreign currency per unit of US dollar.

In international markets, barring few exceptions, all rates are quoted in European terms. For instance, at Singapore, Swiss Franc may be quoted at 1.5425 440 and Japanese Yen at 104.67/70. This could be understood as:

USD 1=CHF 1.5425-1.5440

USD 1=JPY 104.67-104.70 In interpreting an international market quotation, we may approach from the variable currency or the standard currency, viz., the dollar. For instance, we may take a transaction in which Swiss Franc are received in exchange for dollars as: (a) purchase of Swiss Francs against Dollar, or (b) sale of Dollar against Swiss Francs. For the sake of uniformity we will assume the standard currency as the currency being bought or sold.

The quotation for Swiss Franc is CHF 1.5425 and CHF 1.5440 per Dollar. While buying dollar the quoting bank would part with fewer francs per dollar and while selling dollars would require as many francs as possible. Thus CHF 1.5425 is the dollar buying rate and CHF 1.5440 is the dollar selling rate. It may be observed that when viewed from dollar the exchange quotation partakes, the character of a direct quotation and the maxim 'Buy low; Sell high' is applicable. We will denote such rates as Dollar/Foreign Currency Rates, implying that dollar is being bought or sold against foreign currency.

Few currencies such as pound sterling and Euro are quoted in American terms as i.e., variable units of US dollar. They are quoted as so many US dollars per unit of foreign currency concerned. Examples are:

GBP 1 = USD 1.4326/4348

EUR 1 = USD 0.9525/9548

The standard currency here is the foreign currency. Taking Euro as example, the quoting bank will buy that currency at USD 0.9525 and sell at USD 0.9548. We will indicate such quotation as

'Foreign Currency/Dollar Rate', the quotation being for purchase or sale of foreign currency against dollars.

Cross Rates and Chain Rule

As stated earlier, the exchange rate in the foreign exchange market is quoted in terms of the standard currency, viz., US dollar. The exchange rate between a pair of currencies, neither of them being U$ dollar is worked by using the rate for each of these currencies in terms of/US dollar. Such rate 'known as the cross rate. For instance, suppose the rate for Swiss Francs is required in terms o\ Indian rupee and the rates in Mumbai market are as under:

USD 1 = ₹ 46.50

USD 1 = CHF 1.8000

The rate for Swiss francs in terms of rupees can be calculated by 'chain rule' as follows:

₹ = CHF1

if CHF 1.8000 = USD 1

USD 1 = ₹ 46.50

and It should be noted that the currency which appears as the second item (right-hand side) in the first equation appears as first item (left-hand side) in the next equation. Thus franc appears on the right-hand side in the first equation and left-hand side in the second equation. US dollar which, appears on the right-hand side in the second equation appears on the left-hand side in the third equation.

The rate of exchange between Indian rupee and Swiss franc can be calculated by dividing t product of the right-hand side by the product of the left-hand side.

$$\frac{4650 \times 1 \times 1}{1,8000} = ₹ 25.83$$

It would be immediately seen that the above calculation involves simply dividing the rupee dollar rate by the dollar-mark rate.

In respect of currencies quoted indirectly against US dollar, e.g., Euro and Sterling, the foreign currency/rupee rate is calculated by multiplying the dollar/rupee rate and foreign currency/dollar rate. This is illustrated numerically below.

Foreign Exchange Markets

Dollar/rupee is 46.50 and Euro/dollar is 1.1568. Euro/rupee rate can be calculated thus:

? ₹ = Eur 1

Eur 1 = USD 1.1568

USD 1 = ₹ 46.50

$$\frac{1 \times 1,568 \times 46.50}{1 \times 1} = ₹ 53.7912$$

Forward Rates

Forward rate may be the same as the spot rate for the currency. Then it is said to be 'at par' with the spot rate. But this rarely happens. More often the forward rate for a currency may be costlier or cheaper than its spot rate. The difference between the forward rate and the spot rate is known as the 'forward margin' or 'swap points'. The forward margin may be either at 'premium' or at 'discount'. If the forward margin is at premium, the foreign currency will be costlier under forward rate than under the spot rate. If the forward margin is at discount, the foreign currency will be cheaper for forward delivery than for spot delivery.

Under direct quotation, premium is added to spot rate to arrive at the forward rate. This is done for both purchase and sale transactions. Discount is deducted from the spot rate to arrive at the forward rate.

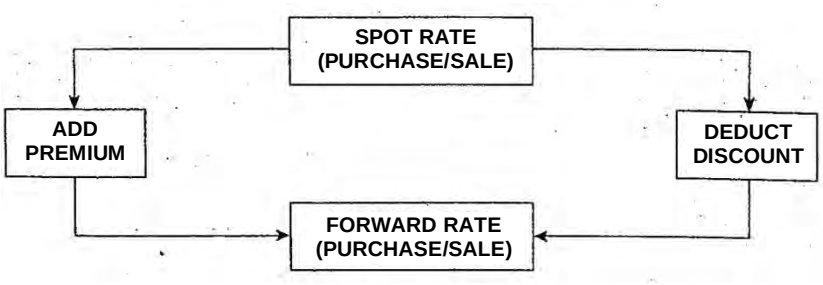


Fig. 4.6: Calculation of Forward Rates under Direct Quotation

Interpretation of Interbank Quotations

The market quotation for a currency consists of the spot rate and the forward margin. The outright forward rate has to be calculated by loading the forward margin into the spot rate. For instance, US .dollar is quoted as under in the interbank market on 25th January as under:

Spot USD 1 = Rf. 48.4000/4200

Spot/February 2000/2100

Spot/March 3500/3600

The following points should be noted in interpreting the above quotation:

(i) The first statement is the spot rate for dollars. The quoting bank's buying rate is ₹ 48.4000 and selling rate is ₹ 48.4200.

(ii) The second and third statements are forward margins for forward delivery during the months of February and March respectively. Spot/February rate is valid for delivery end February. Spot/March rate is valid for delivery end March.

(iii) The margin is expressed in points, i.e., 0.0001 of the currency. Therefore, the forward margin for February is 20 paise and 21 paise.

(iv) We have seen that under direct quotation, the first rate in the spot quotation is for buying and second for selling the foreign currency. Correspondingly, in the forward margin, the

first rate relates to buying and the second to selling. Taking Spot/February as an example, the margin of 20 paise is for purchase and 21 paise is for sale of foreign currency.

(v) Where the forward margin for a month is given in ascending order as in the quotation above, it indicates that the forward currency is at premium. The outright forward rates the arrived at by adding the forward margin to the spot rates.

The outright forward rates dollar can be derived from the above quotation as follows:

	Buying rate		**Selling rate**	
	February	**March**	**February**	**March**
	₹	**₹**	**₹**	**₹**
Spot rate	48.4000	48.4000	48.4200	48.4200
Add: Premium	0.2000	0,3500	0-2100	0.3600
Forward rates	48.6000	48.7500	48.6300	48.7800

from the above calculation, we arrive at the following outright rates:

	Buying	**Selling**
Spot delivery	USDl = ₹ 48.4000	48.4800
Forward delivery February	48.6000	48.6300
Forward delivery March	48.7500	48.7800

If the forward currency is at a discount, it would be indicated by quoting the forward margin the descending order. Suppose that on 20th April the quotation for pound-sterling in the interbank market is as follows:

Spot GBP 1 = ₹ 73.4000/4300

Spot/May 3800/3600 Spot/June 5700/5400 Since the forward margin is in descending order (3800/3600), forward sterling is at discount,

The outright forward rates are calculated by deducting the related discount from the spot rate. This is shown below:

	Buying rate		**Selling rate**	
	May	**]une**	**May**	**June**
	₹	**₹**	**₹**	**₹**
Spot rate	73.4000	73.4000	73.4300	73.4300
Less: Discount	0.3800	0.5700	0.3600	0.5400
Forward rate	73.0200	72.8300	73.0700	72.8900

From the above calculations the outright rates for pound sterling can be restated as follows.

		Buying	**Selling**
Spot	GBP1=	₹ 73.4000	73.4300
Forward delivery May-		73.0200	73.0700
Forward delivery June		72.8300	72.8900

FORWARD RATES IN INTERNATIONAL MARKETS

In the international markets the forward margin is quoted in number of months from the date of quotation. Earlier, in India too, the same method of quotation was adopted period Under this method, the exchange rate for US dollar may be quoted on 22nd March as follows:

Spot	**USD 1 = ₹ 48.4525/4750**
1 month	2200/2300
2 months	4500/4600

Dollar/Foreign Currency Quotation. At Singapore market, dollar may be quoted against Swiss franc and Japanese yen as follows:

	Swiss Franc	**Japanese Yen**
Spot	1.5425/40	104.67/70
1 month forward	50/60	17/16
2 months forward	70/80	30/29

The forward margin (also called swap margin or swap points) is quoted in terms of points. A pint is the last decimal place in the exchange quotation. Thus, in a four digit quotation, a point is 0.0001. In a two decimal quotation, it is 0.01.

As against Swiss franc, the forward margin for dollar is CHF 0.0050/0.0060. Since the order in which the forward margin is ascending forward dollar is at premium. Premium is added to the spot rate to arrive at the forward rates, both in respect of purchase and sale transactions.

Based on the data given above, the forward rates for dollar against Swiss francs are arrived at as follows

	Dollar Buying	**Dollar Selling**
1 month forward	CHF 1.5475	1.5500
2 months forward	CHF 1.5495	1.5520

As against Japanese Yen, the forward dollar is at a discount. (Note that the forward margin is in descending order.) Discount is deducted from the spot rate to arrive at the forward rate, both for buying and selling.

The forward rates for dollar against Japanese yen, based on the data already given are as follows:

	Dollar Selling	**Dollar Buying**
1 month forward	JPY 104.50	104.54
2 months forward	JPY 104.37	104.41

Foreign Currency/Dollar Quotation. Let us assume the following exchange rates are prevailing:

	Pound Sterling	Euro
Spot	1.4326/48	0.9525/35
1 month forward	50/53	65/62
2 months forward	90/93	84/82

Against dollar, the forward pound sterling is at premium. Premium should be added to the spot rate to arrive at the forward rate. Thus the forward rates for pound sterling are as follows:

	Pound Sterling	Pound Sterling
	Buying	Selling
1 month forward	USD 1.4376	1:4401
2 months forward	USD 1.4416	1.4441

Forward Euro is at discount, since the forward margin is quoted in the descending order. Discount should be deducted from the spot rate to arrive at the forward rate.

Based on the data given, forward rates for Euro can be arrived at as follows:

	Euro	Euro
	Buying	Selling
1 month forward	USD 0.9460	0.9473
2 months forward	USD 0.9441	0.9453

Interbank Rates and Arbitraging

Arbitrage operations refer to simultaneous purchase and sale of the same or different assets with a view to earning riskless profits. Financial markets, including currency markets, are efficient and the possibility of earning arbitrage profit rarely exists. However, imperfections may creep into these markets giving rise to arbitraging possibilities. Such chances are fleeting and soon vanish by the action of the arbitrageurs who are ever vigilant to capture them. The arbitraging operations move the rates to convergence and variations in rates are quickly removed. The possibilities of arbitrage in foreign exchange markets are discussed below.

Quotations of Market Makers

The exchange rate quoted for a currency by different market makers may differ slightly. Therefore for a price taker it may be beneficial to scout for best rate from different banks. But the difference) the rates quoted by the market makers will not differ to an extent required to enable arbitraging. for instance, the rupee-dollar rate quoted by SBI and ICICI Bank for US dollar at a particular time maybe as under:

SBI – USD 1 = ₹ 45.6250/6375

ICICI Bank – USD 1 = ₹ 45.6175/6300

US dollar is costlier with SBI. Yet the rates are such that arbitraging is not possible. Suppose dealer wants to utilise the situation by buying from ICICI Bank where the dollar is cheaper and it to SBI where it is costlier. He can buy from ICICI Bank at its selling rate of ₹ 45.6300 per dollar and sell to SBI at its buying rate of ₹ 45.6250 per dollar. He will be buying at a higher rate and selling at a lower rate and incur a loss of ₹ 0.0050 per dollar. Thus arbitraging is not possible and the given situation. As long as the rates quoted by the market markets overlap, there is no arbitraging, possibility.

Arbitraging profits can arise if the rate quoted by a market maker falls outside the range of the other. Suppose the following rates are prevalent:

SBI – USD 1 = ₹ 45.6250/6375

ICICI Bank – USD 1 = ₹ 45.6125/6225

An arbitrageur can buy dollars from ICICI Bank at ₹ 45.6225 and sell them to SBI at ₹ 45.625 thereby making a riskless profit of ₹ 0.0025 per dollar. But continued operations by arbitrager in the market will put pressure on ICICI Bank. After exhausting its dollar balances it will be forced to raise the price of dollars to curb the demand. On the contrary, the large-scale purchases of dollar by SBI will force it to show its disinclination for further transactions by lowering its rate for dollar. As a combined result, the exchange rates by the two market makers will converge, eliminating the arbitraging chances.

Why should the rates quoted by the market makers differ? Initially it may be trial and error effort to reach the equilibrium rate. The difference may also be deliberate attempt by the market maker, either to buy or sell the currency depending upon his exchange position in the currency concerned. A market maker is expected to buy or sell the currency as required by the counterparty irrespective of his own position in the currency. As a result a bank which has overbought position in one currency may end up in transactions which further add to this balance. A market maker cannot explicitly say whether he prefers to buy or sell the currency. However, he may quote the rate in such a way that he ends up with desired type of transactions.

Let us recall the rates quoted by SBI and ICICI Bank for dollar.

SBI – USD 1 = ₹ 45,6250/6375

ICICI Bank – USD 1 = ₹ 45.6125/6225

It seems that SBI prefers to buy dollar rather than sell it. May be, it is oversold in that currency. Or, its dealer may expect a raise in dollar value and wants to acquire it. Sellers of dollars will find its rate beneficial as compared to that of ICICI Bank. On the other hand, buyers of dollars will prefer ICICI Bank which offers dollar cheaper. Perhaps ICICI Bank wants it that way because it has huge dollar balances. After their exchange positions are balance, the exchange rates of these two banks may also converge.

A market maker who wants to avoid transactions in dollar altogether may quote a rate which would be preferred neither by buyers nor by sellers. Say OBC quotes rate for dollar as follows:

USD 1 = ₹ 45.6200/6325.

The buying rate is worse than that of SBI and the selling rate is worse than that of ICICI Bank. Thus, OBC avoids both purchase and sale transactions in dollar.

SUMMARY

The foreign exchange market gets to function through financial Institutions and operate on several levels. Behind the scenes, banks turn to a smaller number of financial firms known as "dealers", who are actively involved in large quantities of foreign exchange trading. Most foreign exchange dealers are banks, so this behind-the-scenes market is sometimes called the "interbank market" (although a few insurance companies and other kinds of financial firms are involved). Trades between foreign exchange dealers can be very large, involving hundreds of millions of dollars. Because of the sovereignty issue when involving two currencies, Forex has little (if any) supervisory entity regulating its actions.

By means of Currency Conversion from domestic currency to foreign currency, the foreign Exchange Market assists International Trade and Investments in a bigger way. For example, it permits a business in the Unites States to import goods from European Union member states, especially Euro zone members, and pay euros even though its income is in United States dollars. It also supports direct speculation and evaluation relative to the value of currencies and trade speculation, based on the differential interest rate between two currencies.

Types of Forex Transactions

The transactions in inter-bank market may fall under any of the following categories:

(a) spot transactions;

(b) forward transactions;

(c) swap transactions;

(d) non-deliverable forwards.

Spot Transactions

The transaction where the exchange of currencies takes place two days after the date of the contra is known as the spot transaction. For instance, if the contract is made on Monday, the delivery should; take place on Wednesday. If Wednesday is a holiday, the delivery will take place on the next day, i.e., Thursday, The date on which the currencies are to be exchanged is the value date. Both the currencies involved are paid on the same day so that there is no loss of interest to either of the parties. For instance, if Central Bank of India buys US dollars from SBI at Mumbai, the rupee payment will be made Mumbai through the accounts maintained by both the banks with Reserve Bank. US dollar payment will be made at New York, by the correspondent bank of SBI paying to the correspondent bank Canara Bank for its account. Both the rupee payment by Canara Bank and dollar payment will take place on the same value date.

When no qualifications are added, a transaction in the interbank market is a spot transaction. But funds may be required urgently by a bank in which case it may require early settlement. In the case it may ask for a special quotation for delivery the same day or the next day.

Where the agreement to buy and sell is agreed upon and executed on the same date, transaction is known as cash or ready transaction. It is also known as value today.

A transaction in which the currencies to be exchanged the next day of the transaction is known as value tomorrow or torn transaction.

Forward Transactions

The transaction in which the exchange of currencies takes place at a specified future date, subsequent to the spot date, is known as a forward transaction or outright forward transaction. The forward transaction can be for delivery one month or two months or three months, etc. A forward contract for delivery one month means the exchange of currencies will take place after one month from the date of contract. A forward contract for delivery two months means the exchange of currencies will take place after two months, and so on. The date for forward contract will be calculated from the spot date. For instance, 1 month forward contract entered into on 22nd March will fall due on 24th April. If it is a holiday, the contract will be due on the next working day. As an exception to this rule, if the next day of such due date runs into the next month, the due date is advanced to the preceding day and not the succeeding day.

Swap Transactions

A swap transaction is a deal between the same counter parties in which the same currency for same value is purchased and sold for different maturities. For instance, Dena Bank and IDBI Bank agree under which Dena Bank buys USD 8 million spot and sells it forward for 2 months. The difference between the spot price and forward price is equivalent to the forward margin discussed in the next section. Therefore, the forward margin is also known as swap points. The swap deal may also involve two forwards like purchase of 3 months forward and sale of 6 months forward. The need and mechanism of swap transactions is discussed in detail in the chapter on Exchange Dealings.

Non-deliverable Forwards

This instrument was developed in 1990s. Under non-deliverable forwards actual delivery of forward contract does not take place. On the due date, the spot rate for the currency concerned is compared with the forward rate agreed under the contract and the difference is settled. The market exists for emerging currencies for which ready market may not exist. The markets concerned also exhibit disparities in interest rates and exchange rates offering arbitraging possibilities. The settlement is invariably done in US dollars.

Quotations in Interbank Markets

The big banks in the market are known as market makers, as they are willing to buy or sell foreign currencies at the rates quoted by them up to any extent. Depending upon its resources, a bank maybe a market maker in one or few major currencies. When a banker approaches the market maker, it would not reveal its Intention to buy or sell the currency. This is done in order to get a fair price from the market maker.

Two-way Quotation

Typically, the quotation in the interbank market is a two-way quotation. It means, the rate quoted by the market maker will indicate two prices, one at which it is willing to buy the foreign currency,

and; the other at which it is willing to sell the foreign currency. For example, a Mumbai bank may quote its rate for US dollar as under:

USD 1 = ₹ 46.1525/1650

More often the rate would be quoted as 1525/1650 since the players in the market are expected know the 'big number', i.e., ₹ 46. In the given quotation, one rate is ₹ 46.1525 per dollar and "other rate is ₹ 46.1650 per dollar.

The buying rate is also known as the bid rate or ask rate and the selling rate as the offer rate. The difference between these rates is the gross profit for the bank and is known as the 'spread'.

Direct and Indirect Quotation

The quotation in the foreign exchange market may be made in either of the two ways. For instance, the rupee-dollar rate may be quoted in Mumbai as USD 1 = ₹ 46.1525/1650. Or it may also be quoted as ₹ 100 = USD 2.1662/1667.

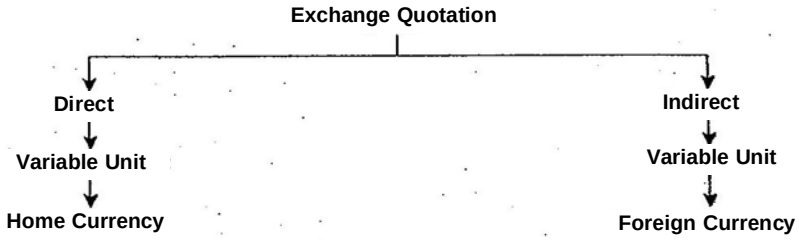


Fig. 4.7: Direct and Indirect Quotation

Direct Quotation

It will be obvious that in the first quotation the quoting bank will be willing to buy dollars at ₹ 46.1525 and sell dollars at ₹ 46.1650. If one dollar and bought and sold, the bank makes a gr profit of ₹ 0.0125. In a foreign exchange quotation, the foreign currency is the commodity that being bought and sold. The exchange quotation which gives the price for the foreign currency' terms of the domestic currency is known as direct quotation. In a direct quotation, the unit of foreign currency is kept constant and change in price is indicated by change in the number of i of the domestic currency equivalent to one foreign currency. For instance, US dollar quoted at ₹ may be quoted at ₹ 46 or ₹ 49 as may be warranted. Direct quotation is also known as 'currency quotation.

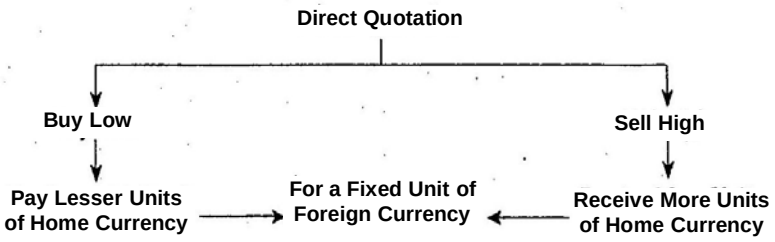


Fig. 4.8: Direct Quotation - Buy Low; Sell High

The Maxim—Buy Low; Sell High. The prime motive of any trader is to make profit. He ear profit by purchasing .the commodity at a lower price and selling it at a higher price. In forex exchange too, the bank buys the foreign currency at a lesser price and sells it at a higher price. F. instance/it may buy US dollar at ₹ 48 and sell at ₹ 48.10. Thus, in direct quotation the principle adopted by the bank is to buy at a lower price and sell at a higher price. This principle is stated in form of a maxim: 'Buy Low; Sell High'.

In India, Direct Quotation was prevalent till 1966. After devaluation of rupee in 1966, follow in the practice in London exchange market, indirect quotation was adopted. Effective from 2nd August 1993, India has switched over to direct method of quotation.

Indirect Quotation

The other way of quoting in the foreign exchange is: ₹ 100 = USD 2.1662/1667.

This type of quotation at Mumbai gives the quantity, of foreign currency per unit of domestic currency and is known as indirect quotation. In this case, the quoting bank will receive USD 2.1667 per ₹ 100 while buying dollars and give away USD 2.1662 per ₹ 100 while selling dollars. In indirect quotation, the unit of domestic currency is kept constant and the change in the price of the currency is indicated by varying units of the foreign currency for fixed sum of domestic Currency. Indirect quotation is also known as foreign currency quotation or simply currency quotation.

An unique characteristics Foreign exchange Markets:

- its huge trading volume representing the largest asset class in the world leading to high liquidity;
- its geographical dispersion;
- its continuous operation: 24 hours a day except weekends, i.e., trading from 22:00 GMT on Sunday (Sydney) until 22:00 GMT Friday (New York);
- the variety of factors that affect exchange rates;
- the low margins of relative profit compared with other markets of fixed income; and
- the use of leverage to enhance profit and loss margins and with respect to account size. Factors mentioned below are influencing the exchange rate of the domestic country.
    1. Balance of Payments,
    2. Inflation
    3. Interest Rates,
    4. Money Supply,
    5. National Income,
    6. Resource Discoveries,
    7. Capital Movements,
    8. Political Factors,
    9. Psychological Factors and Speculation,
    10. Technical and Market Factors,

11. Hedging of External Commercial Borrowings,
12. Impact of Stock market trading on Exchange Rates,
13. Impact of GDP Growth on Rupee.

Strategies adopted for Boosting Currency Trading in India

1. Shifting to Onshore Trading from offshore trading: The RBI had been quite concerned about the subdued volumes and low participation in currency market. The rupee is traded in the Interbank OTC market and on the stock exchanges as exchange traded futures and options. But many foreign investors prefer to trade the rupee in offshore financial centers such as Singapore or Luxembourg. Since the RBI does not have any control on the movement of the currency in these offshore markets, It was feared that the currency would be exposed to volatility if offshore rupee trading increases. Strong linkage between offshore and onshore price of the rupee is another reason why the Central Bank wants the currency trading to shift onshore.

2. Allowing to take up additional Currency position in Onshore Trading: RBI has allowed investors to take up $ 5million of currency position in onshore trading itself in addition to the $30 million. This extra limit is however available only to those already having outstanding positions of $30 million.

3. Increasing exposure to foreign Investors: The exposure limit of foreign investors in exchange traded currency derivatives was increased to $15 million in 2015 from $10 Million.

4. Adding new Currency pairs: Three new Cross –Currency pairs-euro-dollar, pound-dollar and dollar-yen were also introduced in 2015.

5. Extension of Trading Time: The Regulators are now seriously considering to increase the trading time on Indian exchanges to enable traders to make the most of the developments that take place between 5pm and 11pm. Extending the trading time will be another booster for liquidity in currency markets.

6. Positivity in Non Trade Cash flows due to offering High Interest Rates

The participants in the foreign exchange, market comprise:

(i) corporates;
(ii) commercial banks;
(iii) exchange brokers; and
(iv) central banks

International Payment Settlement System through SWIFT

Foreign exchange markets make extensive use of the latest developments in telecommunications for transmitting as well settling foreign exchange transactions. Banks use the exclusive network SWIFT to communicate messages and settle the transactions at electronic clearing houses such as CHIPS at New York.

SWIFT. SWIFT is a acronym for Society for Worldwide Interbank Financial Telecommunications, a co-operative society owned by about 250 banks in Europe and North America and registered as a co-operative society in Brussels, Belgium. It is a communications network for international financial market transactions linking effectively more than 25,000 financial institutions throughout the world who have been allotted bank identifier codes. The messages are transmitted from country to country via central-interconnected operating centres located in Brussels, Amsterdam arid Culpeper, Virginia. The member-countries are connected to the centres through regional processors in each country. The local banks in each country reach the regional processors through the national networks. There are factors determining exchanges rates are namely

REVIEW QUESTIONS

1. What is Foreign Exchange Markets? Explain its features.
2. Discuss the history of Foreign Exchange Trading in India.
3. How does settlement of Transactions carry out through SWIFT Networks?
4. Explain in detail the types of FOREX Transactions
5. What is Cross Rates? How it is computed?
6. What is Direct and Indirect quotation?
7. How do we compute the forward rate?
8. Explain in detail the strategies adopted for boosting Currency Trading in India.

♦ ♦ ♦

5

FOREIGN EXCHANGE RISK MANAGEMENT

Chapter Outline

- Advance of Future
- Features of Forward Genetics
- Types of Contrasts
- Difference between Forward & Futures
- Option Terminologies
- Types of Option
- Hedging with Currency options
- Classification of Foreign Exchange and Exposure Risks
- Risk Management and Minimization of Risk
- Usage of Derivatives
- Case Studies
- Chapter Summary
- Review Questions

Exchange rate volatility is one of the most difficult and unrelenting problems in the era of globalization. Firms with foreign transactions and obligations may face substantial losses due to adverse movements in exchange rates. Firms are exposed to the adverse movement of exchange rates because of three broad reasons:

1. All foreign financial transactions involving cash payments must often be denominated in the creditor's domestic currency. As the exchange rates fluctuate between the time of contract and the date of payment, there is the possibility of losses because the amount of money that has to be available for conversion from the debtor to creditor's currency at the payment date is larger than it was expected on the contract.
2. The exposure arises because of the size of the foreign transactions.
3. The length between the date of contract and the date of payment is also the reason for firms' exposure to foreign exchange rate risk.

There are various tools which are used for hedging exchange rate variations. Some of them are as follows:

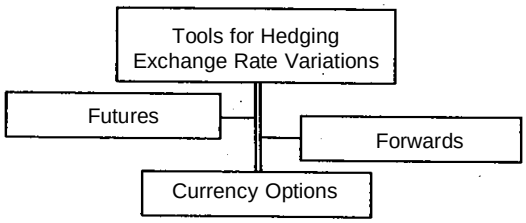


Fig. 5.1

FUTURES-AN INTRODUCTION

A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts. Unlike forward contracts, the counterparty to a futures contract is the clearing corporation on the appropriate exchange. Futures often are settled in cash or cash equivalents, rather than requiring physical delivery of the underlying asset. Parties to a Futures contract may buy or write options on futures.

Future contracts, while similar to forward contracts, have certain features that make them more useful for risk management. These include being able to extinguish contract obligations through offsetting, rather than actual delivery of the commodity. In fact, very few future contracts are ever delivered upon.

Future contracts are traded on organized exchanges in a variety of commodities (including grains, livestock, bonds and currencies). They are traded by open outcry where traders and brokers shout bids and offers from a trading pit at designated times and places. This allows producers, users and processors to establish prices before commodities are traded. Futures prices are forecasts that can and do change according to a variety of reasons, such as crop or weather reports.

Futures Terminology

The terminologies of futures are as follows:

1. **Spot Price:** The price at which an asset trades in the spot market.
2. **Futures Price:** The price at which the futures contract trades in the futures market.
3. **Contract Cycle:** The period over which a contract trades. The index futures contracts on the NSE have one-month, two-months and three-month expiry cycles which expire on the last Thursday of the month. Thus, a January expiration contract expires on the last Thursday of January and a February expiration contract ceases trading on the last Thursday of February. On the Friday following the last Thursday, a new contract having a three-month expiry is introduced for trading.
4. **Expiry Date:** It is the date specified in the futures contract. This is the last day on which the contract will be traded, at the end of which it will cease to exist.
5. **Contract Size:** The amount of asset that has to be delivered less than one contract. For example, the contract size on NSE's futures market is 50 Nifty traded instruments.
6. **Long and Short Position**
   - (i) **Long Position:** In simple terms, long position is a net bought position.
   - (ii) **Short Position:** Short position is net sold position.
7. **Basis:** In the context of financial futures, basis can be defined as the futures price minus the spot price. There will be a different basis for each delivery month for each contract. In a normal market, basis will be positive. This reflects that futures prices normally exceed spot prices.
8. **Cost of Carry:** The relationship between futures prices and spot prices can be summarized in terms of what is known as the cost of carry. This measures the storage cost plus the interest that is paid to finance the asset less the income earned on the asset.
9. **Initial Margin:** The amount that must be deposited in the margin account at the time a futures contract is first entered into is known as initial margin.
10. **Marking-to-Market:** In the futures market, at the end of each trading day, the margin account is adjusted to reflect the investor's gain or loss depending upon the futures closing price. This is called marking-to-market.
11. **Maintenance Margin:** This is somewhat lower than the initial margin. This is set to ensure that the balance in the margin account never becomes negative. If the balance in the margin account falls below the maintenance margin, the investor receives a margin call and is expected to top up the margin account to the initial margin level before trading commences on the next day.

Types of Futures

Future contract can be broadly classified into:

1. Financial Futures: A financial futures contract is a standardized agreement to deliver or receive a specified amount of a specified financial instrument at a specified price and date. The buyer

of a financial futures contract buys the financial instrument, while the seller of a financial futures contract delivers the instrument for the specified price. Financial futures contracts are traded on organized exchanges, which establish and enforce rules for such trading. Futures exchanges provide an organized marketplace where futures contracts can be traded. They clear, settle, and guarantee all transactions that occur on their exchanges.

Financial Futures are of the following types

(i) Stock Index Futures: Stock-index futures offer the investor a medium for expressing an opinion on the genera Course of the market. In addition, these contracts can be used by portfolio managers in a variety of ways to alter the risk-return distribution of their stock portfolios.

By purchasing stock-index contracts, the institutional investors can enter the market immediately and then gradually unwind the long futures position as they are able to get more funds invested in the stock.

As a speculation tool, stock index futures represent an inexpensive and highly liquid short-run alternative to speculating on the stock market. Stock index futures can be used to hedge the risk in a well-diversified portfolio of stocks. Stock index future is an index derivative that draws its value from an underlying stock index like Nifty or Sensex.

(ii) Interest Rate Future: An interest rate future contract is an agreement between two parties to-buy or sell a fixed income security such as Treasury bill or a Treasury bond at a given time in the future for a predetermined price. Interest rate futures are relatively new financial instruments.

(iii) Currencies Futures: These financial futures, as the name indicates, trade in the foreign currencies, thus, also known as exchange rate futures.

(iv) Bond Index Futures: Like stock index futures, these futures contracts are also based on particular bond indices, i.e., indices of bond prices. The prices of debt instruments are inversely related to interest rates, so the bond index is also related inversely to them. The important example of such futures contracts based on bond index is the Municipal Bond Index futures based on U.S. Municipal Bonds which is traded on Chicago Board of Trade (CBOT).

(v) Cost of Living Index Futures: This is also known as inflation futures. These futures contracts are based on a specified cost of living index, for example, consumer price index, wholesale price index, etc. At International Monetary Market (IMM) in Chicago, such futures contracts based on American Consumer Price Index are traded. Since in U.S.A., the inflation rates in 1980s and 1990s were very low, hence, such contracts could not be popular in the futures market. Cost of living index futures can be used to hedge against unanticipated inflation which cannot be avoided. Hence, such futures contracts can be very useful to certain investors like provident funds, pension funds, mutual funds, large companies and governments.

2. Commodity Futures: Commodity futures are agreements of contracts that are utilized to purchase or sell a specified amount of a given commodity. The agreement will commit the buyer and the seller to a fixed price that will be in effect on a specified future date. When this future date arrives,

the buyer is expected to have paid the agreed upon price for the futures, and the seller will have delivered ownership of the commodities to the buyer.

Commodity futures are based on physical commodities that include items such as gold, silver, other precious metals, and grains. Various types of food items, such as corn or pork bellies, are also considered to be commodities. Commodity futures are based on the perceived worth of the goods today and at some future point in time.

Commodity futures are one of the most active forms of investment trading today. Some investors choose to engage solely in commodity futures as a means of generating revenue from an investment portfolio. Others choose to vary investments somewhat, including stock and bond options along with commodity futures in their investment strategies. While carrying some degree of risk, commodity futures often are less volatile than some other forms of investments. Without the occurrence of some catastrophic event that greatly diminishes the physical commodity, the performance of commodity futures tends to be predicted with relative ease.

Hedging in Currency Futures

Traders make use of the market for currency futures in order to hedge their foreign exchange risk. For example, a French importer importing goods from USA for $1.0 million needs this amount for making payments to the exporter. It will purchase US dollar futures contract which would lock in the price to be paid to the exporter in terms of US dollar at a future settlement date. By holding a futures contract, the importer does not have to worry about any change in the spot rate of the US dollar over time. On the other hand, if the French exporter exports goods to a US firm and has to receive US dollar for the exports, the exporter would sell a US dollar futures contract. This way the exporter will be locking in the price of the export to be received in terms of US dollar. It will protect itself from the loss that may occur in case of depreciation of the US dollar over time.

Speculation with Currency Futures

Speculators make use of the currency futures for reaping profits. When they expect that the spot rate of a particular currency will move up beyond those mentioned in the currency futures contract, they buy currency futures denominated in that particular currency. On the other hand, if the spot rate of a particular currency is expected to depreciate below the rate mentioned in the currency futures contract, the speculators will sell currency futures in that currency. It may be noted here that these transactions involve cost that is to be deducted from the gain. The transaction cost is very nominal for the locals, but is significant for the speculators.

Advantages of Futures

There are many inherent advantages of trading futures over other investment alternatives such as savings accounts, stocks, bonds, options, real estate and collectibles. Some of them are as follows:

1. Discovery of Prices: Due to its highly competitive nature, the futures market has become an important economic tool to determine prices, based on today's and tomorrow's estimated amount of supply and demand. Futures market prices depend on a continuous flow of information from around the world and thus require a high amount of transparency. Factors such as weather, war, debt default,

refugee displacement, land reclamation, and deforestation can all have a major effect on supply and demand, and hence upon the present and future prices of a commodity. This kind of information and the way people absorb it constantly changes the price of a commodity. This process is known as price discovery.

2. Reduction of Risk: Futures markets are also a place for people to reduce risk when making purchases. Risks are reduced because the price is preset, therefore letting participants know how much they will need to buy or sell. This helps to reduce the ultimate cost to the retail buyer, because with less risk there is lesser chance of manufacturers jacking up prices to make up for profit losses in the cash market.

3. High Leverage: The primary attraction, of course, is the potential for large profits in a short period of time. The reason that futures trading can be so profitable is the high leverage. To 'own' a futures contract an investor only has to put up a small fraction of the value of the contract (usually around 10-20%) as 'margin'. In other words, the investor can trade a much larger amount of the security than if he bought it outright, so if he has predicted the market movement correctly, his profits will be multiplied (ten-fold on a 10% deposit). This is an excellent return compared to buying and taking physical delivery in stocks.

4. Profit in both Bull and Bear Markets: In futures trading, it is as easy to sell (also referred to as going short) as it is to buy (also referred to as going long). By choosing correctly, investor can make money whether prices go up or down. Therefore, trading in the futures markets offers the opportunity to profit from any potential economic scenario. Regardless of whether we have inflation or deflation, boom or depression, hurricanes, droughts, famines or freezes, there is always the potential for profit making opportunities.

5. Lower Transaction Cost: Another advantage of futures trading is much lower relative commissions. The commission for trading a futures contract is one-tenth of a per cent (0.10-0.20%). Commissions on individual stocks are typically as much as one per cent for both buying and selling.

6. High Liquidity: Most futures markets are very liquid, i.e., there are huge amounts of contracts traded every day. This ensures that market orders can be placed very quickly as there are always buyers and sellers for most contracts.

Disadvantages of Futures

The disadvantages of futures are as follows:

1. Leverage can make trading in futures contracts highly risky for a particular strategy.
2. Futures contract is standardized product and written for fixed amounts and terms.
3. Lower commission costs can encourage a trader to take additional trades and lead to over-trading.
4. It offers only a partial hedge.
5. It is subject to basis risk which is associated with imperfect hedging using futures.

Forwards

A forward contract is a simple customized contract between two parties to buy or sell an asset at a certain time in the future for a certain price. Unlike future contracts, they are not traded on an exchange, rather traded in the over-the-counter market, usually between two financial institutions or between a financial institution and one of its clients.

In other words, it is a privately negotiated contract that is not conducted in an organized marketplace or exchange. Both parties to a forward contract expect to make or receive delivery of the commodity on the agreed-upon date. It is difficult to get out of a forward contract unless the other party agrees. All forward contracts specify quantity, quality and delivery periods.

A forward contract is an agreement to buy (or sell) an asset at a preset price on a future date. At maturity, if the actual price (spot price) is higher than the contracted price, the forward buyer makes a profit. If the price is lower, the buyer suffers a loss. The pay-off to the seller is the opposite to that of the buyer.

Features of Forward Contracts

The basic features of a forward contract are explained below.

1. **Bilateral Contracts:** Forward contracts are bilateral contracts and hence, they are exposed to counter - parties risk. There is risk of non-performance of obligation either of the parties, so these are riskier than to futures contracts.
2. **Customized Contract:** Each contract is custom designed and hence, is unique in terms of contract size, expiration date, the asset type, quality, etc.
3. **Long and Short Position:** In forward contract, one of the parties takes a long position by agreeing to buy the asset at a certain specified future date. The other party assumes a short position by agreeing to sell the same asset at the same date for the same specified price. A party with no obligation offsetting the forward contract is said to have an open position. A party with a closed position is, sometimes, called a hedger.
4. **Delivery Price:** The specified price in a forward contract is referred to as the delivery price. The forward price for a particular forward contract at a particular time is the delivery price that would apply if the contract were entered into at that time. It is important to differentiate between the forward price and the delivery price. Both are equal at the time the contract is entered into. However, as time passes, the forward price is likely to change whereas the delivery price remains the same.
5. **Synthetic Assets:** In the forward contract, derivative assets can often be contracted from the combination of underlying assets, such assets are often known as synthetic assets in the forward market.
6. **Settlement by Delivery on Expiration Date:** In the forward market, the contract has to be settled by delivery of the asset on expiration date. In case the party wishes to reverse the contract, it has to compulsory go to the same counter-party, which may dominate and command the price it wants as being in a monopoly situation.

7. **Covered Parity:** In the forward contract, covered parity or cost-of-carry relations are relation between the prices of forward and underlying assets. Such relations further assist in determining the arbitrage-based forward asset prices.
8. **Popular Contracts:** Forward contracts are very popular in foreign exchange market as well as interest rate bearing instruments. Most of the large and international banks quote the forward rate through their 'forward desk' lying within their foreign exchange trading room. Forward foreign exchange quotes by these banks are displayed with the spot rates.

Types of Forward Contracts

Forwards contracts in India are broadly governed by the Forward Contracts (regulation) Act, 1952. According to this act, forward contracts are of the following three major categories:

1. Fixed Term and Optional Term Forward Contract: Both buying and selling forward exchange contracts may be either fixed or optional term contracts.

(i) Fixed Term Contracts: Fixed Term Contracts allow the customer to specify the date when the delivery of the overseas currency will occur. Earlier delivery is usually an option however a marginal adjustment to the Forward Contract Rate may be required.

(ii) Optional Term Contracts: Optional Term Contracts allow the customer to enter in to an agreement for a specific period, where the customer declares a certain period within which they would like the delivery to be made (this normally occurs for periods shorter than one month), e.g., a customer may enter a contract for a six month period while having the option of receiving a delivery anytime during the final week.

In both cases, there is a contract that affects delivery for both parties: the customer and the bank. An optional delivery contract does not exempt the customer from his obligation to deliver .the forward exchange contract. The optional delivery contract exclusively effects the period which the delivery will occur, making it optional. Forward rates are applicable for transactions in which settlement is expected to occur two or more business days following the transaction date. Forward contract rates are made-up of the Spot rate for the currency being traded which is slightly adjusted due to the relative Forward Margin.

2. Hedge Contracts: These are freely transferable contracts which do not require specification of a particular lot size, quality or delivery standards for the underlying assets. Most of these are necessary to be settled through delivery of underlying assets.

3. Transferable Specific Delivery Forward Contracts: Apart from being freely transferable between parties concerned, these forward contracts refer to a specific and predetermined lot size and variety of the underlying asset. It is compulsory for delivery of the underlying assets to take place at expiration of contract.

4. Non-Transferable Specific Delivery Forward Contracts: These contracts are normally exempted from the provision of regulation under Forward Contract Act, 1952 but the Central Government reserves the right to bring them back under the Act when it feels necessary. These are contracts which cannot be transferred to another party. The contracts, the consignment lot size and quality of underlying asset are required to be settled at expiration through delivery of the assets.

5. Other Forward Contracts

(i) Forward Rate Agreements (FRA): Forward contracts are commonly arranged on domestic interest-rate bearing instruments as well as on foreign currencies. In forward rate agreement, no actual lending or borrowing is affected. Only it fixes the rate of interest for a futures transaction.

(ii) Range Forwards: These instruments are very much popular in foreign exchange markets. Under this instrument, instead of quoting a single forward rate, a quotation is given in terms of a range, i.e., a range may be quoted for Indian rupee against US dollar at 47 to 49. It means there is no single forward rate rather a series of rate ranging from 47 to 49 has been quoted. This is also known as flexible forward contracts.

Advantages of Forward Contracts

1. The contract can be tailored to the user's exact requirements with quantity to be delivered, date and price all flexible.
2. The trader will know in advance how much money will be received or paid.
3. Payment is not required until the contract is settled.

Disadvantages of Forward Contracts

1. The user may not be able to negotiate good terms; the price may depend upon the size of the deal and how the user is rated.
2. Users have to bear the spread of the contract between the buying and selling price.
3. Deals can only be reversed by going back to the original party and offsetting the original trade.
4. The creditworthiness of the other party may be a problem.

DIFFERENCE BETWEEN FORWARD AND FUTURES

Table 5.1

	Basic of Difference	Forwards	Futures
1.	Trading	Forward contracts are traded by telephone or telex.	Futures contracts are traded in a competitive arena.
2.	Regulation	The forward market is self-regulating.	The IMM is regulated by the Commodity Futures Trading Commission.
3.	Frequency of Delivery	More than 90% of all forward contracts are settled by actual delivery.	Less than 1% of the IMM futures contracts are settled by delivery.
4.	Size of Contract	More than 90% of all forward contracts are settled by actual delivery.	Futures contracts are standardized in terms of currency amount.
5.	Delivery Date	Banks offer forward contracts for delivery on any date.	IMM futures contracts are available for delivery on only a few specified dates a year.

6.	Settlement	Forward contract settlement, occurs on the date agreed on between the bank and the customer.	Futures contract settlements are made daily via the Exchange's Clearing House; gains on position values may be withdrawn and losses are collected daily. This practice is known as marking to market.
7.	Quotes	Forward prices generally are quoted in European terms (units of local currency per U.S. dollar).	Futures contracts are quoted in American terms (dollars per one foreign currency units).
8.	Transaction Costs	Costs of forward contracts are based on bid-ask spread.	Futures contracts entail brokerage fees for buy and sell orders.
9.	Margins	Margins are not required in the forward market.	Margins are required of all participants in the futures market.
10.	Credit Risk	The credit risk is borne by each party to a forward contract Credit limits must therefore be set for each customer.	The Exchange's Clearing House becomes the opposite side to each futures contract, thereby reducing credit risk substantially.

Currency Options

A currency option confers on its buyer the right either to buy or to sell a specified amount of currency at a set price known as the strike price. An option that gives the right to buy is; known as a 'Call' while one that gives the right to sell is known as a 'put'. Depending on the contract .terms, an option may be exercisable on-any date during a specified period or it may be exercisable only on the final or expiration date of the period covered by the option contract. In return for guaranteeing the exercise of an option at its strike price, the option seller or writer, charges a premium which the buyer usually pays upfront. Under favorable circumstances, the buyer may choose to exercise it. Alternatively, the buyer may be allowed to sell it.

OPTION TERMINOLOGIES

Following are the terminologies of option:

1. **Index options:** These options have the index as the underlying. Some options are European while others are American. Like index futures contracts, index options contracts are also cash settled.
2. **Stock Options:** Stock options are options on individual stocks. Options currently trade on over 500 stocks in the United States. A contract gives the holder the right to buy or sell shares at the specified price.
3. **Buyer of an Option:** The buyer of an option is the one who by paying.the option premium buys the right but not the obligation to exercise his option on the seller/writer.
4. **Writer of an Option:** The writer of a call/put option is the one who receives the option premium and is thereby obliged to sell/buy the asset if the buyer exercises on him.
5. **Expiration Date:** The date specified in the options contract is known as the expiration date, the exercise date, the strike date or the maturity.

6. **Strike Price:** The price specified in the options contract is known as the strike price or the exercise price.
7. **Option Price/Premium:** Option price is the price which the option buyer pays to the option seller. It is also referred to as the option premium.
   - **(i) Call Option Premium:** The premium on a call option represents the cost of having the right to buy the underlying currency at a specified price. For MNCs that use. Currency call options to hedge, the premium reflects a cost of insurance or protection to the MNCs.
   - **(ii) Put Option Premium:** The put option premium (referred to as P) is primarily influenced by three factors:
     - S - X represents the difference between the spot exchange rate (S) and the strike or exercise price (X), T represents the time to maturity, and
     - 0" represents the volatility of the currency, as measured by the: standard deviation of the movements in the currency.

TYPES OF OPTION

The types of option are in figure below:

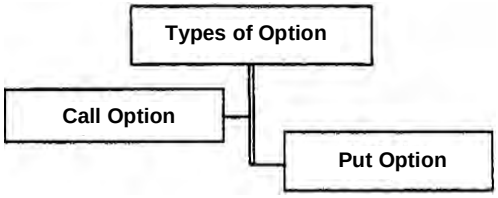


Fig. 5.2

Call Options

In a call option, the option buyer has the right (but not the obligation) to buy the commodity at the predetermined price (in a sense, 'call' for the item from the market, hence the term).

For example, A enters into a contract with B whereby A has the right to purchase 100 ounces of gold from B for $400 per ounce at any time prior to August 1. For granting this option A pays B an option premium of $5 per ounce. This is a call option.

Example 1: Jerry House paid a premium of ₹ 4 per share for one 6-month call option contract (total of ₹ 400 for 100 shares) of the Mahony Corporation. At the time of the purchase, Mahony stock was selling for 5 ₹ 6 per share and the exercise price of the call option was ₹ 55.

(i) Determine Jerry's profit or loss if the price of Mahony's stock is ₹ 54 when the option is exercised`

(ii) What is Jerry's profit or loss if the price of Mahony's stock is ₹ 62 when the option is exercised Ignore taxes and transaction cost.

Solution:

(i) Cost of call = (₹ 4 premium) × 100 = ₹ 400 Ending value = (– ₹ 400 cost) + (0 gain) = ₹ 400 loss

The option was worthless because the stock's price is less than the exercise price at maturity.

(ii) Cost of call = ₹ 400

Ending value = – ₹ 400 + (₹ 62 – ₹ 55) × 100 = – ₹ 400 + ₹ 700 = ₹ 300 gain

1. Buyer of Call Option: The buyer of an equity call option has purchased the right, but not the obligation, to buy 100 shares of the underlying stock at the stated exercise price at any time before the option expires. Once the option is purchased, the buyer is then "long" the call contract, and to purchase 100 underlying shares he notifies his brokerage firm of his intent to exercise the call contract.

For example, the buyer of one XYZ June 60 call option contract has the right to purchase 100 shares of XYZ stock at X 60 per share until the June expiration.

Potential Profit: Unlimited as the underlying stock price increases.

Potential Loss: Limited to premium paid for call option.

2. Writer (Seller) of Call Option: An investor who sells an option contract that he does not already own is known as the option "writer", and is then "short" the contract. The writer of an equity call option, commonly referred to as the "seller", has the obligation to sell 100 shares of the underlying to the stated exercise price if assigned an exercise notice at any time before the option expires.

For example, the writer of an XYZ June 75 call option has the obligation to sell 100 shares of XYZ stock at ₹ 75 per share if assigned at any time until June expiration.

Potential Profit: Limited to premium received from call's initial sale.

Potential Loss: Unlimited as the underlying stock price increases.

Put Options

In put options, the option buyer has the right to sell the commodity (in a sense, 'put' the commodity in the market). For example, A enters into a contract with B whereby he has the option to sell 100 ounces of gold to B at a price of $400 anytime before August 1. For granting him this option, A pays B $6 per ounce as premium. This is a put option.

Example 2: Jim Poston is bearish on the stock of the Justus Corporation. Therefore, Jim purchases four put option contracts on Justus stock for a premium of ₹ 3. The option's striking price is ₹ 40 and it has a maturity of 3 months. Justus has a current market price of ₹ 39. If Jim is correct and Justus's price falls to ₹ 30, how much profit will he earn over the 3-month period Ignore transaction costs and taxes.

Solution:

Cost of put = (3 per share) × (100 shares per contract) × (4 contracts) = ₹1,200

Put's intrinsic value = striking price – ending price = ₹ (40 – 30) = ₹10 per share

Total value at maturity (₹10 per share) × (100 shares) × (4 contracts) = 4,000

Net gain = ₹ 4,000 – ₹ 1,200 = ₹ 2,800

1. Buyer of Put Option: A put option gives the holder the right to sell an asset at a certain price within a specific period of time. Puts are very similar to having a short position on a stock. Buyers of puts hope that the price of the stock will fall before the option expires.

The buyer of an equity put option has purchased the right, but not the obligation, to sell 100 shares of the underlying stock at the stated exercise price at any time before the option expires. Once the option is purchased the buyer is then "long" the put contract, and to sell 100 underlying shares he notifies his brokerage firm of his intent to exercise the put contract.

For example, the buyer of one XYZ June 70 put option has the right to sell 100 shares of XYZ stock at ₹ 70 per share up until the June expiration.

Potential Profit: Substantial and increases as the underlying stock price decreases to zero. **Potential Loss:** Limited to premium paid for put.

2. Writer (Seller) of Put Option: An investor who sells an option contract that he does not already own is known as the option "writer" and is then "short" the contract. The writer of equity put option, commonly referred to as the "seller", has the obligation to purchase 100 shares of the underlying stock at the stated exercise price if assigned an exercise notice at any time before the option expires.

For example, the writer of an XYZ June 80 put option has the obligation to purchase 100 shares of XYZ stock at ₹ 80 per share if assigned at any time until June expiration.

Potential Profit: Limited to premium received from puts initial sale.

Potential Loss: Substantial and increases as the underlying stock price decreases to zero.

HEDGING WITH CURRENCY OPTIONS

The hedging with currency options through purchase and sale of options:

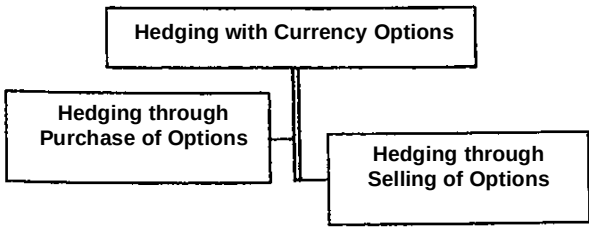


Fig. 5.3

If an appreciation in the pound is expected, the importer will buy a call option on it with maturity coinciding with the date of payment. If the strike price is 83.00/£, the premium is X 0.05 per pound and the spot price at maturity is ₹ 83.20, the importer will exercise the option. He will have to pay ₹ 83.00 × 62,500 + 3,125 = 51, 90,625. If the importer had not opted for an option, he would have had to pay ₹ 62,500 × 83.20 = 52,00,000. Buying of the call option reduces the importer's obligation by

₹ 52,00,000 – 51, 90,625 = 9,375. If, on the other hand, the pound falls to ₹ 82.80, the importer will not exercise the option since his obligation will be lower even after paying the premium.

The exporter buys a put option. For example, Indian exporter exports goods for £ 62,500. He fears a depreciation of pound within two months when payments are to be received. In order to avoid the risk, he will buy a put option for selling the pound for a two-month maturity. If the strike rate is ₹ 83.00 then the premium is ₹ 0.05 and the spot rate at maturity is ₹ 82.80. In case of the hedge, he will receive ₹ 62,500 × 83.00 3,125 = 51,84,375. In the absence of a hedge, he will receive only ₹ 51, 75,000. This means, buying of a put option helps increase the exporter's earnings, or reduces his exposure by ₹ 51,84,375 –51,75,000 = ₹ 9,375).

Hedging through Selling of Options: Hedging through selling of options is advised when volatility in exchange rate is expected to be only marginal. The importer sells a put option and the exporter sells a call option. Let take the case of importers. For example, an Indian importer imports for £62,500. He fears an appreciation in the pound and so it sells a put option on the pound at a strike price of 83.00/£ and at a premium of ₹ 0.15 per pound. If the spot price at maturity goes up to ₹ 83.05, the buyer of the option will not exercise the option. The importer as a seller of the put option will receive the premium of ₹ 9,375 which it would not have received if he had not sold the option. If the spot price at maturity falls to ₹ 82.95, the buyer of the option will exercise the option. .But in that case, the importer received premium of ₹ 9,375. The net gain to the importer will be ₹ 9,375 – 3,125 = ₹ 6,250.

The exporters sell the call option. If an Indian exporter exports for £62,500 and fears that the pound will depreciate and sells a call option on the pound at a strike price of ₹ 83.00 at a premium of ₹ 0.15 per pound. If the spot rate at maturity really falls to 82.95, the buyer of the call option will not exercise the option. The exporter being the seller of the call option will get ₹ 9,375 as the premium.

Speculation with Currency Options

The Speculation with Currency Options are as follows

1. Purchase of Options: Speculators make profit out of purchase of currency options. They normally buy call options when they expect upward movement in the value of the underlying currency. On the expiry date, they buy the currency at the agreed-upon rate and sell it in the open market at a higher rate and thereby reap profits. On the contrary, they buy put options when they expect depreciation of the underlying currency. They sell the underlying currency at an agreed upon rate that is higher than the spot rate. This way they get more of the other currency than they could get in the open market. Besides these simple operations, they often go in for complicated deals mixing either two calls or two puts or one call and the other put.

2. Spreads: In a spread, speculators combine either two calls or two puts. In case of calls or puts, one is sold and the other is purchased. If the expiry of the two is the same but the strike prices differ, it is known as a vertical spread. When the strike price is the same but the expiry differs, it is known as a horizontal spread. When the strike price and the expiry date both differ between the two calls, it is known as a diagonal spread. Similar features are marked with two puts.

3. Combination of Calls and Puts: As a practice, different from spreads, the speculators combine calls with puts and such combinations are of two types. One is known as straddles where the

two options have the same strike price and the same expiry date. The other, called strangles is when the strike price and maturity differ in case of the two options of the combination.

Pricing of Currency Options

As per the Black Scholes model the value of European call option at time t is given by:

PC(t) = S(t).BFN(d,)-BH.N(d2)

Where $d_1 = \left[\frac{In(S.B_F / XB_H) + (\sigma^2/2)T}{\sigma\sqrt{T}}\right]$ and $d_2 = d_1 - \sigma\sqrt{T}$

Where, PC(t) = value of call option at time t,

S(t) = spot rate at time t;

B_F = foreign currency price at time t of a pure discount bond that pays one unit of foreign currency at time (t + T) where T is the time to maturity and its value is given by $B_F = \left[\frac{1}{(I + r_F \times T/360)}\right]$

Where r_F is the risk less interest rate on foreign currency, S(t).B_F = the value of B_F in terms of domestic currency at time t; B_H = home currency price at time t of a pure discount bond that pays one unit of domestic currency at the time t + T where T is again period to maturity and its value is

$$B_H = \left[\frac{1}{(1 + r_H \times T/360)}\right]$$

N (d_1) = cumulative normal probability for a unit normal variate,

N (d) is given as:

$N(d) \int_{-}^{d}\left[\frac{I}{\sqrt{2\lambda}}\right] e^{(-Z2/2)dZ}$

Where Z is standard normal variate.

The value of put-option is given by PP(t) = XB_H N(l_1) – s(t) B_F N (l_2)

Where, $l_1 = -d_2$ and $l_2 = -d_1$

Example 3: Consider the following data

Current spot rate S (₹/$)	=	₹ 36.40/$
Strike price X (₹/$)	=	₹ 37.00/$
Time to maturity	=	3 months
Risk free interest rate on rupee	=	12%
Risk free interest rate on dollar	=	8%
Standard deviation	=	0.35

Solution:

$$\text{The value of } B_H = \left[\frac{I}{(I + r_H(T)}\right] = \left[\frac{1}{(1 + 0.12(0.25))}\right] = \left[\frac{1}{1 + 0.03}\right]$$

$$\text{The value of } B_H = \left[\frac{I}{(I + r_F(T)}\right] = \left[\frac{1}{(1 + 0.08(0.25))}\right] = \left[\frac{1}{0.02}\right] = 0.9804$$

$$d_1 = \left[\frac{\text{In}\left[36.40(0.9804)/37.00(0.9709)\right] + \left[(0.35)^2/0.25\right]}{0.35\sqrt{(0.25)}}\right]$$

$$d_2 = d_1 - 0.35\sqrt{0.25}$$

Valuation of Currency Options

The valuation of options or option pricing means the amount per share that an option buyer pays to the seller. In other words, option price is the price which the buyer of the options contract pays for the right to buy or sell a security at a specified price in the future. It is also called the option premium. The valuation of currency options or option pricing depends on some determinants and principals.

Determinants of Currency Options

Knowledge about the factors to which the value of an option is sensitive is very important for the hedgers and speculators who trade in the options. These factors or sensitivities are:

1. Changes in Forward Rates: The current spot rate and at-the-money position the interest rate differential form the basis of options pricing as well as the forward rate. This is why option rates are close to the forward rates . In other words forward rates are central to option pricing and so, changes in the forward rates influence the pricing of an option.

2. Changes in Spot Rates: Changes in the spot rates influence the option prices. At an at-the-money position, the intrinsic value is zero and the entire premium is represented by the time value. At the out-of-the-money position, the intrinsic value is zero but it-cannot be negative because in that case, the option will not be exercised. But as the spot rate moves to in-the-money position, intrinsic value will emerge and the premium will be made up partly of the intrinsic value and partly of the time value. Again, with the spot rate moving into the in-the-money position, both the intrinsic value and the time value will change and as a result, and so will the premium. The extent of change in the premium due to change in the spot rate is represented by delta. This means:

Delta (&) = Change in premium/Change in spot rate

3. Time to Maturity: The longer the time to maturity, the greater is the option's value. The impact of change in time to maturity on the option value is represented by theta. In other words,

Theta (θ) = Change in premium/Change in time

Theta represents an exponential, and not a linear, relationship between time to maturity and the value of an option. The option price shrinks fast as maturity approaches. A trader buying options for shorter maturity has to pay proportionately less. A six-month option's value is approximately 2.5

times more expensive than that of a one-month option, but a 12-month option is only 3.5 times costlier than a one-month option.

4. Volatility in Exchange Rate: Volatility is expressed as the standard deviation of daily percentage changes in the sport rate of the underlying currency. It is stated as per annum percentage. If the annual volatility is 10.0 per cent, a single day volatility can be found as:

10.0%/V365 = 10.0%/19.105 = 0.523%

The larger the volatility, the larger is the chance for the spot rate moving into the in-the-money zone and greater is the value of the option.

The impact of volatility on the option's value is expressed by Vega. In other words, Vega = Change in premium/Change in volatility

5. Sensitivity to Varying Interest Rate Differential: It is evident from the theory of option pricing that an option value is either equal to the difference between the strike price and the forward rate, or it may be higher. The impact of changes in domestic interest rate on the option's value is expressed by rho and the impact of change in the foreign interest rate on the option's value is expressed by phi. If foreign interest rate increases, forward rate of the foreign currency, at a discount and the value of the option denominated in this currency will fall. But if the domestic interest rate rises, the value of this option will improve.

6. Changing Strike Price: Any change in the strike price leads to a change in the intrinsic value and thereby in the value of an option. In a call option, if the strike price falls with the spot rate being constant, the intrinsic value will be larger and the option's price will be higher. But in a put option, the lowering strike price with the spot price being constant will lower the intrinsic value. The value of the option will fall.

CLASSIFICATION OF FOREIGN EXCHANGE AND EXPOSURE RISKS

Since the advent of floating exchange rates in 1973, firms around the world have become acutely aware of the fact that fluctuations in exchange rates expose their revenues, costs operating cash flows and hence their market value to substantial fluctuations. Firms which have cross border transactions — exports and imports of goods and services, foreign borrowing and lending, foreign portfolio, and direct investment and so on are directly exposed; but even "purely domestic" firms which have absolutely no cross border transactions are also exposed because their customers, suppliers, and competitors are exposed. Considerable effort has since been devoted to identifying and categorizing currency exposure and developing more and more sophisticated methods to qualify it.

Figure 1 presents a schematic picture of currency exposure. In the short term, the firm is faced with two kinds of exposures. It has certain contractually fixed payments and receipts in foreign currency such as export receivables, import payables interest payable on foreign currency loans and so forth. Most of these items are expected to be settled within the upcoming financial year.

The company with foreign operations is at risk in various ways. Apart from political danger, risk fundamentally emanates from changes in exchange rates. In this regard, the spot exchange rate represents the number of units of one currency that can be exchanged for another. Put differently, it is

the price of one currency relative to another. The currencies of the major countries are traded in active markets, where rates are determined by the forces of supply and demand. Quotations can be in terms of the domestic currency or in terms of the foreign currency. If the U.S. dollar is the domestic currency and the British pound the foreign currency, a quotation might be .625 pounds per dollar or $1.60 per pound. The result is the same, for one is the reciprocal of the other (1/.625 = 1.60, while 1/1.60 = .625).Currency risk can be thought of as the volatility of the exchange rate of one currency for another.Since the advent of floating exchange rates in 1973, firms around the world have become acutely aware of the fact that fluctuations in exchange rates expose their revenues, costs operating cash flows and hence their market value to substantial fluctuations. Firms which have cross border transactions —exports and imports of goods and services, foreign borrowing and lending, foreign portfolio, and direct investment and so on are directly exposed; but even "purely domestic" firms which have absolutely no cross border transactions are also exposed because their customers, suppliers, and competitors are exposed. Considerable effort has since been devoted to identifying and categorizing currency exposure and developing more and more sophisticated methods to qualify it.

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We must distinguish a spot exchange rate from a forward exchange rate. Forward transactions involve an agreement today for settlement in the future. It might be the delivery of 1,000 British pound 90 days hence, where the settlement rate is 1.59 U.S dollars per pound. The forward exchange rate usually differs form the spot exchange rate for reasons we will explain shortly.

With these definitions in mind there are following three types of exchange rate risk exposure with which we are concerned:

- Translation exposure
- Transactions exposure
- Economic exposure

The first translation exposure is the change in accounting income and balance sheet statements caused by changes in exchange rates. Transactions exposure has to do with setting a particular transaction, like a credit sale, at one exchange rate when the obligation was originally recorded at another. Finally, economic exposure involves changes in expected future cash flows, and hence

economic value, caused by a change in exchange rates. For example, if we budget 1.3 million British pound (£) to build an extension for a London plant and the exchange rate is now £.615 per U.S. dollar, this corresponds to £1.3 million/.625 = $2,080,000. When we pay for materials and labour, the British pound might strengthen; say to £. 615 per dollar. The plant now has a dollar cost of £1.3 million/. 615 = $2,113,821. The difference - $2,113,821 - $2, 080,000 = 33,821, represents an economic loss.

Translation Exposure

Translation exposure relates to the accounting treatment of changes in exchange rates. Statement No. 52 of the financial accounting standards board (FASB) deals with the translation of foreign currency changes on the balance sheet and income statement. Under these accounting rules, a US company must determine a "functional currency" for each of its foreign subsidiaries. If the subsidiary is a standalone operation that is integrated within a particular country, the functional currency may be the local currency — otherwise it is the dollar. Where high inflation occurs (over 100 per cent per annum), the functional currency must be the dollar regardless of the conditions given.

The functional currency used is important because it determines the translation process. If the local currency is used, all assets and liabilities are translated at the current rate of exchange. Moreover, translation gain or losses are not reflected in the income statement but rather are recognized in owner's equity as a translation adjustment. The fact that such adjustments do not affect accounting income is appealing to many companies. If the functional currency is the dollar, however, this is not the case. Gains or losses are reflected in the income statement of the parent company, using what is known as the temporal method (to be described shortly). In general, the use of the dollar as the functional currency results in greater fluctuations in accounting income but in smaller fluctuations in balance sheet items, than does the use of the local currency. Let us examine the differences in accounting methods.

Transactions Exposure

Transactions exposure involves the gain or loss that occurs when settling a specific foreign transaction. The transaction might be the purchase or sale of a product, the lending or borrowing of funds, or some other transaction involving the acquisition of assets or the assumption of liabilities denominated in a foreign currency. While any transaction will do, the term "transactions exposure" is usually employed in connection with foreign trade, that is, specific imports or exports on open-account credit.

Suppose a British pound receivable of £680 is booked when the exchange rate is £ 60 to the U.S. dollar, payment is not due for two months. In the interim, the pound weak-ens (more pound per dollar), and the exchange rate goes to £ 62 per $1. As a result, there is a transaction loss. Before, the receivable was worth £680/60 = $I,133.33. When payment is received, the firm receives payment worth £680/. 62 = $1,096.77. Thus, we have a transactions loss of $1,133.33 - $1,096.77 = $36.56. If instead the pound were to strengthen, for example, £. 58 to the dollar, there would be a transaction gain and we would receive payment worth £680/58 = $1,172.41. With his illustration in mind, it is easy to produce example of other types of transactions gains and losses.

Accounting Treatment of Transaction and Translation Exposure

We have seen above that transaction and translation exposures give rise to exchange gains and losses, real or notional. In recording and reporting these effects the accountant is essentially confronted with three important questions:

(A) Which exchange rate should be used to translate asset and liability items? Historical, current or some average rate? (Historical rate here refers to the exchange rate ruling at the time the asset or liability came into existence.)

(B) Where in financial statements should he gain/losses be shown? Should they merge with the income statement or should a separate account be kept to be subsequently merged with the firm's net worth?

(C) What are the tax implications of the various choices made regarding 1 and 2 above?

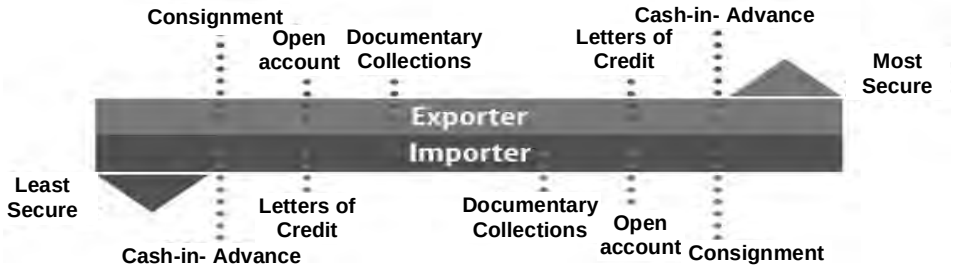
Here we present a brief summary of the various alternatives to cope with accounting problems with transaction and translation exposures

1. Asset and liability items are recorded at the rate prevailing at the time they are acquired.
2. Items, which are settled during the current accounting period, are revalued at the rate prevailing at the time of settlement. This gives rise to exchange gains or losses, which are taken to the income statement.
3. For items not settled within the accounting period, they are taken to the balance sheet either at the historical rate or at the closing rate. In the latter case, a loss or a gain is made, the treatment of which depends on the nature of the item and whether it is a gain or a loss. Losses are normally shown in income immediately while gains may be shown in current and future income according to some set procedure. .
4. When items such as receivables, payables and so on, in foreign currency are hedged by means of a forward contract, the forward rate applicable in that (contract is used to measure and report such items. The difference between the spot rate at the inception of the contract and the forward rate is recognized in income.
5. Suppose an asset was acquired at home, financed out of a foreign currency borrowing. A substantial depreciation to the home currency takes place. Further, there is no practical means of hedging the liability. In such cases, the exchange loss is sometimes regarded as an adjustment to the cost of the asset and the asset is carried at the adjusted value.
6. For translating a foreign entity's balance' sheet into the parent's currency of reporting, various methods can be followed: The closing rate method uses the rate prevailing on the parent's balance sheet date. The current non-current method uses the closing rate for current assets and liabilities and historical raise for concurrent assets and liabilities. The temporal method translates cash, receivables and payables at the closing rate while other items are translated at historical rates. The monetary/non-monetary method translates monetary assets and liabilities such as receivables and parables: cash bank deposits and loans and so on at the closing rate while non- monetary assets and liabilities such as intermarries are slated at historical rates. In contrast to the current/non current method, "the major difference arises in translating long-term debt for which the monetary-non monetary

method uses the closing rate. This can give rise to large translation losses or gains. For revenue and expense items from the income statement, "there is a choice between using the rate prevailing at the time the transaction was booked or a weighted average rate for the period covered the statement.

Apart from the transparency and information content of the financial statements, the key consideration in choosing the accounting treatment of transaction and translation exposures is its tax implications for the company as a whole. For a large multinational, with subsidiaries spread around the world and exposures in multiple currencies, the accounting treatment of exposures becomes quite complex. Readers who would

Economic Exposure



Payment Risk Diagram

Fig. 5.4

Perhaps the most important of the three exchange rate risk exposures-translation, transactions, and economic is the last. Economic exposure is the change in value of a company that accompanies an unanticipated change in exchange rates. Note that we distinguish anticipated from unanticipated. Anticipated changes in exchange rates are already reflected in the market value of the firm. If we do business with Spain, the anticipation might be that the peseta will weaken relative to the dollar. The fact that it weakens should not impact market value. However, if it weakens more or less than expected, this will affect value. Economic exposure does not lend itself to as precise a description and measurement as either translation or transactions expo-sure. Economic exposure depends on what happens to expect future cash flows, so subjectivity is necessarily involved.

Degree of Payment Risk to Exporters and Importers

Payment Risk to Exporters and Importers

1. Consignment: Here the goods are not sold by the Exporter directly to customer in abroad but through an agent or consignee. Until the cash is realized on sale from the consignee, the whole amount of risks need to be borne by the exporter only. This is the riskiest option for Exporters payment. However it is the safest option for Importers.

2. Open Account: An open account transaction means that the goods are shipped and delivered before. Payment is due, usually in 30 to 90 days. Obviously, this is the most advantageous option to the importer in cash flow and cost terms, but it is consequently the highest risk option for an exporter.

An open account transaction means that the goods are shipped and delivered before payment is due, usually in 30 to 90 days. Obviously, this is the most advantageous option to the importer in cash flow and cost terms, but it is consequently the highest risk option for an exporter. Because of the intense competition for export markets, foreign buyers often press exporters for open account terms. In addition, the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may face the possibility of the loss of the sale to their competitors. However, while this method of payment will definitely enhance export competitiveness, exporters should thoroughly examine the political, economic, and commercial risks, as well as cultural influences to ensure that payment will be received in full and on time. It is possible to substantially mitigate the risk of non payment associated with open account trade by using such trade finance techniques as export credit insurance and factoring. Exporters may also wish to seek export working capital financing to ensure that they have access to financing for both the production for export and for any credit while waiting to be paid. This is risk option of payment to the exporters. It cannot be assuredly said that importer will make payment without any mistakes. But is the next option for importers who can take little bit more amount of time in making payment.

3. Documentary Collections: Here in this case, exporter will ship products after receiving necessary documents proof from the Importer. For Example Bills of Exchange, Shipping bill and Customs clearance documents. These documents can be made as pledge against export payment dues. So in all said and done, it is safe mode of payment for Exporters but it is little bit risk one to the importers.

4. Letter of Credit: Here in this case, Exporter will carry out his shipping of goods after collecting Letter of credit which is duly guaranteed by the Importers Banks. So Exporter can very well collect payment from Importer bank if not from Importers at the time of default. It is safe mode of Payment realization from the view point of Exporter but not from the view point of Importers

5. Cash In Advance: Here it is the safest option payment from the view point of exporters. Because, he started shipping goods only after collecting cash from the importers. He does not have to collect anything after Exports. But this method is defiantly not advisable for importers if they intend to import from doubtful exporters. If they commit default in delivery of the products, importer will be severely at risk.

RISK MANAGEMENT AND MINIMISATION OF RISK

Hedging

In international parlance, hedging means a transaction undertaken specifically to offset some exposure arising out of the firm's usual operations.

In the stock market parlance, hedging is the process of buying one selling another in order to produce a risk less security. Hedging involves two investments that are perfectly correlated. For example if the returns of A and B are perfectly correlated, then to hedge, one has to buy A and sell B or vice versa to make the net position risk less. Hedging is a mechanism to reduce price risk inherent in open positions. The following are the hedging devices or instruments available to the investors, and the speculators.

Internal Hedging Tools

A firm may be able to reduce or eliminate currency exposure by means of internal strategies such as:

- Currency invoicing
- Netting and offsetting
- Leading and Lagging
- Indexation clauses in contracts
- Switching the Base of Manufacture
- Currency Invoicing

A firm may be able to shift the entire exchange risk to the other party by invoicing its exports in its home currency and insisting that its imports too be invoiced in its home currency. In order to avoid the exchange rate risk, many companies try to invoice their exports in the national currency and try to pay their suppliers in the national currency as well. This way an exporter knows exactly how much he is going to receive and how much he is to pay, as an importer.

This method is a noble one. However, an enterprise suffers under this method if the national currency appreciates; this is likely to result into a loss of market for the products of the company if there are other competitors.

Companies may also have recourse to invoicing in a currency whose fluctuations are less erratic then those of the national currency. For example, in the countries of the European Union, the use of European Currency Unit (ECU) is gaining popularity.

Netting and Offsetting

A firm with receivables and payables in different currencies can net out its exposure in each currency by matching its receivables with payables. For example, a firm with exports to and imports from France 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 Francs payable or receivable.

This technique consists of accelerating or delaying receipt or payment in foreign exchange as warranted by the position/expected of the exchange rate.

The principle involved is rather simple

If depreciation of national currency is apprehended, importing enterprises like to clear their dues expeditiously in foreign currencies: exporting enterprises prefer to delay their receipt from their debtors abroad. These actions, however, if generalized all over the country may weaken the national currency. Therefore, certain countries like France regulate the credit accorded to foreign buyers to avoid market disequilibrium.

The converse will hold true if an appreciation of national currency is anticipated; importing enterprises delay their payments to foreigners while the exporting ones will attempt to get paid at the earliest. These actions may have a snowballing effect on national currency appreciating further.

Sometimes, a firm might have a receivable in one currency say, DM and a payable not in the same currency but a closely related currency such as Swiss francs; the exposure arising from the same can be offset. To explain further, for example, a loss on a payable due to an appreciation of the Swiss Franc vis-a-vis the firm's home currency will be closely matched by the gain on the receivable due to the appreciation of DM.

Netting (Internal Compensation)

An enterprise may reduce its exchange risk by making and receiving payment in the same currency. Exposure position in that case is simply on the net balance. Hence, an enterprise should try to limit the number of invoicing currencies. The choice of currency alone is not sufficient. Equally important is that the dates of settlement should match.

Bilateral

Netting may be bilateral or multilateral. It is bilateral when two companies have trade rela¬tions and do buying and selling reciprocally. For example, a parent company sells semi finished products to its foreign subsidiary and then repurchases the finished product from the latter.

Multilateral

Netting can equally be multilateral. This is taken recourse to when internal transactions are numerous. Volume of transactions will be reduced because each Company of the group will pay or be paid only net amount of its debit or credit.

Leading and Lagging

This is another way of managing exposures by shifting the timing of the exposures by leading and lagging payable and receivables. The rule of thumb is lead i.e. advance payables and lag i.e. postpone receivables in strong currencies and conversely in weak currencies.

Lead and lags in combination with netting form an important cash management strategy for multinationals with extensive intra-company payments.

Indexation Clauses in Contracts

For protecting against the Exchange rate risk sometimes, several clauses of indexation are included by exporters or importers. A contract may contain a clause whereby prices are adjusted in such a manner that fluctuations in exchange rate are absorbed without any visible impact. If the currency of the exporting country appreciates, the price of export is increased to the same extent or vice versa.

Therefore, the exporter receives almost the same amount in local currency. Thus, the exchange rate risk is borne by the foreign buyer. A variant of the above is the indexation of price to a third currency or to a basket of currencies like ECU or SDR. This clause has repercussion for both the parties to the contract.

Another variant of indexation may be that the contract incorporates a clause stipulating that an appreciation or depreciation would be taken into account only beyond a certain level, say higher than 4 or 5 per cent.

There is another possibility where the contracting parties may decide to share the risk. They may stipulate that part of exchange rate variations, interning between the date of contract and payment, will be shared by the two in accordance with a certain formula, for example, half-half or one-third, etc.

Switching the base of manufacture

In the case of manufacturing companies, switching the base of manufacture may be useful so that costs and revenues are in the same currency, e.g. Japanese car manufacturers have opened factories in Europe.

Re-Invoicing Centre

Re-invoicing centre of a multinational group does billing in respective national currencies of subsidiary companies and receives the invoices made in foreign currency from each one of them. It would be referable, if possible, to locate the re-invoicing centre in a country where exchange regulations are least constraining.

The centre itself is a subsidiary of the parent company. The principle is simple. The invoices in foreign currencies are made in the name of the re-invoicing centre by the subsidiaries.

And, the centre, in turn, will send out equivalent sums in national currency. Like-wise, the centre makes payments in foreign currencies to suppliers and it receives equivalent sums in the national currencies from the subsidiaries concerned.

The management of exchange risk is thus centralized at a single place. This helps in reducing the volumes of foreign currency transfers and hedging costs. However, one often encounters the problem where dates of maturity do not match. Besides, the exchange regulations in some countries may not permit re-invoicing.

External Hedging Tools

A firm may select from the following techniques, to hedge a part or all of the transaction exposure:

- Forward exchange contract
- Futures contract
- Money market hedge
- Currency option hedge

Forward Exchange Contract

It consists of buying or selling a currency to settle exposures or hedge a balance sheet position. An importer can buy in advance through a forward exchange contract the amount of foreign currency needed to pay for the imports when due. Alternatively, an exporter can sell in advance the amount of

foreign currency to be received against exports. If the home currency weakens, the importer makes an opportunity gain, as he will be paying less number of units of home currency and for the exporter, an opportunity loss.

Futures Contract

A futures hedge differs from a forward hedge because of the intrinsic features of futures. A receivable is hedged by selling futures while a payable is hedged by buying futures. Banks use currency futures to hedge position taken in the forward markets.

Example

A firm that buys a currency futures contract is entitled to receive a specified amount of a specified currency for a stated price on a specified date. To hedge payment on future payables in a foreign currency, the firm may desire to purchase a currency futures contract representing the currency it will need in future. By holding this contract, it locks in the amount of its home currency needed to make payment on the payables.

Money Market Hedge

1. **Hedging payables:** This involves the following steps.
   - Borrow funds in home currency;
   - Use them to purchase the foreign currency;
   - Invest the foreign currency for the period after which the foreign currency payable falls due;
   - Use the proceeds to make the payment;
   - Repay the borrowed amount together with interest.

Hedging Receivables this Involves the Follows Steps

- Borrow funds in the foreign currency for the period after which the receivable is due;
- The amount to be borrowed should be equal to the amount of the receivable as discounted by the prevailing rate of interest;
- Convert the borrowed amount into home currency and use it till the receivable arrives;
- If the home currency funds cannot be used gainfully in the enterprise itself, invest them to earn interest.

Currency Option Hedge

On buying a currency option, the owner gets the right to buy or sell currency but is not obliged to do so. This type of hedge would insulate the firm against adverse exchange rate movements and also the firm to benefit from favourable exchange rate movement.

Currency option hedging could be extended to payables and receivables in foreign Currency.

- Hedging payables with currency call options (right and not the obligation to buy): Assume a firm has payables in British pounds. If the spot rate of the pound remains lower than the

exercise price throughout the life of the option, then the firm that needs pounds could let the option expire and purchase them at the existing spot rate. On the other hand, if the spot rate of the Pound appreciates, the option allows the firm to purchase pound at the exercise price.

- Hedging receivables with currency put options (right and not the obligation to sell): If the existing spot rate of the foreign currency is above the exercise price when the firm receives the foreign currency, the firm can sell the currency received at the spot rate and let the put option expire.

RISK MANAGEMENT FEW ISSUES

As protection gives way to market discipline, India's financial markets are being transformed. The changes bring expanded business possibilities but also throw up new or increased risks. By improving their risk management strategies, organisations can benefit from the opportunities while minimising the threats. The major drivers for better risk management are:

Deregulation

A market-driven environment is replacing one administered and controlled by the regulator. However, the risk management agenda of most institutions is still solely driven by compliance with regulatory requirements. Financial organisations must upgrade their risk management techniques and extend them to cover all their activities.

Volatility in Interest Rates

When interest rates were controlled by the RBI organisations never had to consider the cost of funds or the maturity pattern of their deposits and advances while prescribing interest rates. Since interest rates have now been deregulated, organizations can largely fix their own lending and deposit rates. The resulting volatility in interest rates exposes them to higher interest rate risk. Costs, yields and risks differ widely between financial organizations. They now need to urgently measure and manage interest rate risk, and institute a system of prudent asset-liability management.

Competition

Competition has increased significantly after new international entrants and private Indian banks have been allowed entry. Simultaneously, the differences between financial institutions, non banking finance companies and banks are disappearing. As margins shrink, organisations are forced to become more aggressive in defending or acquiring market share and to diversify into new products, markets and distribution channels. Each of these brings new and unfamiliar risks.

A Changing Asset Profile

In the last two years, the performance of financial organizations has deteriorated. A major cause is increased credit risk because their customers are faced with less protection, increased competition, new products and markets of their own. Non-performing assets continue to rise at financial organizations, affecting profitability. The}' must therefore hunt aggressively for new, profitable assets

in unfamiliar areas such as project finance at banks, working capital credit at financial institutions or retail finance at both. Traditional credit evaluation processes must change to address the new risks of this shifting asset profile.

For example, organizations are aggressively entering retail credit where margins are higher than on corporate credit. Credit appraisal techniques, however, are designed for corporate credit and there is no full-fledged credit bureau in the country to provide information on credit worthiness.

Demanding Investors

Financial organizations now invite more private capital to replace dwindling government support. Lenders and investors will drive them inexorably towards transparency, increased disclosure and better risk management.

Other Reasons

Besides this due to globalization all the companies are facing challenges from international players and so all of them must implement risk management procedures in line with the international standards.

The various international credit rating agencies like Moody's and Standard and Poor rate the countries as well as financial institutions and the same is utilized by certain international bodies to review a client for giving loans or transacting with them. So there is a trend right now evident in India is, many financial institutions are now desperate to improve their rating. As such they are now implementing these risk management measures with utmost urgency.

Having discussed the conceptual part of risk, let us know about the various types of risks in International Finance with suitable examples.

Political Risk

Political Risk is the risk that results from political changes or instability in a country. It has adverse impact on the working of foreign enterprise located in that country as well as on financial and commercial operation carried out with such a country. This kind of risk becomes more pronounced when factors of instability such as wars, riots, social and religious conflict, or nationalist movements crop up. From an economic viewpoint, political risk refers to uncertainty over property rights.

Types of Political Risk

Political risk threatens continuance of direct and indirect investments in the host country as well as the exports towards it as it entails the risk of nonpayment. It also results from government measures tending to limit the working and operations of foreign firms. Political risk can broadly classified into the following three categories

1. Country risk: This risk emanates from political, social and economic instability of a country and manifests in the form of more or less strong hostility towards foreign investments. The hostility develops during the periods of crisis. Certain governments succumbing to discontentment of the population proceed to nationalize multinational enterprises. Other, by nationalism, incorporates

nationalization in their programs. Still others want to acquire a right to control in certain sectors considered to the strategic. The political risk takes several forms, such as nationalization or expropriation without indemnity (Compensation). The major episodes in this context are nationalization in Iran (1978), Libya (1969), Algeria (1969); nationalization with indemnity, such as in Chile (1971). Above all latent nationalization in terms of compulsory local or governmental participation constitutes another variant of political risk.

2. Sector risk: Several studies have indicated that certain sectors are prone to greater political risk than others in some countries, though general climate to foreign investment is not unfavorable. Included in this category are Petroleum, Mining, Banking and so on. For instances, petroleum sector has been nationalized in various countries such as Mexico (1938), Libya (1968), Iraq (1972), Venezuela and Kuwait (1975), Iran (1978), and Nigeria (1979). Likewise, nationalization of copper mines took place in Zaire, Zambia, and Chile and of Iron mines in Venezuela. Banking sector was nationalized in Guinea (1962), Vietnam (1975) and Iran and Nicaragua (1978).

3. Project risk: Sometimes, neither a country nor a sector may be a matter of risk; only a project is subject to risk. Often, multinationals take up big projects in foreign countries, like electricity generating plants, dams, exploration of petroleum fields etc. A project requires a huge expenditure and risk is very high in the beginning. In the event of the project turning to be successful (for example finding an exploitable petroleum field), some governments are very demanding, and in certain situations, in particular, with the change of government the latter may even refuse to respect the engagement of the predecessor. In a recent case (1995), a new Government of the Maharashtra State in India refused to fulfill the agreement of the previous government for a large electricity project.

In respect of risk management, project participants need to be convinced that risk management activity will help them meet their own objectives. For powerful customers, a requirement that all tenders include a risk management plan is sufficient inducement for offering contractors to comply at some level. However, enlightened customers expecting risk management from contractors will take pains to demonstrate how contractors can benefit directly by improved cost estimation, greater efficiency, improved project control, and, ultimately, higher profitability.

Derivatives

This Section includes

- Forward
- Future
- Option
- Swap

Introduction

A typical financial transaction is marked by several risks. Derivatives allow us to manage these risks more efficiently by unbundling these risks and allowing either hedging or taking only one risk at a time. And therefore derivatives have become increasingly important in the field of finance.

Derivatives permit the separation of price risks and redistribution to others who can manage them. Derivatives traded on organized exchanges provide liquidity and quick adaptability of exposure to market changes. Derivatives can be used for hedging, protecting against financial risk, or can be used to speculate on the movement of commodity or security prices, interest rates or the levels of financial indices.

Derivatives may be of the following forms:

- Forward,
- Future,
- Option, and
- Swap.

Options and futures are traded actively on many exchanges. Forward contract, swaps and different types of options are regularly traded outside exchanges by financial institutions, banks and their corporate clients in what are termed as over-the-counter markets — in other words, there is no single market place or an organized exchange. Derivatives are available on many aggregate economic risk factors such as global bond and stock portfolios. With many futures contracts, global risk positions and portfolios can be traded as a single financial product.

While, for example, it is difficult to trade baskets of securities at stock exchanges, stock index options and futures offer opportunities to trade aggregate stock market risks for as much as 1/10 or 1/20 of the costs of an equivalent cash market transaction! Derivatives also facilitate diversification because; given that the investment represents only a fraction of the cash instrument (leverage) it is easier to diversify a given amount of capital across several assets. Finally, if more risks can be diversified, the systematic risk exposure of the economy decreases which lowers the overall cost of risk capital for firms.

FORWARD TRANSACTIONS

A forward contract is an agreement between two persons for the purchase and sale of a commodity or financial asset at a specified price to be delivered at a specified future date.An agreement to purchase one currency and sell another for some date beyond two business days. A forward involves no fee, and no cash changes hands until the settlement date of the forward. A forward allows one to lock in an exchange rate today for a future payment or receipt, thereby eliminating rate risk.

Forward contracts are tailor made to the needs of the parties who may be banks in case of financial assets and trader or processor in case of commodities. Forward markets have flourished as a means to reduce price uncertainty.

The Advantages of Forward Contract

The Benefits of Forward Contract Are:

- It can be used to hedge or protect oneself form the price fluctuations on the future commitment date to extent of 100%.

- The up front fees or margins are not applicable to forward contracts and hence no initial costs.

Disadvantages

Forward contracts are not performance guaranteed. Hence involve counter party risk.

- The investor cannot derive any gain from favorable price movements either before or on delivery date.
- Forward contracts are not traded in the secondary market, hence there is no ready liquidity.
- Banks being one of the counter parties enter into reverse transactions to square positions and hence charge huge bid-ask spread.

A forward contract locks one investor to a particular exchange rate, thereby insulating the him or her from exchange rate fluctuations. In India, the forward contract has been the most popular instrument employed by corporate to cover their exposures, and, thereby, offset a known future cash outflow. Forward contracts are usually available only for periods up to 12 months. Forward premiums are governed purely by demand and supply, which provide corporate with arbitrage opportunities. The premiums in this market are quoted till the last working day of the month.

Internationally, the forward premiums, or discounts, reflect the prevailing interest rate differentials. Arbitrage opportunities are, therefore, limited. As a rule, a currency with a higher interest rate trades at a discount to a currency with a lower interest rate. Since there is a forward market available for longer periods, the forward cover for foreign exchange exposures can stretch up to five years. The premiums, or discounts, are quoted on a month-to-month basis. That is, from the spot date to exactly one month, or two months, or even a year.

Forward-to-forward contracts

A forward-to-forward contract is a swap transaction that involves the simultaneous sale and purchase of one currency for another, where both transactions are forward contracts. It allows the company to take advantage of the forward premium without locking on to the spot rate. The spot rate has to be locked onto before the starting date of the forward-to-forward contract.

A forward-to-forward contract is a perfect tool for corporate houses that want to take advantage of the opposite movements in the spot and forward market by locking in the forward premium at a high or low level now. CFO's can defer locking on the spot rate to the future when they consider the spot rate to be moving in their favour. However, a forward to forward contract can have serious cash flows implications for a corporate. Before booking a forward-to-forward contract, CFO should carefully examine his cash flow position bearing in mind the immediate loss that he would make if the spot rate did not move in his favour.

Example

An exporter believes that forward premiums are high, and will move down before the end of, say, December 2000. Also he expects the spot rate to depreciate. Then the optimal strategy would be to lock in the high premium now, and defer the spot rate to a future date. So he opts for a forward-to-forward contract for end-December, 2000, to end-March, 2001, paying a premium of say, ₹ 0.64. By

entering into such a contract, the exporter has the opportunity to lock on the spot rate anytime till December 31, 2000. Alternatively, if the three-month premium between end-December and end-March moves below the ₹ 0.64 level, he can cancel the contract and book his profits.

Range-forwards

A range-forward involves the simultaneous purchase and sale of an option at different strike prices, but having the same maturity date and the same principal amount.

While an option provides a corporate the flexibility to benefit from upside movements while limiting downside risks, it has an associated cost; a high upfront premium. By setting a ceiling on the potential gains, a range-forward trades off some of the upside for a lower premium.

Example

Company X is importing machinery worth DM 1 million. Although the Chief Finance Officer (CFO) wants to insure against downside losses, he finds the option premiums are exorbitant. In exchange for a lower premium, say 0.5%, he is willing to give up some of the upside gains if the DM moves above 1.7600. So, he buys a range-forward, which limits the fluctuation of the DM to a band between 1.7600 and 1.7200.

The regulation

In September, 1996, the RBTs exchange Control Manual was amended to allow the banks to offer range-forwards to corporate to hedge their foreign exchange exposures, provided the net premium paid by the corporate was non-negative. This implies that a corporate cannot buy a range-forward which would result in a cash inflow by way of premium. The best that a corporate can do in such a situation is to opt for a zero-cost range-forward.

Ratio Range-forwards

A ratio range-forward is an improved version of the basic range forward. The difference is that the principal amounts on the two options differ. The buyer gets full protection on the downside but shares the profit with the writer in a predetermined ratio if the currency moves above a specified level.

In the case of a range-forward, the buyer sacrifices the benefit of favourable movements in the currency beyond a predetermined level for a lower premium. However, with the ratio range-forward, the buyer shares the profit in a predetermined ratio if the currency moves above a predetermined ceiling. As this is an additional benefit, the ratio range-forward is more expensive.

If we consider the case of a CFO who would like to restrict his downside to DM 1.7200 to the dollar, however, he does not want to rule out the possibility of a strong dollar appreciation. The ideal instrument would b a ratio range-forward, which allows the CFO to have a specified share — say, 30% in the gains if the DM crosses the 1.7600-mark. The Regulation: These derivative products can be freely booked and canceled. However, the restriction barring the net inflows of premium to corporate still applies.

Terms and conditions applicable to Forward Contracts in India

In March, 1992, in order to provide operational freedom to corporate, the unrestricted booking and cancellation of forward contracts for all genuine exposures whether trade related or not, was permitted.

In February 1992, corporate with cross currency exposures were permitted to split their cover through the dollar. For instance if an importer with a DM 1million payment to make on March 31st 1998, is of the view that the rupee will depreciate against the dollar, but that the dollar will appreciate against the Deutsche mark, he can split his exposure into a $-DM leg and a $-Re leg-and hedge the latter. The Reserve Bank of India (RBI) has also permitted corporate to take cover in a currency of their choice irrespective of the currency receivable or payable.

In January 1997, the RBI allowed the banks to quote rupee forward premiums for more than six months. This has resulted in the development of a local forward market for up to 1year. However, as the link between the local money market and the foreign exchange markets is not strong, and as demand and supply determine prices, activity in the long-term forward market has been limited.

In short the salient features of regulations may be enumerated as:

1. They are available for exposures arising out of genuine export/import transactions
2. They can be entered between authorized dealers and any entity which is a resident of India, at the time of the contract.
3. The authorized dealer must ensure that the investor is exposed to exchange rate risk.
4. They must be in writing, in a prescribed form.
5. The exchange broker cannot act as an authorized dealer.
6. Maximum tenure of forward contract is 6 months and can be extended to another 6 months if the need arises.
7. Forward cover in respect of one commercial transaction cannot be extended to any other foreign exchange commitment or risk.
8. Forward contracts can be canceled for a fee.

FUTURES CONTRACT

A futures contract is an agreement between a seller and a buyer which requires the seller to deliver to the buyer a specified quantity of security, commodity or foreign exchange at a fixed time in future at a price agreed to at the time of entering the contract. Futures contracts are traded in designed futures market unlike forward contracts that are executed over the counter. The terms of the future contracts are standardized to reduce the transaction cost to the bare minimum.

The oldest futures exchange is the Chicago Board of Trade in USA. The CBOT was limited to agricultural futures for the last 100 years. With the increased volatility in the financial markets, CBOT, along with other futures exchanges has started creating markets in financial futures. Why futures?

Futures contracts are bought and sold for many reasons. Individuals deal in futures contracts to speculate about the future price of the asset or commodity underlying the futures contract. Corporates

enter into futures contract to eliminate the risk exposure occurring due to changes in the price of the commodity. Fund managers use futures as a more economical way of achieving heir portfolio goals.

Speculators deal in futures contracts to benefit from the rice fluctuations in the underlying asset or commodity, while hedgers seek to protect themselves against price changes in commodities in which they have an interest. Characteristics of futures

Organized exchanges: Futures contracts are traded in organized exchanges with a designated physical location for futures trading. This provides instant liquidity as futures contracts can be sold and bought anytime like in a stock market.

Standardization: The futures contracts are standardized in the sense that the price, the quantity and the date of maturity is fixed by the exchange in which they are traded.

Clearinghouse: The clearinghouse acts as a middleman between the contracting parties. As soon as the deal is struck between X and Y, two contracts are entered into, one between X and the Clearinghouse and the other between Y and the Clearinghouse. The clearinghouse acts as a buyer for every seller and seller for every buyer. It guarantees the performance of the contracts.

Margins: Only members of the respective exchanges can enter into futures contracts. They are required to deposit margin money with the clearinghouse. The amount of this margin money is generally between 2.5% to 10% of the value of the contract, but can vary.

Marking to market: At the end of each trading session, all outstanding contracts are appraised at the settlement price of that trading session. This is known as Marking to market. 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.

Actual delivery is rare: 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 the maturity of the first.

Example: A fast food seller like Monginis will need to buy additional wheat from his supplier in three months. However, he feels that the price of wheat is going to increase by the time he needs the wheat in three months. May be he feels this year the monsoon will not set in on time. Because of fierce competition, he needs to hold his price constant. He wants to make sure that he pays ₹ 355 per quintal. Therefore, to lock in the ₹ 355 per quintal price, he buys a contract for three months out at ₹ 355 per quintal. If three months later the price of wheat has risen to ₹ 369 per quintal, he will pay his supplier ₹ 369. However, the ₹ 14 increase has been offset by the ₹ 14 increase in his futures contract.

On the other hand, if the price of wheat declines by an amount of ₹ 10 per quintal to ₹ 345 per quintal, the decline in the futures contract will be offset by the lesser amount the manufacturer has to pay his supplier. Irrespective of what happens in the spot market, the manufacturer has locked in a set price for the wheat he needs to purchase in the future.

Types of Futures

Futures may be broadly classified into Commodity and Financial Futures. A commodity is a futures contract in a commodity like tea, coffee, cocoa, aluminium etc. A financial future is a futures contract in a financial instrument like Treasury bill, currency or stock index.

1. Commodity futures: Agricultural: This includes tea, coffee, wheat, spices, rice, sugar etc. For each of these commodities there are different contract months available. Contract months generally revolve around the harvest cycle. More actively traded commodities usually have more contract months available.

Metallurgical: The group of metallurgical commodities includes the metals and the petroleum. The metals group includes gold, silver, copper, palladium and propane. Different contract months, grades, amounts, and types of these contracts are available.

2. Financial futures: Interest Bearing Assets: This group of futures contracts includes Treasury Bills, Treasury Bonds, Treasury Notes, Municipal Bonds, and Eurodollar Deposits. The entire yield curve is represented and it is possible to trade these instruments with tremendous flexibility as to maturity. In fact, it is also possible to trade contracts with the same maturity but different expected interest rate differentials. In addition, foreign exchanges also trade debt instruments.

Indexes: Today, there are futures on most major indexes. The National Stock Exchange, BSE Sensex (of Mumbai Stock Exchange) of India, S&P 500, New York Stock Exchange Composite, New York Stock Exchange Utilities Index, Commodities

Research Bureau (CRB), Russell 2000, S&P 400 Midcap, Value Line, and the FT-Se 100 Index (London), Stock index futures are settled in cash. There is no actual delivery of a good. The only possibility for the trader to settle his positions is to buy or sell an offsetting position or in cash at expiration. Recently the National Stock Exchange has launched derivative futures called S&P CNX Nifty.

An Index future is a future where the underlying asset is a stock index. The NSE stock index (CNX Nifty) has been launched on 12th June 2000. It has been observed that investors like to hedge their entire share portfolio and not just one or two stocks. A portfolio of 10 to 15 stocks tends to have a strong correlation with the indices. Index futures may further be.

Value weighted index (consists of each stock of the index value in proportion to the market value of the outstanding shares) Ex: S&P 500, NYSE.

Price weighted index (is the one that gives a weight to each stock that is proportional to its stock price) Ex: NIKKEI

In value-weighted index, all blue chips with heavy market capitalization have more weightage whereas in price-weighted index, small equity company can also have major weights based on its price.

Trading and Settlement

Index futures are also standardized like all futures. The size and the tenure need to be understood. The size represents the minimum quantity of the index that is bought or sold; trading lots are in multiples of this number. The tenure is the minimum duration for which a futures contract can remain

open. At the end of the period both the parties to the contract necessarily settle. Settlement is in cash and obviously the seller of the index future does not deliver the underlying securities of an index.

Index Futures and SEBI

SEBI has specified the minimum size of 2 lakh and a maximum tenure of three months. Given the current Nifty and Sensex levels, futures contracts based on these will have a minimum market lot of 150 and 50.

Advantage

Index futures help an investor to take a position on the market and also hedge the share portfolio against adverse market conditions. One can get out of the futures position anytime before the contract expires by entering into a reverse contract.

How does it work?

An Index future is essentially a forward contract and hence requires payment of an initial amount called up front or initial margin of the value of the contract ranging from 6 to 10 per cent. They are marked to market daily i.e. profits and losses are received and paid out by the contracting parties every day.

For example, if an investor is optimistic that the Nifty would rise in future and buys, say 100 Nifty futures paying an initial margin of say, 8%. At the time he sells, he gains if the Nifty rises. The profit being the difference between the selling price and the buying price (margin) multiplied by the number of futures purchased.

Foreign Currencies: In the 1970s when freely floating exchange rates were established it became possible to trade foreign currencies. Most major foreign currencies are traded. The principal currencies traded are the Canadian dollar, Japanese yen, British pound, Swiss franc, French franc, Eurodollar, Euromark, and the Deutsch mark. The forward market in currencies is much larger than the foreign exchange futures market. Additionally, there are now cross currency futures those trades. Examples of these are the Deutsch mark/French franc and the Deutsch mark/yen. Almost every month a new type of contract appears to meet the needs of a continuously growing corporate and institutional market.

Forwards vs. Futures

Table 5.2

S. No.	Difference	Forwards	Futures
1.	Size of contract	Decided between buyer & seller	Standardized in each futures market
2.	Price of contract	Remain fixed till maturity	Changes everyday
3.	Market to market	Not done	Market to market everyday
4.	Margin	No margin required	Margins are to be paid by both buyers & sellers

5.	Counter party risk	Present	Not present
6.	No. of contracts in a year	There can be number of contracts	No. of contracts in a year are fixed.
7.	Hedging	These are tailor-made for specific date and quantity and hence are perfect	Hedging is by nearest month or quarter (if there are 4 contracts) and quantity contracts, so it is not perfect
8.	Liquidity	No liquidity, as they are not traded on secondary market	Highly liquid
9.	Nature of market	Over the counter	Exchange traded
10.	Mode of delivery	Specifically decided. Most of the contracts result in delivery	Standardized. Most of he contracts are cash settled

Option

An option is a contract in which the seller (writer) of the option grants the buyer of the option the right to purchase from or sell to the writer a designated instrument for a specified price within a specified period of time.

Unlike a foreign exchange forward, the option does not obligate the buyer to deliver currency on the settlement date. Foreign exchange options are ideal for hedging exposures in which the amount or the timing of exposure are uncertain. Foreign exchange options allow you to protect against unfavourable currency moves while retaining the ability to participate in favourable moves.

In other words, an option is a contract that gives the holder the right, but the not the obligation, to buy (call) or sell (put) a specified underlying instrument at a fixed price before, or at, a future date. The option holder has to compensate the writer (the issuer of the instrument) for this right, and the cost borne is called the premium or the option price.

The premium should be adequate for the risk borne by the writer and yet, from the holder's point of view, must be worth paying. If the option contains provision to the effect that it can be exercised any time before the expiry of the contract, it is termed as an American Contract. If it can be exercised only on the expiry date, it is termed as European Contract.

Options contract gives the holder a right but not the obligation to buy or sell an underlying asset at a specified date in the future at a certain price. The specified date is called the expiration date. The contract expires on that date if the option-holder chooses not to exercise his right to buy or sell the asset. The price at which the option-holder can buy or sell the underlying asset is called the "Strike price." When the contract gives the holder a right to buy an asset, it is termed as "Call option". On the other hand, an option that gives the right to sell an asset is called as "Put option".

Options are available on a large variety of underlying assets like common stock, currencies, debt instruments and commodities. Also traded are options on stock indices and futures contracts where the underlying asset is a futures contract on stock index with options combined. Options have proved to be versatile and flexible tools for risk management by themselves as well as in combination with other instruments. Options also provide a way for individual investors with limited capital to speculate on the movements of stock prices, exchange rate, commodity prices etc. The biggest advantage in this context is the limited loss feature of options.

Let us consider a typical options contract. Suppose person buy call options on Reliance Industries Limited (RIL) at strike price of ₹ 375, expiring December. This gives one the right but not the obligation to buy RIL shares in December at a price of ₹ 375. Naturally, one would not exercise the option unless RIL's price in December is more than the strike price. Suppose RIL then trades at ₹ 400. The option is said to have an intrinsic value of ₹ 25 that is the difference between the strike price and the market price.

Such options are said to be in-the-money as they help one to pocket gains. When the strike price is higher than the market price, the option is said to be out-of-the-money.

What are the Advantages of an Options Contract?

Suppose somebody wants to buy RIL in December but wish to know his or her outflow now. Entering into a contract now to buy RIL at, say, ₹ 425 in December is one way of locking into the outflow.

That would however, put him or her at a loss if the market price then falls below ₹ 425. This is where an options contract helps. One would buy only if the strike price is lower than the market price.

Types of options

Currency call option: grants its owner the right but not the obligation to buy a specific currency at a specific price (exercise price or strike price) within a specified period of time.

Currency put option: grants its owner the right and not the obligation to sell a specific currency at a specified price (the strike price) within a specified period of time.

Stock option: an option on a stock is called stock option.

Bond option: an option on a bond is called bond option.

Stock index option: this involves buying units of index, which represents the whole market in the same proportion in which individual stocks are represented in the market.

Multi-currency option: it is an arrangement whereby a borrower gets an option to draw funds in one or more of the specified currencies and switch over loans from one currency to another.

American option: can be exercised anytime during the option period.

European option: can be exercised only on the expiry or maturity date.

Options can be used for hedging currency exposures when a corporate is not sure which way the currency is going to move. By entering into an option contract, the investor gets the best of both worlds his downside is restricted to the premium that he pays, and he enjoys an unlimited upside. For the buyer of an option, the gains are unlimited and the losses are limited. For the writer of an option the losses are unlimited and the gains are limited to the extent of the premium he gains.

Currency Option and Two of its Components

- **The intrinsic value:** The amount by which an option is in the money. A call option whose exercise price is below the current spot price of the underlying instrument, or a put option whose exercise price is above the current spot price of the underlying instrument, is said to be in the money.

- **The extrinsic value:** It is the total premium of an option less the intrinsic value. It is also known as the time value or volatility value. As the expiry time increases, the premium of an option also increases. However, with each passing day, the rate of increase in the premium decreases. Conversely, as an option approaches expiry, the rate of decline in its intrinsic value increases. This decline is known as the time decay. Therefore, the more volatile a currency, the higher will be its option value.

Example

Company X is importing machinery for DM 1 million. At the time the deal was struck, the DM was trading at 1.7600 to the dollar. Payment has to be made by April 30, 1998. The DM has already depreciated to 1.7700, and the company has made a tidy profit. The CFO believes that the dollar will continue to gain against the DM, but he would not like to loose the gains he already made. Therefore, he buys an in-the-money DM call option, by paying an up front premium of 2.01 per cent. If on April 30, 1998, the DM is above 1.7900, he will let the option lapse; on the other hand, if the DM is 1.7200, he would exercise the option, and buy DM at the predetermined rate of 1.7600.

In January, 1994, corporate houses were permitted to use currency options as a hedging product. In the absence of a rupee-yield curve a rupee-based currency options were not permitted since the pricing of such options would have been arbitrary. Therefore, the banks were allowed to offer only cross-currency options on a fully-covered basis. And the option could be canceled only once; Chief Finance Officers (CFOs) were not permitted to re-book options against the same exposure. They could, however, hedge the exposure using the forward market. In September, 1996, corporate houses were allowed to freely book and cancel options. But rupee-based options are still not permitted by the RBI.

Fixed Rate Debt and Embedded Options

Fixed rate debt typically includes either a prepayment option or in the case of publicly traded debt, a call provision. In substance this right is no more and no less than a put option on interest rates and a right which becomes more valuable the further interest rates fall. By way of contrast, swap agreements do not contain a prepayment option. The early termination of a swap contract will involve the payment, in some form or other, of the value of the remaining contract period to maturity.

SWAPS

Swap in finance means an exchange of one obligation with another. Financial swaps are a funding technique, which permit a borrower to access one market or instrument and exchange the liability for another market or instrument. Investors can exchange one type of risk with another.

It is a device for obtaining the desired form of financing indirectly which otherwise might be inaccessible or too expensive. Swaps allow the borrowers to raise money in one market and to swap one interest rate structure for another (from fixed to floating), or swap principal and interest from one currency to another.

Why swaps?

Swaps are increasingly becoming popular for the following reasons:

- Difference in borrowers and investors preferences and market access;
- A low cost device to achieve certain objectives, which can be achieved by other means but at a higher cost; Market saturation i.e. lack of availability of the desired currency due to saturation and Differences in financial norms followed by different countries.

Financial Benefits Created by Swap Transactions

Consider the Following Statements

1. A company with the highest credit rating, AAA, will pay less to raise funds under identical terms and conditions than a less creditworthy company with a lower rating, say, BBB. The incremental borrowing premium paid by a BBB company, which it will be convenient to refer to as a "Credit quality spread", is greater in relation to fixed interest rate borrowings than it is for floating rate borrowings and this spread increases with maturity.
2. The counterparty making fixed rate payments in a swap is predominantly the less creditworthy participant.
3. Companies have been able to lower their nominal funding costs by using swaps in conjunction with credit quality spreads.

These statements are fully consistent with the objective data provided by swap transactions and they help to explain the "Too good to be true" feeling that is sometimes expressed regarding swaps. Can it really be true, outside of "Alice in Wonderland", that everyone can be a winner and that no one is a loser? If so, why does this happy state of affairs exist? The answer follows:

(a) The Theory of Comparative Advantage

When we begin to seek an answer to the questions raised above, the response we are most likely to meet from both market participants and commentators alike is that each of the counterparties in a swap has a "Comparative advantage" in a particular and different credit market and that an advantage in one market is used to obtain an equivalent advantage in a different market to which access was otherwise denied. The AAA Company therefore raises funds in the floating rate market where it has an advantage, an advantage which is also possessed by company BBB in the fixed rate market.

The mechanism of an interest rate swap allows each company to exploit their privileged access to one market in order to produce interest rate savings in a different market. This argument is an attractive one because of its relative simplicity and because it is fully consistent with data provided by the swap market itself. However, as *Clifford Smith, Charles Smithson and Sykes Wilford point out in their book Managing Financial Risk,* it ignores the fact that the concept of comparative advantage is used in international trade theory, the discipline from which it is derived, to explain why a natural or other immobile benefit is a stimulus to international trade flows. As the authors point out: The United States has a comparative advantage in wheat because the United States has wheat producing acreage not available in Japan. If land in Kansas could be relocated outside Tokyo —the comparative advantage would disappear. The international capital markets are, however, fully mobile. In the absence of barriers to capital flows, arbitrage will eliminate any comparative advantage that exists

within such markets and this rationale for the creation of the swap transactions would be eliminated over time leading to the disappearance of the swap as a financial instrument. This conclusion clearly conflicts with the continued and expanding existence of the swap market.

(b) Information Asymmetries

The much vaunted economic efficiency of the capital markets may nevertheless co -exist with certain information asymmetries. Four authors from a major US money center bank have argued that a company will and should choose to issue short term floating rate debt and swap this debt into fixed rate funding as compared with its other financing options if:

1. It had information not available to the market generally, which would suggest that its own credit quality spread (the difference, you will recall, between the cost of fixed and floating rate debt) would be lower in the future than the market expectation.
2. It anticipates higher risk-free interest rates in the future than does the market short and is more sensitive (i.e. averse) to such changes than the market generally.

In this situation a company is able to exploit its information asymmetry by issuing short term floating rate debt and to protect itself against future interest rate risk by swapping such floating rate debt into fixed rate debt.

Returning to our initial question as to why an interest rate swap can produce apparent financial benefits for both counterparties the true explanation is, I would suggest, a more complicated one than can be provided by the concept of comparative advantage alone.

Information asymmetries may well be a factor, together with the fact that the fixed rate payer in an interest rate swap, reflecting the fact that he has no early termination right, is not paying a premium for the implicit interest rate option embedded within a fixed rate loan that does contain a pre-payment right. This saying is divided between both counterparties to the swap.

Types of Swaps

- Interest rate swap
- Currency swap

Cross currency swap (combination of the above two) Interest Rate Swap

Example: Company A has borrowed $10 million of a floating interest rate of LIBOR (London Inter Bank Offer Rate) plus 2% payable and Company B has borrowed $10 million on which a fixed interest rate of 10% is payable. A and B enter into an interest rate swap transaction under which A agrees to pay B a fixed interest rate of 10% and B agrees to pay A LIBOR plus 2%. Swaps may result in cost savings as the two parties may have different credit risks. To explain further, assume that company A has low rating and can borrow only at a fixed interest rate. On the other hand company B is rated high and can borrow at floating rate basis.

Fixed to floating rate swap is the standard interest rate swap. It is also known as vanilla swap. This refers to an agreement between two parties that contract to make payments to one another on specified dates in future till an agreed termination date in a particular way, where one party, known as the fixed rate payer makes an agreed payment. The other party known as the floating rate payer makes

payments pegged to the movement of a particular interstate index. Usually LIBOR is used as the underlying interest rate index.

There are Three Types of Interest Rate Swaps

- **Coupon swaps:** fixed to floating rates or vice versa.
- **Basis swaps:** the exchange of one benchmark for another under floating rates (LIBOR for Treasury Bill rate)
- **Cross currency interest rates swap:** this swap has fixed rate flows in one currency for floating rate flows in another currency.

Interest Rate Swap: More issues

An interest rate swap is a contractual agreement entered into between two counterparties under which each agrees to make periodic payment to the other for an agreed period of time based upon a notional amount of principal. The principal amount is notional because there is no need to exchange actual amount of principal in a single currency transaction: there is no foreign exchange component to be taken account of. Equally, however, a notional amount of principal is required in order to compute the actual cash amounts that will be periodically exchanged.

Under the commonest form of interest rate swap, a series of payments calculated by applying a fixed rate of interest to a notional principal amount is exchanged for a stream of payments similarly calculated but using a floating rate of interest. This is a fixed-for-floating interest rate swap. Alternatively, both series of cash flows to be exchanged could be calculated using floating rates of interest but floating rates that are based upon different underlying indices.

Examples might be LIBOR and commercial paper or Treasury bills and LIBOR and this form of interest rate swap is known as a basis or money market swap.

Pricing Interest Rate Swaps

If we consider the generic fixed-to-floating interest rate swap, the most obvious difficulty to be overcome in pricing such a swap would seem to be the fact that the future stream of floating rate payments to be made by one counterparty is unknown at the time the swap is being priced. This must be literally true, no one can know with absolute certainty what the 6 months US dollar LIBOR rate will be in 12 months time or 18 months time. However, if the capital markets do not possess an infallible crystal ball in which the precise trend of future interest rates can be observed, the markets do possess a considerable body of information about the relationship between interest rates and future periods of time.

Reversing or Terminating Interest Rate Swaps

The point has been made above that at inception the net present value of the aggregate cash flows that comprise an interest rate swap will be zero. As time passes, however, this will cease to be the case, the reason for this being that the shape of the yield curves used to price the swap initially will change over time. Assume, for example, that shortly after an interest rate swap has been completed there is an increase in forward interest rates, the forward yield curve steepens. Since the fixed rate payments due

under the swap are by definition, fixed, this change in the prevailing interest rate environment will affect future floating rate payments only; current market expectations are that the future floating rate payments due under the swap will be higher than those originally expected when the swap was priced. This benefit will accrue to the fixed rate payer under the swap and will represent a cost to the floating rate payer. If the new net cash flows due under the swap are computed and if these are discounted at the appropriate new zero coupon rate for each future period (i.e. reflecting the current zero coupon yield curve and not the original zero coupon yield curve), the positive net present value result reflects how the value of the swap to the fixed rate payer has risen from zero at inception. Correspondingly, it demonstrates how the value of the swap to the floating rate payer has declined from zero to a negative amount.

If the floating rate payer wishes to terminate the swap with the fixed rate payer's agreement, then the positive net present value figure we have calculated represents the termination payment that will have to be paid to the fixed rate payer. Alternatively, if the floating rate payer wishes to cancel the swap by entering into a reverse swap a new counterparty for the remaining term of the original swap, the net present value figure represents the payment that the floating rate payer will have to make to the new counterparty in order for him to enter into a swap which precisely mirrors the terms and conditions of the original swap.

Credit risk implicit in Interest Rate Swaps

To the extent that any interest rate swap involves mutual obligations to exchange cash flows, a degree of credit risk must be implicit in the swap. Note however, that because a swap is a notional principal contract, no credit risk arises in respect of an amount of principal advanced by a lender to a borrower which would be the case with a loan. Further, because the cash flows to be exchanged under an interest rate swap on each settlement date are typically "Netted" (or offset) what is paid or received represents simply the difference between fixed and floating rates of interest. Contrast this again with a loan where what is due is an absolute amount of interest representing either a fixed or a floating rate of interest applied to the outstanding principal balance. The periodic cash flows under a swap will, by definition, be smaller therefore than the periodic cash flows due under a comparable loan.

An interest rate swap is in essence a series of forward contracts on interest rates. In distinction to a forward contract, the periodic exchange of payment flows provided for under an interest rate swap does provide for a partial periodic settlement of the contract but it is important to appreciate that the net present value of the swap does not reduce to zero once a periodic exchange has taken place.

This will not be the case because in the context of reversing or terminating interest rate swaps, the shape of the yield curve used to price the swap initially will change over time giving the swap a positive net present value for either the fixed rate payer or the floating rate payer not withstanding that a periodic exchange of payments is being made.

Users and uses of Interest Rate Swaps

Interest rate swaps are used by a wide range of commercial banks, investment banks, non-financial operating companies, insurance companies, mortgage companies, investment vehicles and trusts, government agencies and sovereign states for one or more of the following reasons:

1. To obtain lower cost funding
2. To hedge interest rate exposure
3. To obtain high yielding investment assets
4. To create types of investment asset not otherwise obtainable
5. To implement overall asset or liability management strategies
6. To take speculative positions in relation to future movements in interest rates.

The advantages of Interest Rate Swaps

1. A floating -to-fixed swap increases the certainty of an issuer's future obligations
2. Swapping from fixed-to-floating rate may save the issuer money if interest rates decline.
3. Swapping allows issuers to revise their debt profile to take advantage of current or expected future market conditions.
4. Interest rates swaps are a financial tool that potentially can help issuers lower the amount of debt service.

Typical transactions would certainly include the following, although the range of possible permutations is almost endless.

(a) Reducing funding costs. A US industrial corporation with a single A credit rating wants to raise US$ 100 million of seven year fixed rate debt that would be callable at par after three years. In order to reduce its funding cost it actually issues six month commercial paper and simultaneously enters into a seven year, non amortising swap under which it receives a six month floating rate of interest (Libor Flat) and pays a series of fixed semi annual swap payments. The cost saving is 100 basis points.

(b) Liability management. A company actually issues seven year fixed rate debt which is callable after three years and which carries a coupon of 7%. It enters into a fixed-to-floating interest rate swap for three years only under the terms of which is pays a floating rate of Libor + 185 bps and receives fixed rate of 7%. At the end of three years the company has flexibility of calling its fixed rate loan —in which case it will have actually borrowed on a synthetic floating rate basis for three years, or it can keep its loan obligation outstanding and pay a 7% fixed rate for further four years. As a further variation, the company's fixed-to-floating interest rate swap could be an "Arrears reset swap" in which, unlike a conventional swap, the swap rate is set at the end and not at the beginning of each period. This effectively extends the company's exposure to Libor by one additional interest period which will improve the economics of the transaction.

(c) Speculative position. The same company described in (b) above may be willing to take a position on short term interest rates and lower its cost of borrowing even further (provided that its judgment as to the level of future interest rates is correct). The company enters into a three year "Yield curve arbitrage swap" in which the floating rate payments it makes under the swap are calculated by reference to a formula. For each basis point that Libor rises, the company's floating rate swap payments rise by two basis points. The company's spread over Libor, however, falls from 185 bps to 144 bps. In exchange, therefore, for significantly increasing its exposure to short term rates, the company can generate powerful savings.

(d) Hedging interest rate exposure. A financial institution providing fixed rate mortgages is exposed in a period of falling interest rates if homeowners choose to prepay their mortgages and re-finance at a lower rate. It protects against this risk by entering into an "Index amortising rate swap" with, for example, a US regional bank. Under the terms of this swap the US regional bank will receive fixed rate payments of 100 bps to as much as 150 bps above the fixed rate payable under a straightforward interest swap. In exchange, the bank accepts that the notional principal amount of the swap will amortize as rates fall and that the faster rates fall, the faster the notional principal will be amortized.

A less aggressive version of the same structure is the "Indexed principal swap". Here the notional principal amount continually amortizes in line with a mortgage pre-payment index such as PSA but the amortization rate increases when interest rates fall and the rate decreases when interest rates rise.

(e) Creation of new investment assets. A UK corporate treasurer whose company has substantial business in Spain feels that the current short term yield curves for sterling and the peseta which shows absolute interest rates converging in the two countries is exaggerated. Consequently he takes cash currently invested in the short term sterling money markets and invests this cash in a "Different swap". A differential swap is a swap under which the UK Company will pay a floating rate of interest in sterling (6 mth. Libor) and receive, also in sterling, a stream of floating rate payments reflecting Spanish interest rates plus or minus a spread. The flows might be: UK Corporation pays six month sterling Libor flat and receives six month Peseta Mibor less 210 bps paid in sterling. Assuming a two year transaction and assuming sterling interest rates remained at their initial level of 5.25%, peseta Mibor would have to fall by 80 bps every six months in order for the treasurer to earn a lower return on his investment than would have been received from a conventional sterling money market deposit.

(f) Asset management. A German based fund manager has a view that the sterling yield curve will steepen (i.e. rates will increase) in the range two to five years during the next three years he enters into a "Yield curve swap" with a German bank whereby the fund manager pays semi-annual fixed rate payments in DM based on the two year sterling swap rate plus 50 bps. Every six months the rate is re-set to reflect the new two year sterling swap rate. He receives six months fixed rate payments calculated by reference to the five year sterling swap rate and re-priced every six months. The fund manager will profit if the yield curve steepens more than 50 bps between two and five years.

Example

Company X has obtained a loan of $20 million, with interest rates pegged to the six month LIBOR. The CFO is of the view that interest rate in US are on the rise. To prevent a loss by way of a higher interest outflow in the coming years, he decided to enter into an interest swap with his banker. Essentially, the banker agrees to pay the corporate a six month LIBOR rate in return for a fixed interest payment by the corporate. The possibilities are almost endless but the aforementioned examples do give some general indication of how interest rate swaps can be and are being used.

Currency Swaps

Currency swap converts a stream of cash flow from one currency to another without exchange rate risk. Currency swaps enable a corporation to lower its borrowing costs in any desired currency.

The basic principle is that a corporation should borrow in the country in which it receives the cheapest possible source of financing. A currency swap would then enable it to convert this to inexpensive financing in the desired currency.

In currency swap, both principal and interest payments in one currency are exchanged to another currency. An exchange of principal amounts in the beginning and reexchange at termination is also possible. This may take the form of fixed to fixed, fixed to floating and floating to floating currency swaps.

- Fixed to fixed currency swap involves exchange of principals which are equivalent and denominated in different currencies, where both the parties make fixed payments to each other till the termination on a specified date.
- Floating to floating swap involves both payments at floating rate but in difference currencies.
- Fixed to floating currency swap is a combination of fixed to fixed and floating to floating currency swap.

Credit Derivative

Credit risk is an inevitable risk faced by almost everyone entering into a loan contract. Credit risk is a risk that arises if a counter party does not honour or fails to fulfill his contractual obligation. For example, a bank giving loans to its client often fears default in its repayment.

Therefore, to minimize the impact of credit risk an innovative instrument called "Credit Derivatives" was designed. Credit derivative is an Over-the-Counter (OTC) derivative designed to transfer credit risk from one party to another. These privately negotiated bilateral contracts allow users to manage their exposure to credit risk. For example, a bank, concerned that one of its customers may not be able to repay a loan can protect itself against loss by transferring the credit risk to another party while retaining the loan on its books. This mechanism can be used for any debt instrument or basket of debt instruments.

Types of Credit Derivatives

Four major types of derivative instruments contribute maximum volume in OTC exchanges. These are explained below:

Credit Default Swaps

Two parties enter into an agreement, whereby one party pays the other a fixed periodic coupon for the specified life of the agreement. The other party makes no payment unless a specified credit event occurs. Credit events are typically defined to include a material default, bankruptcy or debt restructuring for a specified reference asset. If such a credit event occurs, he makes a payment to the first party, and terminates the swap. The size of the payment is usually linked to the decline in the reference asset's market value following the credit event.

Future of Credit Derivative

Credit derivatives have radically altered the credit market. The range of positions, include long, flat, short, asymmetric and option-like. Credit derivatives have unlocked market.

The interest rate swap market is likely to make rapid strides. This in turn, is likely to affect the credit derivative business as banks develop tools to manage credit using the portfolio theory. Quite similar to the upsurges in the interest rate swap market which banks developed good asset/liability management models. Most importantly, capital regulations will reflect the shift from large, illiquid, long maturity credit exposures to liquid risks and basis risk.

MANAGING INTEREST RATE: MORE TO LEARN

Forward Rate Agreements

A Forward Rate Agreement (FRA) is an agreement between two parties who wish to protect themselves against fluctuations in interest rates. The parties agree on an interest rate for a specific period of time on a specified principal amount.

The Instrument: FRAs are an effective instrument for companies which have borrowed at floating rates of interest, and wish to hedge their interest rate risks. The buyer of an FRA is a party wishing to protect itself against a rise in the interest rates, and the seller is a party insuring itself against a decline.

The price of an FRA will depend on the slope of the yield curve which essentially reflects interest rate expectations. Earlier the FRA was linked to dollar linked borrowings since the dollar was perceived to be more volatile than the European currencies. However, FRAs now cover a wide selection of currencies and maturities. In an environment of increasing interest rate volatility, a FRA helps a corporate crystallize its interest costs.

The banks can offer FRAs linked to the LIBOR. Again, they have to ensure that such agreements are used purely as a liability management tool.

Example

Company X is raising a dollar loan, with the effective annual rate at the London Inter-Bank Offered Rate (LIBOR) plus 100 basic points. Installments are payable every six months. The CFO believes that the interest rates in the US will rise in the near future by at least 0.25%. The payments are due in end-September, 1997 and end-March, 1998. Since this is a floating interest loan, the LIBOR for interest payments is crystallized six months in advance. While the LIBOR in August 1, 1997 was 5.70%, the corporate enters into an FRA for two against eight months to protect its interest liability in March, 1998, the LIBOR for which will be fixed in end-September, 1997. The “2s vs. 8s” FRA costs 5.77%. If no interest rate hike takes place, the LIBOR will be applied (5.70%) and the corporate will pay the difference of 0.07% to the FRA seller as the FRA is independent of the loan agreement. In case the hike happens as expected, and interest rate rise to 5.95%, the corporate will receive 0.18% (5.95 - 5.77) from the seller, and interest on the installment will be calculated at 5.95%.

What is an Interest Rate Swap?

An interest rate 'swap' is an exchange of interest payments between two parties. In the above example it means that fixed rate payments and floating rate payments are exchanged at periodic intervals based on an underlying notional principal amount by the counterparties. This is an Interest Rate Swap. Thus Interest rate swaps are generally used for 'swapping' from a floating rate of interest into a fixed rate of interest, or vice-versa.

Interest rate swaps are used to hedge interest rate risks as well as to take on interest rate risks. If a treasurer is of the view that interest rates will be falling in the future, he may convert his fixed interest liability into floating interest liability take a home loan borrower who 2 years ago, took a fixed rate home loan from ICICI bank also his floating rate assets into fixed rate assets. If he expects the interest rates to go up in the future, he may do vice-versa [As it is now when many home loan borrowers chose to convert floating rate home loans to fixed rate loans]. Since there are no movements of principal, these are off balance sheet instruments and the capital requirements on these instruments are minimal. Please note that individual borrowers do not perform swap though they may face similar situations with their borrowings.

Definition: A contract which involves two counter parties to exchange over an agreed period, two streams of interest payments, each based on a different kind of interest rate, for a particular notional amount.

Mechanism of an Interest Rate Swap

Take the case of an interest rate swap, in which Counter Party A and Counter Party B agree to exchange over a period of say, five years, two streams of semi-annual payments. The payments made by A are calculated at a fixed rate of 6% (Fixed rate) per annum while the payments to be made by B are to be calculated using periodic fixings of 6-month Libor (floating). The swap is for a notional principal amount of USD 10 million. The above swap is called the "plain vanilla" or the "coupon swap". Interest rates are normally fixed at the beginning of the contract period, but settled at the end of the period.

The contract can be simplified as follows.

Counter parties :: A and B

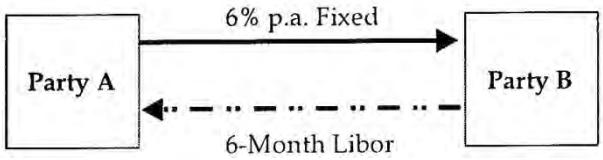
Maturity :: 5 years

A pays to B: 6% fixed p.a.

B pays to A: 6-month LIBOR

Payment terms: semi-annual

Notional Principal amount: USD 10 million.



Diagram

Fig. 5.5

Cash flows in the above swap are represented as follows:

Table 5.3

Period	Fixed Payments	Floating Payments	Net Cash from A to B	LIBOR Rate
1	300000	337500	−37500	6.75
2	300000	337500	−37500	6.75
3	300000	337500	−37500	6.75
4	300000	325000	−25000	6.50
5	300000	325000	−25000	6.50
6	300000	325000	−25000	6.50
7	300000	312500	−12500	6.25
8	300000	312500	−12500	6.25
9	300000	312500	−12500	6.25
10	300000	325000	−25000	6.50
		-250000		

Typical Characteristics of the Interest Rate Swaps

The principal amount is only notional. Opposing payments through the swap are normally netted. The frequency of payment reflects the tenor of the floating rate index.

Interest Rate Swap with Bank as an intermediary

The following diagram illustrates the case in which an intermediary, e.g. a bank, is involved in a swap deal between two counter parties. Borrower A has a floating rate loan, but would prefer a fixed rate loan. There is another borrower B who has a fixed rate loan, but would prefer a floating rate loan. The intermediary can now match these two borrowers as described in the following diagram.

Diagram:

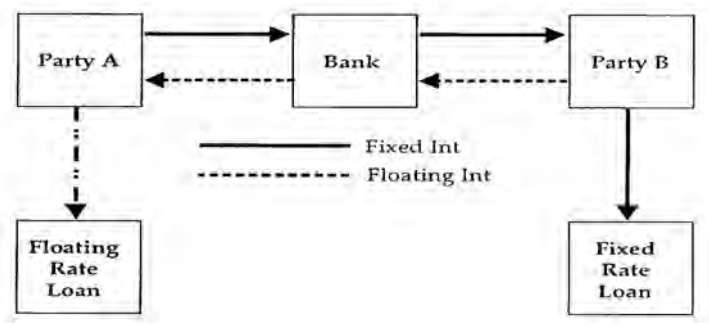


Fig. 5.6

Example

Consider two companies, rated AAA and BBB. AAA has a higher credit rating than BBB. Both companies can raise funds either by issuing fixed interest bonds or by taking bank loans (at a floating interest rate). Their borrowing costs are:

Table 5.4

		Cost of Funds to AAA and BBB	
	objective	**Fixed rate bonds**	**Floating rate loans**
AAA	Floating	10.00% p.a.	Libor+1 OObp
BBB	Fixed	12.00% pa	Libor+160bp
Differential		200bps	60bps

Assume now that AAA wants to raise floating rate money and BBB wants to raise fixed rate money. It will be realized that the advantage (200 basis points) of AAA raising fixed rate money in the bond market as against BBB, and an advantage (60 basis points) of AAA raising floating rate money in the bond market as against BBB, can be exploited by both parties if they meet. The key to an interest rate swap is the QSD (Quality Spread Differential), the difference or spread between fixed interest rates, and floating interest rate. There is a comparative advantage Le. QSD of 140(200-60) basis points. Both the parties can share the difference and reduce their borrowing costs. A Banker normally acts as an intermediary and arranges most of these deals. A share of the advantage is passed on to the banker. In this case, if the three parties agree to share the difference as 80:40:20 basis points, then we examine as follows:

Table 5.5

Firm	Paid to Bank	Received from Bank	Paid to market	Net Cost	Savings
AAA	Libor	9.8%	10%	Libor + 20bp	(Libor +100bp) - (Libor + 20bp) = 80bp
BBB	10%	Libor	Libor + 160bp	11.6%	(12-11.6) = 40bp

The following diagram illustrates the transaction.

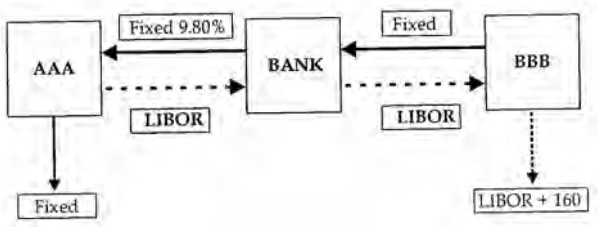


Fig. 5.7

Uses of Interest Rate Swap

Interest Rate swaps without offsetting underlying create interest rate risk. Each counter party in an interest rate swap is committed to pay a stream of interest payments and receive a different stream of interest payments. A payer of fixed interest rate payments is exposed to the risk of falling interest

rates, while a payer of floating interest rate payments is exposed to the risk of rising interest rates. Similarly, a receiver of fixed interest rate payments is exposed to the risk of rising interest rates while the receiver of floating interest payments is exposed to the risk of falling interest rates. To summarize, interest rate swaps create an exposure to interest rate movements, if not offset by an underlying exposure. Interest rate swaps can be used to hedge interest rate risk

Floating rate loans expose the debtor to the risk of increasing rates. To avoid this risk, he may like to go for a fixed rate loan, but due to the market conditions and his credit rating, his fixed rate loans are available only at a very high cost. In that case, he can go for a floating rate liability and then swap the floating rate liability into a fixed rate liability. He can do the swap with another counter party whose requirements are the exact opposite of his or as is more often the case, can do the swap with a bank.

Example

A manufacturing company embarks on a project for which it borrows USD 4 million working capital on a floating interest rate basis, payable quarterly for two years. Since the treasurer of the company felt that the floating rate payments will involve serious risks, he decides to enter into a swap with a bank and convert the same into a fixed rate loan. The bank now swaps the floating rate payments into a fixed rate at 12%. The resultant cash flow arising out of the transaction is illustrated below.

Table 5.6

Quarter	Floating rate	Floating rate payments	Fixed rate payments	Net cash paid by Co.
1	12.25	122500	120000	-2500
2	12.25	122500	120000	-2500
3	12.25	122500	120000	-2500
4	12	120000	120000	0
5	12	120000	120000	0
6	12	120000	120000	0
7	11.75	117500	120000	2500
8	11.75	117500	120000	2500
		962500	960000	-2500

Interest Rate Swaps in India

With a view to deepening the money market and also to enable banks, primary dealers and allIndia financial institutions prefer to hedge interest rate risks. The Reserve Bank of India has allowed scheduled commercial banks, primary dealers and all-India financial institutions to make markets in Interest Rate swaps from July 1999. However, the market which has taken off seriously so far, is the one based on Overnight Index Swaps (OIS). Benchmarks of tenor beyond overnight have not become popular due to the absence of a vibrant inter-bank term money market. The NSE publishes MIBOR(Mumbai Interbank Offered Rate) for three other tenors viz., 14-day, 1 month and 3 months. The other longer tenor benchmark that is available is the yield based on forex forward premiums. This is called MIFOR (Mumbai Inter bank Forward Offered Rate). Reuters published 1 m, 3m, 6m, 1 yr MIFOR's are the market standard for this benchmark.

Example

XYZ company has entered into a "plain-vanilla" interest rate swap on $1,900,000 notional principal. XYZ company pays a fixed rate of 8 per cent on payments that occur at 90 day intervals. Six payments remain with the next one due in exactly 90 days. On the other side of the swap, XYZ company receives payments based on the UBOR rate. Describe the transaction between XYZ company and the dealer at the end of the sixth period if the appropriate UBOR rate is 5 per cent.

XYZ company owes the dealer ($l,000,000)(.08)(90/360) = $20,000. The dealer owes XYZ company ($1,000,000)(.05)(90/360) = $12,500. Net: XYZ company pays the dealer $7,500.

Example

Company X wishes to borrow U.S. dollars at a fixed rate of interest. Company Y wishes to borrow Japanese yen at a fixed rate of interest. The amount required by the two companies are roughly the same at the current exchange rate. The companies are quoted at the following interest rates:

Table 5.7

	Yen	**Dollars**	**Y**	**D**
Company X	5.0%	9.6%	6	10.6
Company Y	6.5%	10.0%	7.5	11.0

Design a swap that will net a bank, acting as an intermediary, 50 basis points per annum. Make the swap appear equally attractive to the two companies.

Solution:

Let x be the spread in the yen market (in this case 150 basis points) and let y be the spread in the dollar market (40 basis points). The total gain available is x-y = 110 basis points. The bank will take 50 basis points, so that leaves 60 basis points to be split equally between X and Y. Therefore, X must end up paying 10.3% [10.6-0.30] in dollars and Y must end up paying 7.2% [7.5-0.30] in yen. One way to accomplish this is as follows:

Table 5.8

X	Pay 6% in yen to outside lenders
	Pay 10.3% in dollars to the bank in the swap
	Receive 6% in yen from the bank in the swap
Total	10.3% in dollars
Y	Pay 11 % in dollars to outside lenders
	Pay 7.2% in yen to the bank in the swap
	Receive 11 % in dollars from the bank in the swap
Total	7.20% in yen

Note that the bank's profits of 50 basis points come from receiving 7.20% and paying 6% in yen (thereby gaining 120 basis points in yen) while receiving 10.30% and paying 11 % in dollars (thus

losing 70 basis points in dollars). Also, the final exchange of principal will expose X and Y to exchange rate risk, but not the bank.

CURRENCY SWAPS

Introduction

In Great Britain, during the 1970's, the British government sought to encourage domestic investment by taxing foreign exchange transactions on its own currency. This control made it difficult for British multinational companies to transact in the foreign exchange market. As a result, British companies often engaged in what was known as back-to-back loans.

A back-to-back loan involves two companies located in separate countries. Each company will borrow money in their domestic financial marketplace and then lend this borrowed money to the other firm. By this simple exchange, each company can access the capital markets in the other country without involving foreign exchange transactions. The currency swap is merely a simple extension of the back-to-back loan concept. The back-to-back loan suffered two problems that gave birth to currency swaps.

1. Finding counterparty with mirror image needs was often an exhaustive task for a corporation.
2. Secondly, as these back-to-back loans were two different loans, they were evidenced by two loan agreements, completely separate from one another

Currency swaps solved these problems to great extent. The currency swap would operate in a manner such that two counterparties would be brought together by a central matchmaker, or swap dealer (often an investment house or a bank) thus eliminating the exhaustive search costs to the corporation of finding another counterparty. Secondly, the transaction would now be witnessed by one document that would spell out the circumstances and provisions under the possibility of default by one counterparty.

Definition

Currency swaps involve an exchange of cash flows in two different currencies. A currency swap is a contract which commits two counter parties to an exchange, over an agreed period, two streams of payments in different currencies. These payments are each calculated using a different interest rate. At the end of the period, exchange takes place of the corresponding principal amounts, at an exchange rate agreed at the start of the contract.

Currency Swap differ from Interest Swaps on the following counts

1. An exchange of payments in two currencies.
2. Not only exchange of interest, but also an exchange of principal amounts.
3. Unlike interest rate swaps, currency swaps are not off balance sheet instruments since they involve exchange of principal at the end of the period.
4. The interest payments at various intervals are calculated either at a fixed interest rate or a floating rate index as agreed between the parties.

5. Currency swaps can also use two fixed interest rates for the two different currencies - different from the interest rate swaps.
6. The agreed exchange rate need not be related to the market.
7. The principal amounts can be exchanged even at the start of the swap.

U.S. MNC's like GM have a subsidiary in Germany, and there is an investment opportunity for expansion in Germany that will require 40m and will have an economic life of 5 years. Current spot rate is $0.90/, so the firm could consider raising $36m in U.S. by issuing bonds at 8% (payable in Dollars), and converting $36m to 40m to finance the expenditure. Hopefully CFs (in Euros) would be generated from the project to make the interest payments in $.

Currency Swap example in USA

Problem

Transaction Exposure (potential change in the financial position of the project due to currency changes over 5 years), because German earnings are in Euros, interest payments due in U.S. are in USD. What is the MNC worried about ?

Alternative: Raise 40m in the Eurobond market by issuing 5-year Eurobonds, payable in Euros. Eurobond rate is 6% for a well known firm, but the German subsidiary of the US MNC pays 7% because it is unknown (1% risk premium).

In Germany

Assume there is a German MNC with a mirror-image financing need. It has a U.S. subsidiary needing $36m for an expansion project in U.S. with a 5 year life.

Problem

Transaction Exposure German MNC could borrow Euros in Germany at 6% convert to dollars, but there is transaction exposure since dollar CFs would be generated in U.S. to make Euro interest payments in Germany. Worried about what over 5 years???

Alternative: Company could issue Eurodollar bonds in U.S., but would face a 9% (normal rate is 8%) interest rate because the German subsidiary is not well known in U.S.

Opportunity

Swap Bank could arrange a Currency Swap to:

1. Eliminate the long term currency risk for both MNCs (transaction exposure), and
2. Reduce interest expense for both companies.

Each company has a "comparative advantage" at raising money in its home country, so each MNC would issue debt domestically at a savings of 1 % compared to the foreign MNC raising funds (U.S. company raises $36m in U.S. at 8%, vs. 9% for the German MNC; German company raises 40m in Germany at 6%, vs. 7% for the U.S. MNC).

The principal sums would be exchanged through a Swap Bank - U.S. company transfers $36m to the German subsidiary in U.S. and the German company transfers 40m to the U.S. subsidiary in Germany. Every year the U.S. subsidiary in Germany would submit 2.4m (40m @ 6% instead of

borrowing at 7%) to its parent company in U.S., which would transfer the money to the Swap Bank, which transfers funds to the German MNC to pay the Euro loan. The German subsidiary in U.S. would submit $2.88m (S36m @ 8% instead of 9% on its own) to the German MNC, which would transfer the money to the Swap Bank, and the bank would transfer to the U.S. MNC to pay for the dollar loan. At maturity, principal payments would take place the same way.

Currency Swap Locks in Three Ex-rates

1. Principal sums are exchanged at the current ex-rate, $36m/e40m = $.90/.
2. The contractual (implicit) exchange rate for the annual payments would be $1.20/, which is fixed.
3. The implied exchange at maturity for last interest payment and principal payment is also fixed, viz. the prevailing spot rate.

Therefore, the currency swap locks in a fixed exchange rate and there is no currency risk.

Case Study on Clearing Corporation of India Limited's FOREX settlements and risk management process

FX-CLEAR, a forex dealing system, which was launched by CCIL on August 7, 2003, offers two modes of dealing i.e. Order Matching mode and Negotiation mode. FX-CLEAR covers the inter-bank US Dollar-Indian Rupee (USD- INR) Spot and Swap transactions and transactions in major cross currencies (EUR/USD, USD/JPY, GBP/USD etc.) The USD-INR deals constitute about 85% of the transactions of the total Forex transactions in India in terms of value.

The new version of FX-CLEAR platform launched w.e.f. 6th April 2015, offers guaranteed settlement from the point of trade for all the trades concluded on the Order Matching Mode of the platform, wherein these trades shall be automatically sent to Clearing Corporation. Accordingly, Clearing Corporation (CCIL) shall be the Counterparty for these trades. The settlement of Forex transactions by CCIL started from November 8, 2002. This segment accepts the inter-bank cash, Spot and Forward USD-INR transactions for settlement through a process of multilateral netting. The multilateral netting system provides a netting benefit of well over 95%. Every eligible foreign exchange contract, entered into between members, will get novated and be replaced by two new contracts - between CCIL and each of the two parties, respectively. CCIL has since moved to a settlement on a Payment V/S Payment basis from April 2015.The Corporation has been granted an 'Authorized Person' License under FEMA 1999 by the Reserve Bank of India for conduct of foreign exchange clearing and settlement operations and activities related thereto. By choosing to settle their trades through CCIL, market participants will gain in the following ways:

- Elimination of principal/credit risk
- Assurance of settlement on the settlement date.
- Improved Operational efficiency
- Easier reconciliation of accounts
- Improved liquidity and better leveraging
- Lower operational cost

CCIL started the settlement of cross currency deals of banks in India through the CLS Bank in April 2005. Through this arrangement, CCIL aggregates trades reported by all Member banks and enables banks to collectively enjoy the benefits of cross currency settlement through CLS Bank. This is a unique experiment whereby cross border settlement of an entire country is being achieved through a third party arrangement. Settlement through the CLS mechanism is on a payment versus payment basis.

LS provides a continuous mechanism for the simultaneous settlement of both sides of an FX deal. CLS operates as a Payment versus Payment (PvP) system. Time zone differences increase the risk of one party defaulting before both sides of the trade are settled. PvP eliminates time zone risk because both sides of a transaction are settled simultaneously. Settlement in CLS is final and irrevocable. Under CLS, transactions are settled on a gross basis, whereas funding is on a netted basis.

The mechanism involves an ongoing process of submitting trade instructions, matching those trades, funding the deals, and then paying out to the participating accounts. When a CLS eligible foreign exchange deal is struck between Settlement Members of CLS/or third parties, each counterparty transmits the details of the deals to CLS Bank via a Settlement Member, where they are matched and held until the settlement date. At the start of day, each Settlement Member's net position in each currency for that day is calculated. A payment schedule is devised by CLS for short currency positions and by given pay-in times during the CLS day (within the settlement window i.e. 7:00 to 12:00 CET), the Settlement Member makes the payments to CLS Bank and correspondingly receives payments for its long positions.

The settlement procedure adopted by CCIL is on similar lines as that of CLS Bank. CCIL provides CLS Settlement through a CLS Settlement Bank namely UBS Switzerland AG. CCIL has, using the services of its settlement bank, customized the CLS product for the members. CCIL offers a real time web based tool – UBS Key Link; that enables its members to track online status of deals submitted and currency wise net positions and obligations. Online information of payment status and positions is made available on CCIL IRIS platform. CCIL also offers its members the facility to pay and receive currency obligations within the operating timelines of the respective currencies, subject to availability of limits. CCIL offers banks various options to avail required limits including against available free collateral in the SGF (Securities Segment) account. CCIL's product has been customized to local requirements and offers members flexibility, efficiency and value.

Calculation of Charges/Expenses/Penalties

Schedule of Fees and Charges

Table 5.9

Sr. No.	Particulars	Charges	
1		Trade Value (in USD)	Charges (per trade accepted per segment)
	Settlement of Trades (Payable by each counter-party)	Less than 1 mio	₹ 90/-
		1 mio to less than 3 mio	₹ 110/-
		3 mio to less than 5 mio	₹ 125/-
		5 mio to less than 10 mio	₹ 150/-

		10 mio to less than 20 mio	₹ 175/-
		20 mio and above	₹ 200/-
		Note: Service Tax shall be applicable on above Charges at Applicable rate.	
2.	Delayed payment of Transaction Charges and System Usage charges. (If payment is made after 10th of a calendar month.)	5 basis point per day on the amount of charges.	
3.	Default	(A)	Bank Rate plus 5% p.a per day on the amount of default (INR or USD) till the default is fully met and
		(B)	Line of Credit (LOC) charges incurred by Clearing Corporation to meet such (INR or USD) default.
4.	Penalty on Cash Settlement	A penal charge of 0.01% shall be levied on the amount Cash settled.	
5.	Penalty on delayed payment	Settlement obligations in US Dollar received by Clearing Corporation after the cut-off time on the settlement date shall be considered as delayed payment and the applicable charges shall be levied, The charges levied will be @ 0.30% p.a.plus applicable taxes shall be payable by members on the US Dollar settlement obligations received by Clearing Corporation after 8:30 p.m. IST on the settlement date.	

Risk management process

Apart from settlement of trades, another major function of a Clearing Corporation is to reduce risks of its members from failed trades arising out of the defaults by their counterparties. By becoming central counterparty to the trades done by its members, the Corporation absorbs risk. It manages the risks through its risk management processes in such a manner that the ultimate risk to its members from fails is either eliminated or reduced to the minimum. Risk Management Department in CCIL has been entrusted with the responsibility of designing the Risk processes and its execution. The department is also responsible for keeping the processes efficient, current and user friendly. During the settlement processes, CCIL assumes certain risks which may arise due to a default by a member to honour its obligations. Settlement being on Delivery Versus Payment basis, the risk from a default is the market risk (change in price of the concerned security). CCIL processes are designed to cover the market risk through its margining process.

CCIL collects Initial Margin and Mark to Market Margin (both Intraday and EOD) from members in respect of their outstanding trades. Initial Margin is collected to cover the likely risk from future adverse movement of prices of the concerned securities. Mark to Market Margin is collected to cover the notional loss (i.e. the difference between the current market price and the contract price of the security covered by the trade) already incurred by a member. Both the margins are computed trade-wise and then aggregated member-wise.

In case of sudden volatility, Intraday Mark to Market Margin is collected if the difference between the Mark to Market Margin at previous EOD and intra-day Mark to Market Margin is greater than a specified threshold level of the initial margin as at previous EOD. In addition, CCIL may also collect Volatility Margin in case of unusual volatility in the market.

Members are required to keep balances in Settlement Guarantee Fund (SGF) in such a manner that the same is enough to cover the requirements for both Initial Margin and Mark-to-Market Margin for the trades done by such members. In case of any shortfall, CCIL makes margin call and the concerned member is required to meet the shortfall before the specified period of the next working day.

Members' contribution to the SGF is in the form of eligible Govt. of India Securities/T-Bills and cash, with cash being not less than 10 % of the total margin requirement at any point of time.

Another important risk emanating from the process is Liquidity Risk. To ensure uninterrupted settlement, CCIL is required to arrange for liquidity both in terms of funds and securities. CCIL has arranged for Lines of Credit from Banks to enable it to meet any reasonable shortfall of funds arising out of a default by a member either in its Securities Segment or Forex Segment. In regard to the Securities Segment, member's contributions to SGF is mainly in the form of securities and through the list of specified securities acceptable for contribution to SGF, CCIL ensures that the most liquid securities in which a significant portion of the trades are settled are likely to be available in the SGF. For requirements of other securities, CCIL has put in place a limited purpose security borrowing arrangement with two major market participants.

Questions

1. How is CCIL administering Clearing and Settle Process in FOREX Trading?
2. Explain briefly about PVB basis system?
3. How is the pattern of fees charges by CCIL for each forex Trade?
4. How is the Risk Management being handled by CCIL?

SUMMARY

A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange traded contracts. Unlike forward contracts, the counterparty to a futures contract is the clearing corporation on the appropriate exchange. Futures often are settled in cash or cash equivalents, rather than requiring physical delivery of the underlying asset. Parties to a Futures contract may buy or write options on futures.

But forward contract is an agreement between two persons for the purchase and sale of a commodity or financial asset at a specified price to be delivered at a specified future date. An agreement to purchase one currency and sell another for some date beyond two business days. A forward involves no fee, and no cash changes hands until the settlement date of the forward. A forward allows one to lock in an exchange rate today for a future payment or receipt, thereby eliminating rate risk. Swap in finance means an exchange of one obligation with another. Financial swaps are a funding technique, which permit a borrower to access one market or instrument and exchange the liability for another market or instrument. Investors can exchange one type of risk with another. Swaps are classified in to various types namely Interest Swaps, Currency swaps, Credit Default swaps and Plain Vanila Swapping.

REVIEW QUESTIONS

1. What is Foreign Exchange Risk Management?
2. Explain in detail the tools for Hedging Exchange Rate Variations?
3. What do you mean by Futures?

4. What is the meaning of Marking to Market?
5. Explain in detail the types of Financial Futures? Discuss the advantages and Disadvantages in Futures.
7. What do you mean by Forward Contracts? Explain its merits and Demerits.
8. Explain in detail the difference between Forwards and Futures.
9. What do you mean by Option? Explain its types.
10. Discuss the details of Foreign Exchange Risk Exposures.
11. Evaluate the degree of Payment Risk to both Importers and Exporters.
12. Give the list of Internal and External Hedging Tools and Explain?

♦ ♦ ♦

6

EXPORT AND IMPORT FINANCE

Chapter Outline

- Introduction
- Special need for Finance in International Trade
- Sources of Finance in International Trade
- Debt Financing
- Venture Capital
- Factoring
- Forfeiting
- Pre Shipment Finance
- Chapter Summary
- Review Questions

INTRODUCTION

Finance is the life and blood of any business. The survival and growth of the business depends, among other things, on the continuous availability of the required amount of funds. Financing international trade means providing fund for various international business transactions. This is done by making use of international factoring (international buyers) or by purchase order financing (international suppliers). There is a wide range of options in international trade financing available for the borrowers. Projects for financing international trade vary greatly. However, these programs offer facilities for availing the fund depending on the requirements. They offer enough flexibility for reducing costs of transactions and for increasing profits.

Trade finance is related to international trade. While a seller (the exporter) can require the purchaser (an importer) to prepay for goods shipped, the purchaser (importer) may wish to reduce risk by requiring the seller to document the goods that have been shipped. Banks may assist by providing various forms of support.

The export/import trade cannot function smoothly, efficiently, and effectively unless new techniques, methods and instruments have been evolved in the field of international finance.



The international trade is growing faster than the world output. India is also realised the need for international trade and introduced economic liberalisation and favourable EXIM policy, etc, from 1991-92 onwards. The capital flow and direct investment across the countries have increase enormously in tune with the growth of international trade. The fast growth of multinational, national corporations has place at the disposal at the disposal of world large and varied quantum of goods/services. In order to cope with the growth of international trade in leaps and bounds, the international monetary and fiscal systems have also developed fast and are improving their sophistication. A number of important innovations like. Letter of Credit, bill of exchange have taken place in international payment and credit mechanisms which have facilitated free exchange of goods and services.

SPECIAL NEED FOR FINANCE IN INTERNATIONAL TRADE

1. Need of short-term Finance to Exports: Since the export activity involves huge international finance, the success of it depends on providing such credit/finance to importers. The exporter gets his export based needs from the banks for the purposes of:

(i) Procuring raw materials.

(ii) Manufacturing process or making advances to other producers from whom exportable goods are ordered.

(iii) To meet the expenses of packing, handling, internal transport, insurance, and warehousing charges.

(iv) Shipment charges.

2. Need of short-term Finance to importers: Mostly the short-term finances are provided by the exporter and hence the importers do not require much short-term finance generally. However, an importer may require short-term finance/credit for the following:

(i) For payment of advance to the exporter.

(ii) For meeting the shipping charges, insurance, etc, when he undertakes them.

(iii) To pay duty in obtaining import license and other import formalities.

3. Need of long-term finance for exporter/importer: The long-term finance is equally essential to the exporter and importer. Developing countries need long-term finance from the point of manufacturing to the stage of sales, for various purposes. These purposes are as follows:

(i) Import-export of capital goods.

(ii) To provide finance on liberal terms to importer.

(iii) To carry-out export promotion programs involving huge sums.

(iv) Establishment of new enterprises.

(v) Capital investment in other countries.

4. Growth of international trade and domestic trade: International trade has a pervasive importance for our standard of living and our daily lives. Importance of international finance springs from increasing importance of international flow of goods and capital. The reason for increasing importance of international trade and domestic trade are:

(i) A liberalization of trade and investment has occurred via reductions in tariffs, quotas, currency controls, and other impediments to the international flow of goods and capital. Much of liberalization has come from the development of free-trade areas: EU, NAFTA, ASEAN, etc.

(ii) Precedent shrinkage of "economic space" has occurred via rapid improvements in communication and transportation technologies and cost reduction as a result.

5. Risk of International Trade: Due to the following risks involved in international trade there has been emerging need of finance in international trade:

(i) Rewards Accompany Risks: Most obvious risk of international trade arises from uncertainty about exchange rates. Unexpected changes of exchange rates have important impacts on sales, prices, and profits of exporters and importers.

(ii) Country Risk: This includes the risk as a result of war, revolution, or other political or social events a firm may not be paid for its exports. This applies to foreign investments and to credit granted in trade.

(iii) Practices have evolved to cope with risk. For example, special types of foreign exchange contracts designed hedge or cover some of the risks from unexpected changes in exchange rates.

(iv) Export credit insurance schemes established to help country risk and letters of credit developed to reduce other risks of trade.

SOURCES OF FINANCE IN INTERNATIONAL TRADE

Finance plays an important role in securing overseas projects and it is important for both importers and exporters. Any business whether domestic or international, always requires some kind of financing for its operations. Because international financing must deal with financial and economic conditions in more than one country, this activity involves more uncertainty and complexity than domestic financing. The greater complexity of international financing, however, is accompanied by a greater number of financing options. There are several sources of finance/funds available for international business. These sources are as follows:

1. Internal sources of funds,
2. External sources of funds.

Internal Sources of Finance

Before an MNC's parent or subsidiary in need of funds searches for outside funding, it should check other subsidiaries cash flow positions to determine whether any internal funds are available. Internal sources of funds are those funds generated from within a parent company itself. They include capital contributions from the parent, loans with parent company guarantees, funds provided by operations from retained earnings and depreciation, and inter subsidiary funds transfers.

1. **Funds from the Parent:** Three major types of funds supplied by the parent are:

   (i) Equity Contributions: Every new foreign subsidiary must receive some funds in the form of equity to satisfy both authorities in the host country and outside creditors about its solvency. Occasionally,

   MNCs decide on expansion funds in the form of an equity investment for their own foreign subsidiary. This part of recapitalization gives the foreign subsidiary an increased capital base to support additional loans.

   (ii) Parent/Direct Loans: MNCs may elect to provide investment funds to their foreign operations in the form of intra-company loans instead of increasing their equity contributions. However, the parent company lends money as an owner to its subsidiaries. The intra-company loan usually contains a specified repayment period for the loan principal and earns interest income that is taxed relatively lightly.

   (iii) Parent Guarantees: When foreign subsidiaries have difficulty in borrowing money, a parent may affix its own guarantees. While MNCs have traditionally been reluctant to guarantee the debts of their subsidiaries, indications are these guarantees will increase. There are a variety of parent guarantees which are as follows:

   The parent may sign a purchase agreement under which it commits itself to buy its subsidiary's note from the lender in the event of the subsidiary's default. The lender may be protected on only a part of the specific loan agreement. Another type of guarantee is limited to a single loan agreement between a lender and the subsidiary. The strongest type requires that the lender be protected on all loans to the subsidiary without limits on amount or time.

2. **Funds provided by Operations:** Once a newly formed subsidiary gets on its feet, internal fund flows - retained earnings and depreciation are the major sources of funds. These internal fund flows, coupled with local, leave relatively little need for fresh funds from the parent. Foreign subsidiaries are not always free to remit their earnings in hard currency elsewhere. Many developing countries have problems with their balance of payments and do not have sufficient international reserves.
3. **Loans from sister subsidiaries:** The availability of intersubsidiary credit, in addition to funds from the parent, vastly expands the number of possibilities for internal financing. For example, if a subsidiary in Austria has funds which it does not need immediately, it may lend these funds to a sister subsidiary in Norway, and vice versa.
4. **Global Cash Management:** The theory of international cash management is the same as that of domestic cash management - the maximisation of the firm's financial resources is achieved by effectively receiving payments as fast as possible while taking advantage of all liability provisions, payable periods, which are lower cost. Cash management means optimisation of cash flows and the investment of excess cash.
5. **Multilateral Netting:** Netting is the process of coordinating cash inflows and outflows among subsidiaries so that only net cash is transferred, reducing transaction costs. Multilateral netting allows subsidiaries to transfer net intercompany flows to a cash centre, or clearing account, which disburses cash to net receivers. Netting is a service for reducing costs and improving work procedures and other administrative routines for inter company payments. Typically, multilateral netting is done by inspection. Consequently, opportunities to reduced transfer costs may be missed, especially if there are a large number of affiliates with a complex pattern of cross-border transactions.

External Sources of Finance

There are several financial and non-financial institutions that can provide financing to international companies which are considered as the external sources of funds. These institutions help in funding in following manner:

Equity Financing

Unlike the case of loans and bonds, the intemationalisation of equities did not take off until about 1983.

International equity markets encompass primary market functions (underwriting of new equity issues) and Secondary market functions (trading) of equities outside the issuer's home country. The London International Stock Exchange is the best example of an international secondary equity market, accounting for a large portion of international equity trading.

Public equity issues can be primary or secondary. In a primary issue new shares are sold and new funds are raised for the company, whereas in a secondary issue existing shares simply change hands and the company, receives no new funds. Some of the biggest secondary issues of the 1980s and 1990s occurred through privatisations (that is, government sell-offs of their shareholdings). Many public equity issues are a combination of the two.

Most equity issues are straight cash offers to the public at large where shares are traded for cash. Some, however, are restricted to existing shareholders and are called rights issues. In a rights issue, existing shareholders are issued number of warrants, called rights, based on the number of shares they own. These warrants confer the right to purchase a certain number of new shares at the official subscription price. The warrants can then be sold, exercised or discarded, depending on the shareholder's inclination and the market price of the stock.

Public issues are handled by a syndicate of underwriters. The syndicate, led by the lead manager, provides the company with procedural and financial advice buys the issue and then resells it to the public. For this it is paid a fee.

DEBT FINANCING

Debt financing is a major source of financing for international investments. This can be done through international bank loans, the Euro-note market, and the international bond market.

International bank loans are often sourced in the Eurocurrency markets. These international bank loans are often called Euro-credits. Lending banks typically form a syndicate in order to diversify the risk for these types of loans due to their size. The borrowing interest rate for a Eurocurrency loan is usually tied to the London Inter-bank Offered Rate (LIBOR), which is the deposit rate applicable to inter-bank loans within London.

The Euro-note market is the collective term used to describe short- to medium-term debt instruments sourced in the Eurocurrency markets. The Euro-note is a less expensive source of short-term funds than syndicated loans because the notes are placed directly with the investor public. Euro-notes can be underwritten (i.e., one to three banks organise the others to share the total loan and are committed to buy any of the borrower's notes that could not be placed successfully in the market at the promised rates) or non-underwritten. The non-underwritten Euro-notes include Euro Commercial Paper (ECP) and Euro Medium Term Notes (EMTNs). ECP is a short-term debt obligation of a corporation or bank. Maturity is usually one, three or six months, while the EMTN's typical maturity ranges from as short as nine months to a maximum of ten years.

VENTURE CAPITAL

Venture capital refers to an equity-related investment in a growth oriented small/medium business to enable the investors to accomplish corporate objectives, in return for monetary shareholding in the business or the irrevocable right to acquire it. Venture capital is a typical 'private equity investment'.

Venture capital is a popular method by which investors support entrepreneurial talent with finance and business skills to exploit market opportunities with a view to obtaining long-term capital gains. It involves the provision of risk bearing capital, usually in the form of equity participation, to companies with high growth potential, besides providing some value addition in the form of management advice and contribution to overall strategy.

Long-term investment, generally in high-risk industrial projects with high reward possibilities, is called 'venture capital'. The investment may take place at any stage of implementation of the project, between start-up and commencement of commercial production. Venture Capital is also invested in financing the new business and professional activities that carry a higher degree of success and failure as well. Venture capital implies a high level of risk implicit in the investment of funds.

Thus Venture Capital (also known as VC or Venture) is a type of private equity capital typically provided for early stage, high-potential and growth companies in the interest of generating a return through an eventual realization event such as an IPO or trade sale of the company. Venture capital investments are generally made as cash in exchange for shares in the invested company. It is typical for venture capital investors to identify and back companies in high technology industries such as biotechnology and ICT (Information and Communication Technology).

FACTORING

Factoring is a special type of trade service usually targeted at exporters, incorporating debt collection, finance, cash flow management and credit insurance aimed largely at open account sales. It is usually provided by the subsidiary or associate company of the bank, known as the factor or the factoring company. The factor usually is a member of the Factoring Association.

The market for the firm's product is highly competitive, making it essential for the exporter to offer favourable credit terms to the importer. The credit terms usually range from immediate sight payment to 180 days (typically 90 days) open account. Besides, the client base is broad and located throughout the world, with the characteristics of repetitive sales.

The exporter may need financial support and he may find it too costly to set up a credit collection department. As an alternative to ease one or more of the above, the exporter can look for a factor for assistance.

Scope of Factoring Services

1. **Debts Collection:** When the seller has shipped the goods, he will submit relevant invoices to the factor which will find an overseas correspondent to onward transfer the documents to the overseas buyer for payment. The overseas correspondent which is usually a member of the Factoring Association, is more familiar with the buyer's customs, language and possible reason to defer payment. In this way, the factor collects the account receivable for the seller. However, it looks as if it were the exporter's debt collection department sending invoices, making collections from debtors, keeping records and sending reminders as necessary.
2. **Finance:** Finance is a very important service within the definition of factoring. Upon receipt of an invoice, the factor may pay the exporter a percentage (upto 80%) of the invoice value. The factor, in fact, purchases the bill of exchange which is drawn on the importer. Under the agreement, the factor retains a right of recourse to the exporter unless credit insurance is also incorporated in the agreement.
3. **Credit Insurance:** If the factor also provides credit insurance in a factoring service, in addition to providing finance, it has to check the buyer's credit standing very carefully. If

the factoring service incorporates credit insurance, the finance is granted on a non-recourse basis. In other words, the factor also provides against bad debts. It should be noted that the scope of cover is usually against the buyer's insolvency arising from protracted default (unwilling or unable to pay). Political risk may not be covered. Therefore, this type of credit insurance provided under factoring is most suitable for exporters who are selling goods to markets in which political risks do not exist or are minimal.

Banks may offer one or a combination of the above services, depending on the customers need. Some factors may completely refuse to provide insurance cover in a certain region because of the high default risk.

The advantages of factoring services availed to the following

1. To the Exporter: Factoring services allow exporters to become more competitive in the existing markets. An exporter can grant longer credit terms to the overseas importer on the understanding that the factoring company can provide him with finance by purchasing his account receivables. Undoubtedly, offering a longer credit period to the buyer is an effective way to compete successfully in the existing market.

Factoring services can also enhance the exporter's cashflow. A factor may provide the exporter with upto 80% of the invoice value. This enables the exporter to recycle his funds back to the business for other useful purposes.

Factoring services may lead to a gain in controlling administrative costs and improvement in debt management. With the help of a professional factor who offers expert advice (although at relatively high charges), the exporter may have an overall gain in administrative costs and a much more effective way of collecting payment. He does not need to set up his own debt collection department but this is at the expense of a discount charge and service fee.

With the help of a factor, the exporter does not need to spend time and take the trouble to collect the debts. He can concentrate more on other management functions such as marketing, manufacturing, and quality control, etc.

A factoring service may enable the exporter to explore new markets more easily and safely. Factoring companies provide much information about the buyers' credit standing, which enables the exporter to adopt a bolder marketing strategy and render him more willing to enter into new markets.

2. To the Factor: The factor can increase its income in the form of discount charges and service fees. The discount charge is based on the amount actually drawn-down by the exporter against each invoice and its tenor until full payment is received from the overseas buyer. With respect to service fees, factors in Hong Kong usually charge 0.25%-3.5% of the invoiced value and the exact percentage depends on the range of services provided, and the volume of the client's business. The range of services usually includes:

(i) Answering customers' enquiries;

(ii) Handling customers' wholesale ledger;

(iii) Collecting debts by means of sending out statements and regular reminders/chasers; and

(iv) Credit insurance against default payment.

Export-Factoring in India: An Overview

Factoring is a fund-based facility of RBI as a measure to solve the problem of the working capital of the suppliers extended the factoring as the new form of the financial services in India. It was set up after the recommendation of the Kalyanasundaram Committee in 1988. They initially developed the concept of inland factoring, but later on Export financing become one of their emphasized areas. In factoring, a financial institution (factor) buys the accounts receivables of a company client and pays up to 80% (and or rare cases up to 90%) of the amount immediately on agreement and remaining amount i.e.20% or 10% when the customer pays the debt. Collection of the debt depends either on the factor or client depending upon the type of the agreement. Usually the period of factoring is 90 to 150 days.

Some factoring companies allow even more than 150 days, depending upon the type of agreement or the relation between the factor and the client. The factoring cost varies from 1.5% to 3% per month, according to the transaction size, financial strength of the customer etc. The factoring in India can be done for invoices as low as ₹ 1000. Considering the growth of the International markets and globalization there was the need to lay emphasis on the Export factoring. In the international trade it is customary to use two-factor system, i.e. system constituting the Export factor and Import factor. Under this arrangement Factoring essentially means to undertake to collect the receivables and thereby get entitled to all rights of the beneficiary towards specific receivables. Therefore in a factoring transaction, the seller assigns and transfers all entitlements towards a supply/receivable to the factor. Introduction of export factoring in India will certainly provide additional window facility to the exporters. Further, the position of realization of export proceeds of shipment made by the Indian exporters is sufficiently encouraging for the interested organization to offer factoring services to exporters from India. There are many companies offering export-factoring services a few like:

SBI Factors and Commercial Services Private Limited. It is subsidiary company of State Bank of India is one of the leading factoring companies in India with an asset base of ₹ 919.36 crores as on March 2006. It is the first factoring company to be set up in India. It was incorporated in February 1991 and commenced business operations from April 1991. State Bank of India and its 2 associate banks have a 70% stake in SBI Factors while 20% is held by Small Industries Development Bank of India(SIDBI) and 10% by Union Bank of India. As on March 31st 2006, it has a market share of approximately 40% in the factoring business.

Global Trade Finance Limited (GTF)

It is the only provider of International factoring period. Domestic factoring and forfeiting services are under one roof in India. Global Trade Finance is headquartered in Mumbai. GTF commenced its operations in September 2001, as a joint venture between West LB, Germany(40%), Export- Import Bank of India(35%) and International Finance Corporation, Washington(25%) which is the private arm of the World Bank.

Based on its nature it can be classified as follows:

(a) Credit risk Centred factoring: It can have recourse or non recourse, the factor acts as an agent for collection of bills and does not cover the risk of customer's failure to pay debt or Interest on it. In the case of recourse factoring, the risk is borne by the factor.

(b) Location wise Factoring: It could be domestic or international factoring.

(c) Information Centric: Factoring could be either open or sealed. In the former case, debtor is informed of assignments of debts to the factor and in the later, the information is concealed from the debtor.

Process of Export Factoring

1. Exporter sells goods on open credit.
2. Export receivables are factored to the factor on the non-

   Recourse basis (generally). All the supporting documents relating to the export Transaction is given to the export factor.
3. Export factor performs its function of credit collection, sales ledger accounting and collection to the import factor with respect to the customers located in the Importing country.
4. Import factor collects the money due from the customers concerned.
5. Import factor effects the payments to the export factor on assignment or maturity or collection or as per the agreement.
6. Export factor makes payment to the exporter upon assignment or maturity or Collection or as per the agreement

Advantage over the other export financial services

- Factoring involves a pre-payment against all unpaid and not due invoices purchased by the factor whereas in bill discounting, each bill is separately assessed and discounted by the financial intermediary.
- Factoring involves other facilities also like collection of debts and sales ledger administration and advisory whereas these facilities are unavailable in a bill discounting arrangement.

Factoring can be non recourse type of an arrangement while bill discounting is usually a recourse type of an arrangement.

FORFEITING

The concept of "forfeiting" was originally developed in Switzerland in mid 1960s and became important after the end of Second World War with the objective of helping to finance the West German exports to eastern block countries. "Forfeit" is a French word which means "to surrender something or give up one's right". Accordingly, the exporters surrender their right to the forfeiter to receive future payment from the buyer to whom goods have been supplied. The exporters offer credit terms to the importer and sell the debt to the forfeiter. Hence, the forfeiter waives recourse to the exporter, if the importer defaults in payments. Generally speaking, forfeiting is a technique to help the exporter sell his goods in credit and yet receive the cash well before the due date.

Forfeiting is a form of financing of receivables pertaining to international trade. It denotes the purchase of trade bills/promissory notes by a bank/financial institution without recourse to the seller.

The purchase is in the form of discounting the documents covering the entire risk of non-payment in collection. All risks and collection problems are fully the responsibility of the purchaser (forfeiter) who pays cash to seller after discounting the bills/notes.

Need for Forfeiting

1. Forfeiting is non-recourse and off-balance sheet financing. It eliminates all risks from the exporter's books.
2. Commercial banks usually do not fund credit risks beyond 180 days. Hence, for financing long tenure receivables, forfeiting is the only option.
3. Forfeiting helps in eliminating interest rate fluctuation as it involves upfront discounting. The interest cost is known to both the exporter and importer and is built into the contract thereby providing protection against adverse interest rate fluctuations.

Characteristics of Forfeiting

1. Forfeiting is 100 per cent financing without recourse to the exporter. This means that the exporter is insulated against the possibility of default in payment by the importer.
2. Trade receivables are usually evidenced by bills of exchange, promissory notes, or a letter of credit.
3. The trade receivables are required to be denominated in a freely convertible currency. The most common currency denominations are the US Dollar and Euro.
4. Credit periods can range from 60 days to 10 years.
5. Forfeiting is flexible as it can be structured on fixed interest rate basis as well as floating rate basis and can be tailormade to accommodate variations in terms such as credit period, shipment schedule, and so on.
6. An importer's obligation is normally supported by a local bank guarantee or an aval. An aval means an unconditional financial obligation; it takes the form of an endorsement on a debt instrument like a promissory note or bills of exchange. The act of giving an aval is known as avalising. It represents an irrevocable, unconditional, and fully transferable guarantee given by the foreign buyer's local bank and is normally a requirement in forfeiting transaction.
7. Forfeiting is suitable for high-value exports such as capital goods, consumer durables, vehicles, consultancy and construction contracts, project exports, and bulk commodities. Forfeiting is also suitable for low value but repetitive products, including pharmaceuticals, dyes, chemicals, cotton textiles, yarn, leather garments, granite, handicrafts, and carpets.

Working/Mechanism of Forfeiting

The working of forfeiting can be explained with the help of following figure 6.1:

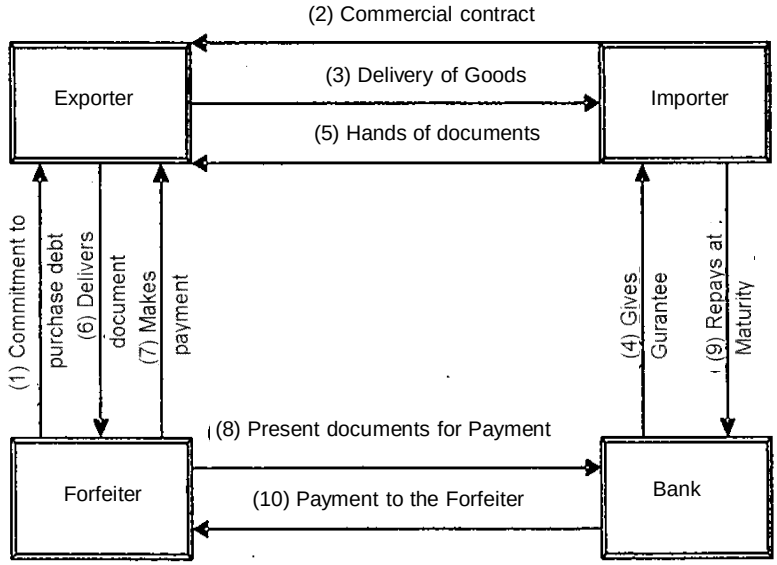


Fig. 6.1: Working of Forfeiting

Commercial Contract

1. At the request of the exporter, and normally nearer the time of shipment, the forfeiter provides the exporter with a written commitment to purchase the debt from him on a without recourse basis.
2. The exporter and the importer sign the commercial contract.
3. A forfeiting certificate is provided by the authorised dealer (AD) to be attached to the goods received form prior to submission to customers. The rest of the shipping documents are prepared as per the commercial contract. The goods are then dispatched to the importer.
4. The importer's bank provides guarantee at the request of the importer.
5. The guarantee is forwarded by the importer to the exporter.
6. The exporter then assigns the guarantee in favour of the forfeiter and forwards other documents relating to forfeiting
7. On receipt of complete documentation, the forfeiter makes the payment to the exporter on a without recourse basis.
8. On maturity, the forfeiter presents the documents to the importer's bank for payment.
9. The importer makes the payment to his guaranteeing bank.
10. The importer's bank guaranteeing the transaction makes the payment to the forfeiter on due date.

Pricing of a Forfeiting Transaction

The pricing consists of four elements: discount rate, commitment fees, grace days, and handling fee.

1. **Discount Rate:** Discount rate is the interest element and reflects the cost of funds. It is the rate at which the face value of a negotiable instrument is discounted. The discount rate is usually quoted as a margin over London Inter-Bank Offer Rate (LIBOR). The margin depends upon the country's bank risk and the credit period. A high country risk and longer credit period will attract higher margins.
2. **Commitment Fees:** The commitment fees is calculated from the date the forfeiter is committed to undertake the financing until the date of discounting.
3. **Grace Days:** These are the number of days beyond the stated maturity. They represent the anticipated number of days required for transmission and receipt of funds at maturity. It normally ranges from 2-5 days and can extend upto 15 days and beyond.
4. **Handling Fee:** A handling fee is applicable for documentation and custom clarification.

Benefits of Forfeiting

Following are the benefits of financial assistance through forfeiting:

1. **Simplicity and Flexibility:** Forfeiting provides service in such a manner to meet the needs of the exporters and importers. One of the greatest advantages of forfeiting is its simplicity and flexibility. Forfeiting can be used to finance any export transaction. This technique is highly useful for medium term fixed rate financing.
2. **Non-Recourse Basis:** Since the transaction does not have a recourse basis, it helps the exporters convert their credit sale into a cash sale.
3. **Fixed Interest Rate and No Currency Risk:** Where the exporter's bankers are not quick enough to provide additional credit limit for extended period, the forfeiting route, with the advantage of a fixed interest rate and no currency risk, acts an export facilitator.
4. **No Need to Carry Receivables:** The biggest advantage of forfeiting is that exporters do not have to carry the receivables in their balance sheet.
5. **EXIM Bank:** The exporters do not deal with the forfeiter. Instead, the EXIM bank does everything for them.
6. **No Hassles of Collection:** Exporters are saved of all the hassles in collecting dues as once sold to the forfeiter, they are out of the transaction.
7. **Simple Documentation:** Documentation procedure is simple and, therefore, it provides an opportunity to structure the deal.
8. **Measure of International Risk:** Forfeiting is a very good measure of international risk. Therefore, now Indian banks are allowed to discount their overseas customers' bills without adding their name.

Initially, forfeiting was used mainly for capital goods but the situation today has changed and the forfeiting company is now willing to look at smaller export orders.

Limitations of Forfeiting

1. **High Interest Rates:** The main disadvantage is the high interest rates and the fact that the forfeiter assumes the risk.
2. **Unfavorable exchange and administrative controls:** The exchange and administrative controls in some countries are not favourable for forfeiting.
3. **Reluctant importers:** Importers are often not very willing to offer collateral or a guarantee.
4. **No legal framework:** There is, presently, no legal framework to protect the banker or forfeiter except the existing covers for the risks involved in any foreign transactions.
5. **Insufficient data:** Data available on credit rating agencies or importer or foreign country is not sufficient. Even EXIM bank does not cover high risk countries like Nigeria?

PRE-SHIPMENT FINANCE

Types of pre shipment finance

- Packing Credit
- Advance against Cheques/Draft etc., representing Advance payments
- Preshipment finance is extended in the following forms:
  (a) Packing Credit in Indian Rupee
  (b) Packing Credit in Foreign Currency(PCFC)

Requirements for getting Packing Credit

This facility is provided to an exporter who satisfies the following criteria:

1. A ten digit importer exporter code number allotted by DGFT
2. Exporter should not be in the caution list of RBI
3. If the goods are to be exported are not under OGL(Open General Licence), the exporter should have the required license/quota permit to export the goods

Packing Credit facility can provided to an exporter on production of the following evidences to the bank:

(a) Formal application to release the packing credit with undertaking to the effect that the exporter will ship the goods within stipulated due date and submit the relevant shipping documents to the banks with in prescribed time limit.

(b) Firm order or irrevocable Letter of Credit or original cable/fax/telex message exchange between the exporter and the buyer.

The confirmed order received from the overseas buyer should reveal the information about the full name and address of the overseas buyer, description quantity and value of goods (FOB or CIF) destination port and last date of payment.

Eligibility

Pre Shipment Credit is only issued to that exporter who has the export order in his own name. However, as an exception, financial institution can also grant credit to a third party manufacturer or supplier of goods who does not have export orders in their own name. In this case, some of the responsibilities of meeting the export requirements have been out sourced to them by the main exporter.

Quantum of Finance

The Quantum of Finance is granted to an exporter against the LC or an expected order. The only guideline principle is the concept of need based finance. Banks determine the percentage of margin depending on the factors such as:

The Nature of Order

1. The nature of Commodity

The capability of exporter to bring in the requisite contribution

Different stages of preshipment Finance

1. Appraisal and sanction of limits: Before making any of an allowance for credit facilities, banks need to check the different aspects like product profile, political and economic details about the country. Apart from these things, the bank also looks in to the status report of the prospective buyer with whom the exporter proposes to do the business. In order to check all these information, banks can seek the help of institution like ECGC or International consulting agencies like Dun and Brad Street. The bank will consider the packing credit facilities after ensuring

1. The exporter is the regular customer, a bonafide exporter and has good standings in the market,
2. Whether the exporter has the necessary license and quota permit or not
3. Whether the country with which the exporter wants to deal is under the list of Restricted Cover Countries.

2. Disbursement of packing Credit Advance: Once the proper sanctioning of the documents is done, the bank ensures whether exporter has executed the list of documents mentioned earlier or not. Disbursement is normally allowed when all the documents are properly executed. Sometimes an exporter is not able to produce the export order at time of availing packing credit. So in these cases, the bank provides a special packing credit facility and is known as Running Account Packing. Before disbursing, the bank specifically check the particulars in the submitted documents namely

(a) Name of Buyer,
(b) Commodity to be exported,
(c) Quantity,
(d) Value (either CIF or FOB),

(e) Last date of Shipment/Negotiation,

(f) Any other terms to be complied with.

3. Follow up of packing Credit Advance: The quantum of finance is fixed depending on the FOB value of contract/LC or the domestic values of goods whichever is found to be lower. Normally Insurance and freight charges are considered at a later stage when the goods are ready to be shipped. In this case disbursals are made only in stages and if possible not in cash, the payments are made directly to the suppliers by drafts/bankers/cheques. The bank decides the duration of packing credit depending upon the time required by the exporter for processing of goods. The maximum duration of packing credit period is 180 days, however bank may provide a further 90 days extension on its own discretion, without referring to RBI.

4. Follow up of Packing Credit Advance: Exporter needs to submit stock statement giving all the necessary information about the stocks. It is then used by the banks as a guarantee for securing the packing credit in advance. Bank also decides the rate of submission of this stock. Apart from this, authorised dealers(banks) also physically inspect the stock at regular intervals.

5. Liquidation of Packing Credit Advance: Packing Credit advance needs to be repaid out of export proceeds of the relevant shipment, thereby converting pre-shipment payment credit in to post shipment credit. This liquidation can also be done by the payment receivable from the Government of India and includes the duty drawback, payment from the Market Development Fund(MDF) of the Central Government or from any other relevant source.

In case if the export does not take place then the entire advance can also be recovered at a certain interest rate. RBI has allowed some flexibility in to the regulation under which substitution of commodity or buyer can be allowed by a bank with out any reference to RBI. Hence in effect, the packing credit advance may be repaid by proceeds from export of the same or another commodity to the same or any other buyer. However, bank need to ensure that the substitution is commercially necessary and unavoidable.

6. Overdue Packing: Bank Considers a packing credit as an Overdue, if the borrower fails to liquidate the packing credit on the due date and if the condition persists then the bank takes the necessary step to recover its dues as per normal recovery procedure. However there are a few special cases namely packing credit to sub supplier and Running account facility

Packing Credit to subsupplier

Packing Credit can only be shared on the basis of disclaimer between the Export Order Holder(EOH) and the Manufacturer of the goods. This disclaimer is normally issued by the EOH in order to indicate that he is not availing any credit facility against the portion of the order transferred in the name of the manufacturer. This disclaimer is also signed by the bankers of EOH after which they have an option to open an inland Letter of Credit specifying the goods to be supplied to the EOH as a part of the export transaction. On the basis of such an L/C, the sub supplier bank may grant a packing credit to the sub supplier to manufacture the components required for exports. On supply of goods, the L/C opening bank will pay to the sub supplier’s bank against the inland documents received on the basis of the inland L/C opened by them. The final responsibility of EOH is to export the goods as per guidelines. Any delay in export order can bring EOH to penal provisions that can be issued anytime.

The main objective of this method is to cover only the first stage of production cycles and is not extended to cover supplies of raw material etc.

Running Account facility

It is a special facility under which a bank has right to grant pre shipment advance for export to the exporter of any origin. Sometimes banks also extent these facilities depending upon the good track record of the exporter. In return, the exporter needs to produce the letter of credit/firms export order within a given period of time.

Pre shipment Credit in Foreign Currency (PCFC)

Authorised dealers are permitted to extend Pre shipment Credit in Foreign Currency (PCFC) with an objective of making the credit available to the exporters at internationally competitive price. This is considered as an added advantage under which credit is provided in foreign currency in order to facilitate the purchase of raw material after fulfilling the basic export orders.

The rate of interest on PCFC is linked to London Interbank offered Rate(LIBOR).According to guidelines, the final cost of exporter must not exceed 0.75% over 6 month LIBOR excluding the tax. The exporter has freedom to avail PCFC in convertible currencies like USD, Pound Sterling, Euro, Yen etc. However, the risk associated with the cross currency truncation is that of exporter. The sources of funds for the banks for extending PCFC facility include the Foreign Currency Account (EEFC), Resident Foreign Currency Accounts RFC and Foreign Currency(Non Resident) Accounts.

Banks are also permitted to utilize the foreign currency balances available under Escrow account and Exporters Foreign Currency accounts. It ensures that the requirement of funds by the account holders for permissible transactions is met. But the limit prescribed for maintaining maximum balance in the account is not exceeded. In addition, banks may arrange for borrowings from abroad. Banks may negotiate terms of credit with overseas bank for the purpose of grant of PCFC to exporters with out the prior approval of RBI, provided the rate of Interest on borrowing does not exceed 0.75% over 6 month LIBOR.

Modes of Packing Credit

1. Packing Credit facilities to deemed exports: Deemed exports made to multilateral funds aided projects and programmes under orders secured through global tenders for which payments will be made in free foreign exchange are eligible for concessional rate of Interest facility both at pre and post supply stages.

2. Packing Credit facilities for consulting services: In case of consultancy services, exports do not involve physical movement of goods out of Indian Customs territory. In such cases, Pre shipment finance can be provided by the bank to allow the exporter to mobilize resources like technical personnel and training them.

3. Advance against cheque/drafts received as advance payment: Where exporters receive direct payments from abroad by means of Cheques/drafts etc., the bank may grant export credit at concessional rate to the exporters of goods track record till the time of realization of the proceeds of

the cheques or draft etc. The bank however must satisfy themselves that the proceeds are against an export order.

4. Extended Packing credit loan: It is extended to those exporters rates as first class exporters by the commercial banks on the basis of their credit worthiness. It is granted for making advance payment to the suppliers for acquiring goods to be exported. Such advance is generally clean, i.e., granted without any documentary evidence for a very short period of time.

5. Packing Credit loan(hypothecation): It is extended for the acquisition of raw materials, work in process or finished goods meant for exports. The goods so acquired are treated as security for sanctioning of loan. Under this facility, the exporter is required to execute a hypothecation deed in favour of the bank while the possession of goods remains with the exporter.

6. Packing credit loan(pledge): It is extended for the acquisition of seasonal raw materials or raw material in odd or bunched lots. Export takes place in due course after processing as per the shipping and delivery schedule agreed upon by the overseas buyer. The documents relating to raw materials are pledged with the bank while possession remains with the exporter.

7. Secured shipping loan: Secured Shipping Loan can be obtained once goods are handed over to the transport operator or clearing and forwarding agent for shipment. It is released against lorry receipt or railway receipt. It is extended for a very short duration considering the time taken for dispatch of goods to the port and completion of shipping and customs formalities.

8. Advances against Red Clause L/C: If the exporter desires to obtain packing credit then he should request the importer to open red clause L/C. Res clause L/C authorises the local banks to grant advances to exporters to meet their working capital requirement for the processing of export order. Such advances are guaranteed by the issuing bank.

POST SHIPMENT FINANCE

Post Shipment Finance means any loan or advance granted provided by a bank to an exporter of goods or services from India from the date of extending credit after shipment of goods or rendering of services to the date of realization of export proceeds. Banks serves with low interest rate to exporters under post shipment credit based on the guidelines of Reserve Bank.

Modes of Post Shipment Finance

1. Export Bills Purchased or Discounted or Negotiated: Once after export by completing necessary export formalities, the exporter obtains necessary export documents from various authorities like carrier of goods, customs department and other agencies. The exporter submits Bill of Landing, invoice, packing list, Certificate of Origin another necessary export documents with bank. The bank extends post shipment finance by discounting or purchasing of such export bills with a concessional rate of interest. Once after realization of export bills from overseas buyer, the said amount is credited to such post shipment credit. If amount from Overseas buyer does not realize within the stipulated period, bank may crystallize such export bills by charging commercial rate of Interest.

2. Advances against bills for collection: If Exporter does not want to discount/purchase export bills obviously he arranges to send export bills for collection. In this case, bank can allot a portion of

export bills as advance against bills for collection with concessional rate of Interest. Once after realization of export bills from overseas buyer, the said amount is credited to such post shipment credit. If amount from overseas buyer does not realize within the stipulated period, bank may hold back such export bills by charging commercial rate of interest up to the extent of amount advanced.

3. Advances against duty drawback receivable from government: It is very much obvious that government of each country promotes exporters to earn foreign currency to their country. One of the government supports to exporters is Duty drawback. Duty Drawback is disbursed by customs department after submission of necessary export documents with customs.

Bank provides advance against such duty drawback receivable from customs department. The exporter submits with his bank necessary export documents on such eligibility on duty drawback. Bank after satisfaction of such eligibility, sanctions advance amount against duty drawback to exporters. However now a days, customs department disburse duty drawback with least period of time, subjected all documents in order.

4. Finance against export bills negotiated under L/C: If the exporter has obtained documentary letter of credit and he has submitted the required documents as mentioned in Letter of credit to the bank, the bank negotiates them and sanctions the equivalent amount of post shipment finance to the exporter, post shipment finance is released after liquidating the pre-shipment finance availed by the exporter.

5. Advance against goods sent on consignment basis; When goods are exported on consignment basis delivers documents export proceeds are received after sale of goods. In such cases, the overseas branch of exporter's bank delivers documents against Trust Receipt and the post shipment advance is adjusted against export proceeds realised later.

6. Advance against undrawn balance: In Certain cases of exports, exporters, exporters do not draw bills for the full invoice value of goods but leave a small part undrawn for adjustments on account of differences in rates, weight, quality etc. Such differences can be adjusted only on the approval of the goods. Banks offer post shipment finance against such balances.

7. Advance against retention money: In the case of exports of capital goods contracts, the importer retains a part of contract price towards guarantee of performance or completion of the project. This unpaid part is known as retention money. Banks offer post-shipment finance against such money for a period of 90 days.

8. Advance against deferred payments: In case of exports of capital goods or construction contracts, exporters receive a certain portion of the contract advance or down payment while the balance is receives in instalments over a period of time. Banks together with the Exim Bank offer post shipment finance against such deferred payment.

CHAPTER SUMMARY

Finance plays an important role in securing overseas projects and it is important for both importers and exporters. Any business whether domestic or international, always requires some kind of financing for its operations. Because international financing must deal with financial and economic conditions in more than one country, this activity involves more uncertainty and complexity than

domestic financing. The greater complexity of international financing, however, is accompanied by a greater number of financing options. There are several sources of finance/funds available for international business. These sources are two types namely

1. Internal sources of funds: Before an MNC's parent or subsidiary in need of funds searches for outside funding, it should check other subsidiaries cash flow positions to determine whether any internal funds are available. Internal sources of funds are those funds generated within a parent-affiliate network. They include capital contributions from the parent, loans with parent-company guarantees, funds provided by operations from retained earnings and depreciation, and inter subsidiary funds transfers namely Funds from the Parent: Three major types of funds supplied by the parent are Equity Contributions, Parent/Direct Loans, Parent Guarantees, Funds Provided by Operations, Loans from Sister Subsidiaries, Global Cash Management,

2. External sources of funds. There are several financial and non-financial institutions that can provide financing to international companies which are considered as the external sources of funds;

(a) Equity Financing, (b) Debt Financing, (c) Venture Capital, (d) Factoring,

(b) Forfeiting, (a) Pre-shipment and (b) Post Shipment Finance

REVIEW QUESTIONS

1. Elucidate the needs for Finance in International Trade.
2. Explain in detail the sources of Finance in International Trade.
3. Explain in detail about Export factoring and its procedures.
4. What is Forfeiting, Need for forfeiting, characteristics and Mechanism of Forfeiting?
5. What is the meaning of Pre Shipment finance and Discuss in detail all the modes of packing credit in India.
6. What is Post shipment Finance and Explain its modes of Post Shipment finance in India.

♦ ♦ ♦

7

INCO TERMS (FOB, CIF. Etc.)

Chapter Outline

- INCO TERMS - An Introduction
- Rules for Carriage by any Mode or Modes of Transport
- Comparison of INCO Terms
- Chapter Summary
- Review Questions

TRADE contract imposes certain rights and obligations on the buyer and seller, these rights and obligations varying in accordance with the convenience of the parties concerned and as agreed by them. Certain specific terms have been evolved, known as 'trade terms' or 'contract terms', as Free on Board (FOB), Cost, Insurance and Freight (OF), each of which carries a specific set of rights and obligations between the parties. While quoting the price, the seller takes into account not only the cost of production but also additional costs and risks involved as per the trade term agreed. For instance, the price quoted for a consignment on CIF basis will be higher than that on FOB basis as the former requires insurance and freight charges to be incurred additionally.

INCO TERMS-AN INTRODUCTION

The existence of difference in interpretation of trade terms in different countries has been a cause of friction in international trade leading to misunderstanding, disputes and references to courts with all the waste of time and money. The Inco terms (International Commercial Terms) were evolved by the International Chamber of Commerce to provide a set of international rules for the interpretation of the chief terms used in foreign trade contracts.

Incoterms were published first in 1936 and subsequently amended and added to periodically to keep pace with the developments in transport and communication. The latest 2010 version, in force from 1st January 2011, defines 11 contract terms, providing an up-to-date set of rules broadly in the with the current international trade practices. What was earlier known as contract term is now 60 *Incoterms Rule*. Thus we have FOB rule, CIF rule etc.

Incoterms 2000 had 13 terms. Incoterms 2010 deleted four terms Delivered at Frontier (DAF), Delivered Ex-Shjp (DES), Delivered Ex-Quay (DEQ) and Delivered Duty Unpaid (DDU). Two new terms were introduced Delivered Terminal (DAT) and Delivery at Place (DAP) which replace the deleted terms.

Scope

The adoption of Incoterms is optional. Merchants wishing to use these rules should specify in their contracts, the specific Incoterms rule followed by Incoterms 2010. For instance, if the price quoted by a Mumbai merchant is USD 10,000 FOB Mumbai, the price would be quoted as: Price: USD 10,000 FOB (Mumbai) Incoterms 2010.

Regarding the scope of Incoterms, the introductory part of Incoterms states as follows: "Incoterms rules do say which party to the sale contract has the obligation to make carriage or Insurance arrangements, when the seller delivers the goods to the buyer, and which costs each party is responsible for. Incoterms rules, however, say nothing about the price to be paid or the method of payment. Neither do they deal with the transfer of ownership of goods, or the consequences of breach of contract. These matters are normally dealt with through express terms in the contract of sale or in the law governing the contract. The parties should be aware that mandatory local laws may override any aspect of the sale contract, including the chosen Incoterms rule."

The Rules

The rules are presented in two distinct classes. The first group containing seven rules are applicable where any mode or modes of transport are used for transporting the goods. The second group containing four rules are to be used when the goods are carried by sea and inland waterways transport. Table 7.1 lists the rules, which are in the order of increasing obligation to the seller in each category:

Table 7.1: Classification of Inco terms rules

Any Mode or Modes Of Transport	Sea or Inland Waterways Transport
EXW Ex Works	FAS Free Alongside Ship
FCA Free Carrier	FOB Free On Board
CPT Carriage Paid To	CFR Cost and Freight
CIP Carriage and Insurance Paid to	CIF Cost, Insurance and Freight
DAP Delivered at Place	
DDP Delivered Duty Paid	

• General obligations under all rules

There are certain obligations of the seller and the buyer in every Incoterms rule adopted.To avoid repetition they are listed below. Under each of the rules that are described subsequently these obligations are to be added under respective heads of seller's obligation and buyer's obiligation.

Seller's Obligations

The Seller should

- provide the goods and the commercial invoice
- package the goods with appropriate marking
- arrange for and pay the cost of checking operations such as checking quality, weighing or counting necessary for delivering the goods
- provide to, or render assistance to the buyer in obtaining, any document and informal the buyer may request, that is needed for the export/import of goods and their final destination.

Buyer's Obligation

The Buyer should

- Pay the price
- Pay the preshipment inspection charges non-mandated by the country of export
- Take delivery at destination reimburse the seller in providing documents and information as requested by the buyer.

Insurance

Only under two of the rules, viz., CIP arid CIF the seller has the obligation to take marine insurance. In all other other rules, the parties have no obligation to the other party in this regard. In case the seller to take insurance on his own, the buyer should provide the necessary information at seller's risk. Similarly, if the buyer wishes to take insurance, the seller must provide the necessary at the cost and risk of the buyer.

Delivery and risk transfer the Incoterms rules, the seller's obligation is to deliver the goods at the agreed place. This time event of delivery is important because it determines who should bear the risk of loss or damage to the goods. Till delivery is effected, the risk is borne by the seller. The risk passes to the buyer when the delivery is effected.

Rules for Carriage by any Mode or Modes of Transport

Following is a brief description of the Incoterms rules that can be used irrespective of mode of transport selected. These may also be used where more than one mode of transport is employed -Ex Works (... named place of delivery) means that the seller delivers when the goods are placed at the disposal of the buyer at the seller premises or at another named place (i.e., works, factory, warehouse etc.) not cleared for export and not load on any collecting vehicle. The buyer bears all costs and risks involved in taking the goods from the named place of delivery.

Seller's Obligations

EXW Obligations represents the minimum obligation to the seller.

The seller should prepare the goods and keep them ready at the agreed place of delivery. He should issue a notice to the buyer to enable the buyer to take delivery of goods.

Buyer's Obligations

If the buyer is entitled under the sale contract to determine the time of delivery of goods, the buyer should give sufficient notice of his intention to the seller.

- He should pay for mandatory pre-shipment inspection charges, when required by the export - should obtain export/import licenses, where required, and carry out customs formalities.
- **FCA-Free Carrier (... named place of delivery)**

Free Carrier means that the seller delivers the goods to the carrier or another person nominated by the buyer at the seller's premises or another named place. The chosen place of delivery has an impact on the obligations of the seller on loading the goods. If delivery occurs at the seller's premises, the seller is responsible for loading. If delivery occurs at any other place, the seller is not responsible for unloading.

Seller's Obligation

If the delivery is at the seller's premises, the seller has the responsibility to load the goods in to the vehicle provided by the buyer. However, if requested by the buyer, or if it is the commercial practice, the seller may contract for carriage on usual terms at -the buyer's risk and expense.

If the delivery is at any other place, the goods should be carried to that place by the seller means of transport and placed at the disposal of the carrier or another person nominated by the buyer ready for unloading.

The seller has the responsibility to clear the goods for export. He should obtain export licence, if required, and complete export customs formalities.

Buyer's Obligation

Buyer should arrange for contract of carriage and bear the cost of transportation.

He should notify the seller of the name of the carrier or another person nominated to take delivery of the goods on his behalf, the mode of transport, time and point of delivery.

He should obtain import licences and carry out import customs formalities.

➨ CPT-Caniage paid to (...named place of destination)

Carriage Paid To means that the seller delivers the goods to the carrier or another person nominated by the seller, and that the seller must contract for and pay the costs of carriage necessary to bring the goods to the place of destination.

The delivery is effected and the risk passes to the buyer when the goods are delivered to the carrier. If several carriers are used, the risk passes when the goods are delivered to the first carrier. Thus, the point at which risk passes to the buyer (delivery to carrier) and up to which the seller bears the cost (place of destination) are different.

Seller's Obligation

Seller should arrange for carriage of goods from the agreed point of delivery (shipment place) to the named place of destination; The freight charges and all other costs including costs of loading the goods and any charges for unloading at the place of destination that were for the seller's under the contract of carriage are borne by the seller.

He should provide a freight paid transport document to the buyer.

He should arrange for obtaining export licence and for compliance with customs formalities for export.

Buyer's Obligation

Where the buyer is entitled to determine the time for dispatching the goods, he should give sufficient notice thereof to the seller.

He should arrange for import licence if required and comply with the import customs formalities.

➨ CIP-Carriage and Insurance Paid to (... named place of destination)

Carriage and insurance paid to means that the seller delivers the goods to the carrier or another nominated by the seller and that the seller must contract far and pay for the cost of carriage necessary to bring the goods to the named-place of destination. The seller also contracts for insurance cover against the buyer's risk of loss or damage to the goods during the carriage.

This rule is same as CPT except for the provision relating to insurance. The seller must obtain cargo insurance with at least the minimum cover as provided by Clause (C) of the Institute Cargo Clauses, for a minimum value of 110% of the contract price and in the currency of the contract.

- **DAT-Delivered at Terminal** (... named terminal at port or place of destination) Delivered at Terminal means that the seller delivers the goods, once unloaded from the arriving means of transport are placed at the disposal of the buyer at a named terminal at the named port or place of destination. The seller bears all risks involved in bringing the goods to and unloading them at the terminal at the named port or place of destination.

Terminal includes any place, whether covered or not, such as a quay, warehouse, container yard or road, rail or air cargo terminal.

Sellers's Obligation

The seller must arrange for carriage of the goods and pay the cost of carriage till place of destination.

- He should obtain export clearance including export licences and compliance with customs formalities.
- He should arrange for unloading the goods from the arriving means of transport at the named terminal in the port or place of destination.
- He delivers by placing the goods at the disposal of the buyer at the named terminal on the agreed date or within the agreed period.
- He should provide the buyer with a document that enables the buyer to take delivery of the goods.

Buyer's Obligation

The buyer has to arrange for import license and comply with import customs clearance. DAP-Delivered at Place (... named place of destination)

Delivered at Place means that the seller delivers when the goods are placed at the disposal of the buyer on arriving means of transport ready for unloading at the named place of destination. The seller bears all risks involving in bringing the goods to the named place.

Seller's obligation

This rule is similar to DAT with the difference that the seller's obligation does not include unloading goods at the named place of destination.

The place mentioned may be the one where the terminal is situated. In this case, the seller delivers when the goods arrive at the terminal and the buyer is provided with document needed to get the goods unloaded and taken delivery.

The place mentioned may be other than the terminal for arrival of goods. In this case, the seller should arrange for movement of goods from the terminal to the place of destination. The seller delivers the goods by placing them at the disposal of the buyer ready for unloading from the means of transport at the named place of destination.

Buyer's obligation

The buyer has to arrange for unloading the goods from the arriving means of transport at the named place of destination.

He should arrange for import licence and import clearances.

➨ **DDP-Delivered Duty Paid (... named place of destination)**

Delivered Duty Paid means that the seller delivers the goods when the goods are placed at the disposal of the buyer, cleared for import on the arriving means of transport ready for unloading at the named place of destination.

Seller's obligation

DDP represents the maximum obligation for the seller. The seller bears all the costs and risk involved in bringing the goods to the place of destination.

He has an obligation to clear the goods not only for export but also for import and carry out all customs formalities. Any VAT or other taxes payable upon import are also for the seller's account unless expressly agreed otherwise in the sale contract.

Buyer's obligation

If the place of destination is the buyer's premises, the only duty of the buyer is to take delivery of the goods. If the place of destination is other than the buyer's premises, the seller will provide the buyer with an appropriate transport, document to enable the buyer on taking delivery of the goods.

RULES FOR CARRIAGE BY SEA AND INLAND WATERWAY TRANSPORT

Incoterms 2010 recommends that the rules meant for sea transport are not to be used w~ goods are containers and are handed over to the carrier at a terminal and not placed directly af the ship or on board the ship. In such cases appropriate rule for all modes of transport, such CPT, CIP may be used.

➨ **FAS-Free Alongside Ship** (... named port of shipment)

Free Alongside Ship means that the seller delivers when the goods are placed alongside the vessel nominated by the buyer at the named port of shipment. The risk of loss or damage to the goods passes when the goods are alongside the ship, and the buyer bears all the costs from that moment onwards.

Seller's Obligation

The seller's obligation is to bring the goods to the named port and place them alongside the vessel nominated by the buyer.

He should obtain the export license where required and carry out customs formalities.The seller has no obligation to make a contract of carriage. However, if requested by the buyer or if it is commercial practice, the seller may contract for carriage on usual terms at the buyer's risk and expense.

After placing the goods alongside the ship, the seller should provide the buyer the usual documentary proof that the goods have been delivered. This may be a dock receipt or dock warrant.

The buyer should contract for carriage of goods from the named port of shipment; He should intimate the seller about the name and loading berth of the ship and the delivery date. The buyer should obtain import licence, if required, and comply with import customs formalities.

FOB Free on Board (... named port of shipment)

Free on Board means that the seller delivers the goods on board the vessel nominated by the buyer at the port of shipment. The risk of loss of or damage to the goods passes when the goods are on board the vessel and the buyer bears all costs from that moment onwards.

Seller's Obligation

The seller should carry the goods to the port of shipment, get them cleared by customs and place them on board the vessel nominated by the buyers. He should obtain from the shipping company freight to pay bill of lading and provide it to the buyer. The seller has no obligation to contract for carriage of goods. However, if requested by the buyer or if it is commercial practice, the seller may contract for carriage on usual terms at the buyer's risk and expense.

Buyer's Obligation

The should contract for the carriage of the goods from the named port of shipment. He should give the seller sufficient notice of the vessel name, loading point and delivery time.

At the destination, the buyer should arrange for import customs clearance, pay the freight, import duty and port charges to take delivery of the goods.

CFR-Cost and Freight (... named port of destination)

Cost and Freight means that the seller delivers the goods on board the vessel. The seller must contract for and pay the costs and freight necessary to bring the goods to the named port of destination. The risk of loss of damage to the goods passes when the goods are on board the vessel. This rule corresponds to CPT rule for all modes of transport.

The delivery is effected and the risk passes to the buyer when the goods are on board the ship place of shipment. However, the seller obtains a freight paid bill of lading and therefore bears cost of transportation up to destination.

Seller's Obligation

Exporter's should arrange for carriage of goods from the agreed point of delivery (shipment place) to the named place of destination. The freight charges and all other costs including costs of loading the goods and any charges for unloading at the place of destination that were for the seller's account the contract of carriage are borne by the seller. He Should provide a freight paid bill of lading to the buyer. He should arrange for obtaining export license and for compliance with customs formalities for export.

Buyer's Obligation

Where the buyer is entitled to determine the time for dispatching the goods, he should give sufficient notice thereof to the seller.

He should arrange for import licence if required and comply with the import customs formalities.

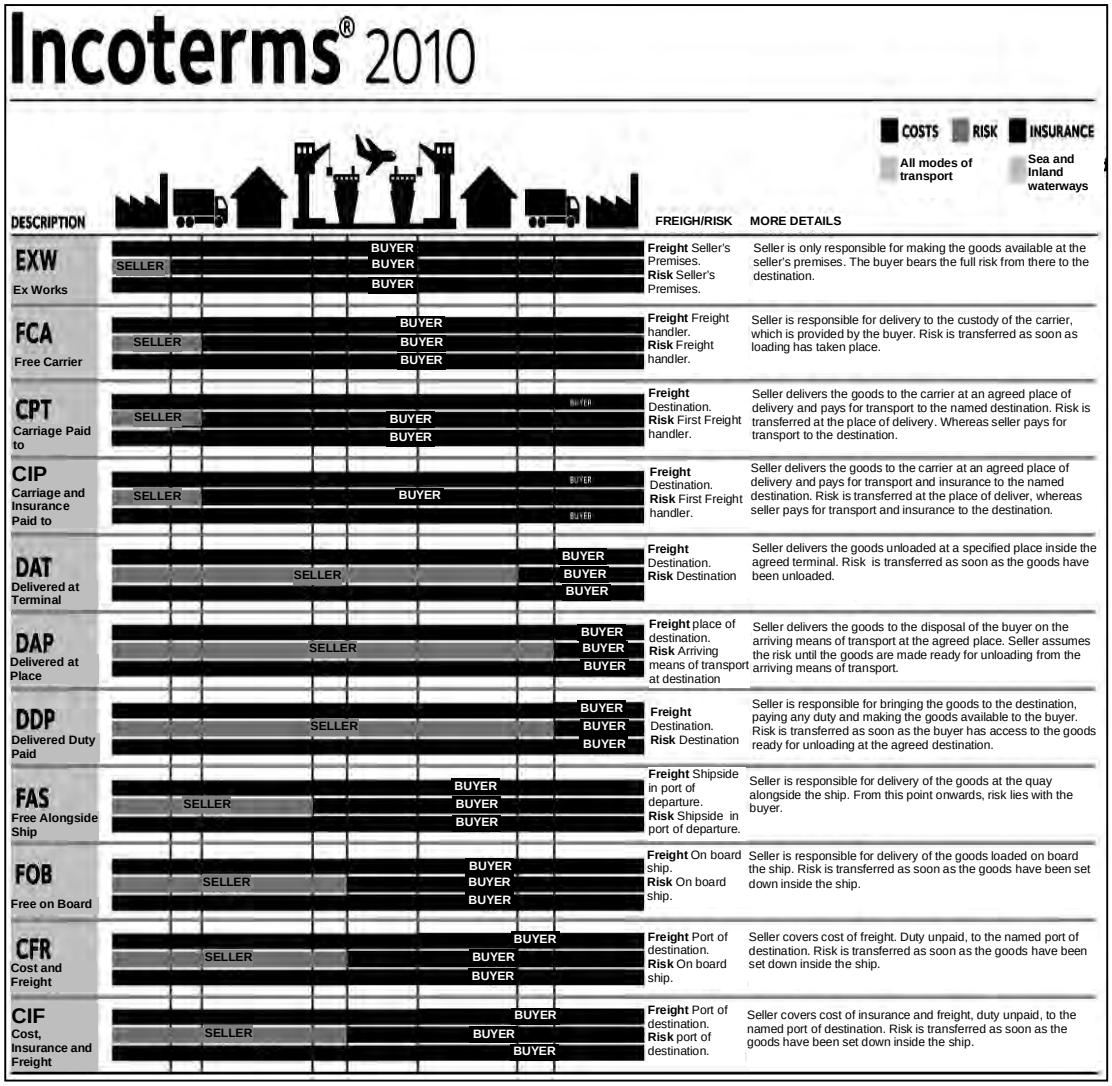
➨ CIF- Cost, Insurance and Freight (...named port of destination)

Cost, Insurance and Freight means that the seller delivers the goods on board the vessel. The seller must contract for and pay the costs of freight necessary to bring the goods to the named port of destination. The seller also contracts for insurance cover against the buyer's risk of loss of or damage to the goods during carriage. The risk of loss of or damage to the goods passes when the goods are on board the vessel.

This rule corresponds to CIP rule applicable for all modes of transport. This rule is same as CFR except for the provision relating to insurance. The seller must obtain cargo insurance with at least the minimum cover as provided by Clause (C) of the Institute (Clauses, for a minimum value of 110% of the contract price and in the currency of the contract.

CHAPTER SUMMARY

- International Commercial Terms or Incoterms are a set of terms specifying the rights and obligations of the buyer and seller under a contract. The Incoterms were evolved by the International Chamber of Commerce to provide a set of International rules for the interpretation of the chief terms used in foreign trade contracts.
- There are 11 terms defined. Seven terms were EXW, FCA, CPT, CIP, DAT and DDP can be used for all other modes including multimodal transport. Four terms FAS, FOB, CFR and CIF are relevant for transportation by sea and Inland waterways.
- EX Works means seller delivers when the goods are placed at the disposal of the buyer at the seller's premises or another named place (i.e. works, factory, warehouse, etc.) not cleared for export and not loaded on any collecting vehicle. This term represents the minimum obligation for the seller.
- Free Carrier means that the seller delivers the goods, cleared for export to the carrier nominated by the buyer at the named place. If delivery occurs at the seller's premises, the seller is responsible for loading.
- Free long side ship means that the seller delivers when the goods are placed alongside the vessel at the named post of shipment. This means that the buyer has to bear all costs and risks of loss or damage or damage to the goods from that moment.
- Free on Board means that the seller delivers when the goods pass the ship's rail at the named port of shipment.
- Cost and Freight means that the seller delivers the goods on board the vessel. The seller must contract for and pay the costs and freight necessary to bring the goods to the named port of destination.
- Cost Insurance and Freight is same as Cost and Fright with the addition that the seller also has to procure marine insurance against the buyer's risk of loss or damage to the goods during the carriage.
- Carriage Paid to means that the seller delivers the goods to the carrier nominated by him but in addition, the seller must pay the cost of carriage necessary to bring the goods to the named destination.



REVIEW QUESTIONS

1. What is Incoterms? and Explain their Terminologies.
2. Short Note on
   (a) CIF
   (b) Ex works
   (c) FAS
   (d) FOB
   (e) CFR
   (f) CIF

♦ ♦ ♦

8

DOCUMENTATION IN INTERNATIONAL TRADE

Chapter Outline

- Introduction
- Need for Export Trade Documents
- Financial Documents
- Transport Documents
- Official Documents
- Insurance Cover note
- Chapter Summary
- Review Questions

Introduction

Documents required for an international sale can vary significantly from transaction to transaction, depending on the destination and the product being shipped. International market involves various types of trade documents that need to be produced while making transactions. Each trade document is differ from other and present the various aspects of the trade like description, quality, number, transportation medium, indemnity, inspection and so on. So, it becomes important for the importers and exporters to make sure that their documents support the guidelines as per international trade transactions. A small mistake could prove costly for any of the parties.

The word *"document"* comes from the Latin word *'documentum'* meaning *'official paper'*. The word also carries meanings of *"proof and evidence"*. Therefore, a document is an official paper that serves as proof or evidence of something.

For example, a trade document about the bill of lading is a proof that goods have been shipped on board, while inspection certificate certifies that the goods have been inspected and meet quality standards. So, depending on these necessary documents, a seller can assure a buyer that he has fulfilled his responsibility whilst the buyer is assured of his request being carried out by the seller.

The major types of international trade documentation can be broadly classified into following forms, as per the ease of knowing and studying them:

1. Export trade documents, and
2. Import trade documents.

Export Trade Documents

Introduction

An exporter without any commercial contract is completely exposed of foreign exchange risks that arises due to the probability of an adverse change in exchange rates. Therefore, it becomes important for the exporter to gain some knowledge about the foreign exchange rates, quoting of exchange rates and various factors determining the exchange rates. In this section, we have discussed various topics related to foreign exchange rates in detail. Export from India required special document depending upon the type of product and destination to be exported. Export Documents not only gives detail about the product and its destination port but are also used for the purpose of taxation and quality control inspection certification. Export documentation means the use of various documents in the export trade. Export documentation plays a vital role in international marketing as it facilitates the smooth flow of goods and payments thereof across national frontiers.

Export documentation is a tedious but necessary process that all exporters must pay close attention to, as documentation requirements vary considerably by country, commodity, and situation. Although exporters must fill out and submit many different forms for each international shipment, most require similar data elements and can be duplicated precisely from one document to the next.

Export documentation is necessary because export trade cannot take place without certain documents. These documents help to protect the interests of both the exporter and the importer. With the help of these documents, the exporter is able to get his sale value and the importer is able to get the ordered goods. In modern days, goods of the exporter are carried to the importer in a ship owned by a

third party. After loading the goods on the ship, the exporter has no physical control over the goods. The exporter is not sure whether he will get the payment. He wants to ensure that the importer will not get the goods from the shipping company at the destination before.

NEED FOR EXPORT TRADE DOCUMENTS

Need for documentation arises primarily because of certain peculiarities of international trade transactions which are as follows:

1. Vital interest to exporter and importer: The shipment is represented by the set of documents once the goods have been cleared by the customs for their transportation to the importer. These documents are of vital interest to both the exporter and the importer. The importer needs them to claim peaceful and legal possession and delivery of the goods in his country; the exporter needs to hand them over to him to claim payment for the shipment.

2. Evidence of shipment and Title of Goods: Export document provides evidence to shipment and title of goods, as once the goods are being shipped, then the exporter is required to have an evidence with him, so that in case of any miss happening or loss of goods, exporter can claim the goods and also in case the importer asks about the status of goods, then the exporter can provide him the relevant documents. As a part of evidence, the export documents help the exporter in getting the payments from the importer if delayed.

3. Documentary requirements of exporting: The documentary requirements are both regulatory and operational in nature, and the necessary documents should be prepared to comply with the rules and regulations of the exporting and the importing country. Moreover, these requirements are different for different types of products. When exporting for the first time, the exporter should, therefore, always find-out from the buyer the documents required by him/her for the import of the product. Accuracy and completeness are of paramount importance in documents covering export shipments.

4. Complete description of the goods: The main purpose of the documents accompanying a shipment is to provide a specific and complete description of the goods so that they can be assessed correctly for duty purpose and meet the import licensing requirements or import quota restrictions imposed on the goods for clearance purpose.

5. Long distance: Unlike domestic trade, buyers and sellers are separated by long distances in overseas trade Transactions. This necessitates concluding a formal contract laying down duties and responsibilities of buyers and sellers respectively.

6. Assistance from Intermediaries: No international trade transactions can be completed without the assistance of at least three intermediaries - a carrier, who undertakes to deliver the goods to the buyer on behalf of seller, an insurance company that covers the risks arising out of hazards of long voyage and finally a banker who collects the sale proceeds from the buyer and hands over the same to the exporter. Documentation and attendant formalities become necessary to ensure compliance of contract obligations of the concerned parties i.e., the exporter, importer and intermediaries

Types of Export Trade Documents

Full knowledge and accurate compliance of procedures and documentation formalities ant as essential as looking into areas of marketing mix to ensure success in international marketing.

The exact documentation required for exporting goods from the one country depends on the goods in question as well as the country to which the goods are being exported. However, the most common export documents required may be classified into following, in general:

- Financial Documents
- commercial Documents
- Transport Documents
- Official Documents

FINANCIAL DOCUMENTS

Financial Documents are the documents related to the financial aspect of the transaction and the payment export trade. Financial Documents in an export contract are as follows:

- Letter of credit
- Bill of Exchange
- Trust Receipt
- Letter of Hypothecation
- Bank Certificate of Payment
- Standby Credit

Letter of Credit

A letter of credit is a document containing the guarantee of a bank to honour drafts drawn on it by an export under certain conditions and up to certain amounts, provided that the beneficiary fulfils the stipulated conditions. Letter of credit, popularly known as L/C, is by far the most important single document international trade. It forms the basis of a very large volume of world trade. Through the instrument of letter credit, the promise to pay usually made by the overseas importer is substitute by the promise to pay by his ba It is this characteristic of the letter of credit which gives the exporter great security.

Letter of Credit is the most appropriate and secured method of payment adopted to settle international transactions, on the finalization of the export, contract, and the importer opens a letter of credit in favour of exporter, if agreed upon in the contract. On securing the letter of credit, the exporter procures pre-shipment finance from his bank for procuring raw materials and other components, processing and packing of goods transfer of goods to the port of shipment.

Bill of Exchange

Bill of exchange refers to an unconditional written order prepared by an exporter asking the importer to pay specified sum of money to a specified person at a specified time. The specified amount

is represented by amount of the invoice; the specified person here refers to the banks and the specified time is a matter negotiation between the exporter and the importer. The exporter may agree to supply goods to the import against immediate payment or payment to be made after the expiry of an agreed period of credit. (The period credit is known as Usance period). In case the payment is to be made by the importer immediately or demand to get the documents then the Bill of Exchange is known as Sight Bill of Exchange or Sight Draft international trade, Bill of Exchange is also known as a Draft). But if the payment is to be made after the ex of a certain period of time, then the bill of exchange is known as Usance Bill of Exchange or Usance Draft.

The bill of exchange is prepared in two sets viz. the First of Exchange and the Second of Exchange. The for for the Second of Exchange is the same as given above in the case of the First of Exchange. The reason preparing the bill of exchange in two sets is that in case the first set is lost or is mutilated or is torn or cease be a negotiable instrument then the second copy can be used for the purpose of negotiation/collection oi documents.

The Negotiable Instruments Act, 1881, defines the bill of exchange as “an instrument in writing containing unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, c the order of, a certain person or to the bearer of the instrument”.

When a draft is drawn on a foreign bank, it is known as a foreign draft or bill of exchange. A bill of exchange is, thus, a means of collecting payment from the foreign buyer through the banking channel. It is also a set of extending credit. It has two main functions. If the bill of exchange is payable at sight, it becomes a den for payment and a receipt for payment made. If the bill of exchange is payable at some future date after sign is a demand for payment by the exporter, a promise of payment by the importer, and a receipt for payment; such payment has been made.

The bill of exchange under a documentary credit must be drawn strictly in accordance with the terms of the credit The bill will be drawn on the bank through which the credit is opened, advised or confirmed.

Parties to a Bill of Exchange

There are five important parties to a bill of exchange:

1. **Drawer:** The drawer is the person who has issued the bill. In an export ‘transaction, exporter draws the bill as money is owed to him.
2. **Drawee:** The drawee is the person on whom the bill is drawn. Exporter draws the bill on the importer who is the drawee. Drawee is the debtor who owes money to the exporter (creditor).
3. **Payee:** The payee is the person to whom the money is payable. The bill can be drawn by the exporter payable to the drawer (himself) or his banker.
4. **Endorser:** The endorser is the person who has placed his signature on the back of the bill signifying that he has obtained the title for the bill on his own account or on account of the original payee.
5. **Endorsee:** The endorsee is the person to whom the bill is endorsed. The endorsee can obtain the payment from the drawer.

Types of Bills of Exchange

1. Sight Bill of Exchange: In this bill of exchange, also known as demand bill of exchange, the drawee has to make the payment, on presentation.

2. Usance Bill of Exchange: In case of usance or time bill of exchange, payment is to be made on the maturity date, after a certain period, known as tenor. When the calculation of period is made with reference to the sight of bill, the bill is known as 'after sight usance bill'. Sometimes, the maturity date is calculated with reference to the date of bill of exchange, it is known as after date usance bill.

3. Documentary bill of exchange: A documentary bill of exchange is one where the relative shipping documents such as bill of lading, marine insurance policy, invoice and other documents are sent along with the bill of exchange. This is the common form in export trade. The documents are given to the bank either for collection or negotiation. In case the importer gets the documents on acceptance, it is called Documents against Acceptance. If the importer gets the documents only on payment, it is called Documents against Payment.

After shipment of goods, the exporter draws the bill on the importer or, more frequently, on bank acting for the importer, as agreed between the exporter and importer. The exporter usually draws the bill to his own order or that of his bank. Later, he endorses the bill in favour of his bank. Exporter may request his bank to collect or purchase the bill. In case of purchase of bill, exporter receives the export proceeds immediately. In any case, the exporter's bank sends the documents to its branch or correspondent's bank in importer's place. The bank at that end sends the intimation of receipt of documents to the importer either for acceptance or payment, dependant on the nature of bill drawn. In case of Documents against Acceptance, importer accepts the bill and then only gets title to goods. In case of Documents against Payment, importer has to make the payment for securing delivery of documents.

4. Other Bills of Exchange

(i) **D/A Bills:** In this case, the documentary evidence accompanying the bill of exchange is deliverable against acceptance by the drawee. This means the documentary bill becomes a clean bill after delivery of the documents.

(ii) **D/P Bills:** In case a bill is a "documents against payment" bill and has been accepted by the drawee, the documents of title will be held by the bank or the finance company till the maturity of the B/E.

(iii) **Clean Bills:** These bills are not accompanied by any documents that show that a trade has taken place between the buyer and the seller. Because of this, the interest rate charged on such bills is higher than the rate charged on documentary bills.

(iv) **Inland Bills:** Bills that are drawn on Indian residents are called 'inland bills'. Such bills may be endorsed in a foreign country, or may remain in circulation in foreign countries. A bill drawn in a foreign country is considered an inland bill if it is drawn on a resident of India.

(v) Foreign Bills: Bills that are payable outside India are called 'foreign bills'. Such bills are either:

(a) Drawn outside India and payable in India by a party outside India, or

(b) Drawn outside India and payable outside India by a person resident in India, or

(c) Drawn outside India and payable outside India by a person not resident in India, or

(d) Drawn in India but made payable outside India.

Another classification of foreign bills is export bills and import bills. Bills that are drawn by exporters on a party outside India are called export bills, and when exporters outside India draw bills on importers in India, it is called an import bill.

(vi) Accommodation Bills: Accommodation bills, also called kite bills or wind bills, are those bills that are created by borrowers and lenders simply to help each other, without the backing of any trading transaction. It works essentially as a mutual financing arrangement, whereby parties draw bills on each other for creating instruments, which are subsequently accepted and discounted with their respective bankers. This way, the financial requirements of both the parties are easily met.

(vii) Supply Bills: Bills that are drawn by a supplier or contractor on a government or semi-government department for supplies made are 'supply bills'. These bills are not 'accepted' by government departments and therefore, do not enjoy the status of a negotiable instrument. However, it is possible for the supplier to obtain an advance from commercial banks against such bills in order to meet financial needs, pending payment from the government department. Due to the non-negotiability of character, these bills are eligible for clean advances by banks.

(viii) Hundis/Promissory Notes: Indigenous bills of exchange and promissory notes are known as 'hundis'. These are used for financing agriculture and inland trade. They are handled by various types of indigenous bankers. A 'promissory note' is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of a certain person, or to the bearer of the instrument. The person who makes the promissory note and promises to pay is called the maker. The person to whom the payment is to be made is called the payee.

Trust Receipt

A Trust Receipt or TR is a document of release of goods to a customer by a bank. After an L/C is drafted and the import shipment has arrived, this type of additional financing may be offered in place of a buyers immediate payment. The customer may use or sell the goods but the bank retains title to them. Commonly, if the importer is in good standing with the bank, an offer of TR financing will be extend. When the terms of the TR are agreed to (usually for payment in 60 to 90 days at a specified rate), the bank will release the goods to the buyer for the purpose of manufacture or sale whilst retaining the title to the goods. The buyer is required to keep the goods separate from it other business and hold the goods or proceeds from the sale of goods subject to remittance or repossession of the bank.

In case of D/P bill, the importer has to make the payment to take delivery of goods. If the importer is unable to make the payment, on arrival of the shipment, and take possession of goods, he executes a trust receipt to take delivery of goods. Importer will have the right to sell the goods and would be acting as agent of the bank. Importer will be depositing the sale proceeds with the bank, as and when sales are made. Till the importer makes the final settlement, bank retains ownership for the merchandise and the role of the importer is not that of owner but that of agent to the bank. This arrangement facilitates the importer to take delivery of goods when sufficient funds are not available with him. This facility provides the flexibility to the importer while the interests of bank are protected, at all times.

Letter of Hypothecation

A letter of hypothecation is a document signed by the customer conveying to a banker the full ownership ol goods at the port of destination in respect of which he has made advances either by loan or by acceptance on negotiation of bills of exchange. This is a sort of blanket document which any banker, who accepts bills advances money or negotiates bills and shipping documents, demands from a customer to give him recourse or the bills and control of the documents. The letter of hypothecation pledges the documents of title with the banker as security for an advance and gives bank the power to sell the goods. If necessary, to insure them and to warehouse them at the customer's expense.

Bank Certificate of Payment

It is a certificate issued by the negotiating bank to the exporter that the bill covering the shipment has been negotiated through it and export proceeds have been received from the importer. The certificate indicates the details of the merchandise exported. Exporter submits this certificate of payment for establishing that the export transaction has been completed totally by him. This certificate is required to comply with the requirements for the discharge of export obligation.

Standby Credit

It is an arrangement between customer and his bank by which the customer may enjoy the convenience of cashing cheques, up to a certain value. Or a credit set up between the exporter and the importer guaranteeing the expense will pay the importer a certain amount of money if the contract is not fulfilled. It is also known as performance bond. This is usually found in large transactions, such as crude oil, fertilizers, fishmeal, sugar, urea, etc.

Commercial Documents

Commercial documents are required for effecting physical transfer of goods and their title from the exporter to the importer and the realisation of export sale proceeds. Out of the sixteen commercial documents in the export documentation framework as many as fourteen have been standardized and aligned to one another. These are pro forma invoice, commercial invoice, packing list, shipping instructions, intimation for inspection, certificate of inspection of quality control, insurance declaration, certificate of insurance, mate's receipt, bill of lading or combined transport document, application for certificate origin, certificate of origin, shipment advice and letter to the bank for collection or negotiation of documents. However, shipping order and bill of exchange could not be brought within

the fold of the Aligned Documentation System. The major commercial documents used in expan trade are as follows:

- Commercial Documents
- Proforma Invoice
- Commercial Invoice
- Consular Invoice
- Customs Invoice
- Legalized Invoice
- Certified Invoice
- Certificate of Value
- Packing List and Note
- Certificate of Weight
- Certificate of Measurement
- Certificate of Analysis & Quality
- Certificate of Inspection
- Certificate of Health

Proforma Invoice

Proforma invoice is the starting point of an export contract. As and when the exporter receives the trade inquiry from importer, exporter submits the pro forma invoice to the importer. The pro forma invoice contains details such as name and address of the exporter, name and address of the intending importer, nature of goods, mode of transportation, unit price in terms of internationally accepted quotation, name of the country of origin of goods, name of the country of final destination, period required for executing contract after receipt of confirmed order and finally signature of the exporter.

A proforma invoice is a quote in an invoice format that may be required by the buyer to apply for an import license, contract for pre-shipment inspection, open a letter of credit or arrange for transfer of hard currency. A proforma may not be a required shipping document, but it can provide detailed information that buyers need in order lo legally import the product. Proforma invoices basically contain much of the same information as the formal quotation, and in many cases can be used in place of one. It should give the buyer as much information about the order as possible so arrangements can be made efficiently.

Importance and significance of Proforma Invoice

1. It forms basis of all trade transactions and further negotiation or contract is made on this basis.
2. It helps the importer to obtain the import license, where required, and obtain foreign exchange for completion of the contract.

The starting point of the export contract is in the form of offer made by the exporter to the foreign customer. The offer made by the exporter is in the form of a proforma invoice. It is a quotation given as a reply to an inquiry. It normally forms the basis of all trade transactions.

Contents of Proforma Invoice

1. Name and address of the exporter.
2. Name and address of the importer.
3. Mode of transportation, such as sea or air or multi-modal transport.
4. Name of the port of loading.
5. Name of the port of discharge and final destination.
6. Provisional invoice number and date.
7. Exporter's reference number.
8. Buyer's reference number and date.
9. Name of the country of origin of goods.
10. Name of the country of final destination.
11. Marks and container number.
12. Number and packing description.
13. Description of goods giving details of quantity, rate, and total amount in terms of internationally accepted price quotation.
14. Signature of the exporter with date.

Commercial Invoice

A commercial invoice is the seller's bill for merchandise or goods sold by him. This is the basic document in an export transaction. It contains all the information which is required for the preparation of all other documents.

It is, thus, a document of contents. An invoice is the seller's bill for merchandise and contains particulars of goods, such as the price per unit at a particular location, quantity, total value, packing specifications, terms of sale, identification marks of the package, bill of lading number, name and address of the importer, destination, name of the ship, etc. The date, name and address of both buyer and seller, name of the shipping vessel and the port of debarkation should also be specified.

Some importing countries insist that the invoice should be signed by the importing country's consul located in the exporter's country. Such invoices signed by the consul are known as consular invoice. The main purpose of a consular invoice is to enable the authorities of the importing country to collect accurate information about the volume, value, quality, grade, source, etc., of its imports for purpose of assessing import duties and also for statistical purposes.

The special invoice forms for various countries may be obtained from any Recognized Chamber of Commerce. Exporters may consult the respective Export Promotion Councils regarding the correct producers and invoice forms for different countries.

There is no standard form of commercial invoice. The exporter has to design its own form. Some countries, however, prescribe their own forms. In such cases, the exporter has necessarily to use the form prescribed by the importing country.

The description of merchandise as given in the commercial invoice must correspond exactly to the description in the letter of credit; other documents must also contain the similar description.

Significance of Commercial Invoice

1. It is prima facie evidence of the contract of sale and purchase of goods. On the basis of the invoice, all the other documents, in the context of export, are prepared as it is the basic document.
2. Invoice constitutes the main document for various export formalities such as pre-shipment inspection, quality, excise, & customs procedures.
3. It is useful for accounting purposes, both by the exporter and importer.
4. This document is required in collection/negotiation of documents through the bank.
5. For claiming incentives, this document is essential.
6. It is the basic document useful in preparation of various other shipping documents.
7. It is used in various export formalities such as quality and pre-shipment inspection excise and customs procedures, etc.
8. It is also useful in negotiation of documents for collection and claim of incentives.
9. It is useful for accounting purposes to both exporters as well as importers.

Commercial invoice is an important and basic export document. It is also known as a 'Document of Contents as it contains all the information required for the preparation of other documents. It is actually a seller's bill of merchandise. It is prepared by the exporter after the execution of export order giving details about the goods shipped. It is essential that the invoice is prepared in the name of the buyer or the consignee mentioned, in the letter of credit. It is a prima facie evidence of the contract of sale or purchase and therefore, must be prepared strictly in accordance with the contract of sale.

Contents of Commercial Invoice

1. Name and address of the exporter.
2. Name and address of the consignee.
3. Name and the number of vessel or flight.
4. Name of the port of loading.
5. Name of the port of discharge and final destination.
6. Invoice number and date.
7. Exporter's reference number.
8. Buyer's reference number and date.
9. Name of the country of origin of goods.
10. Name of the country of final destination.

11. Terms of delivery and payment.
12. Marks and container number.
13. Number and packing description.
14. Description of goods giving details of quantity, rate, and total amount in terms of internationally accepted price quotation.
15. Signature of the exporter with date.

Consular Invoice

Certain nations require a consular invoice, which is used to control and identify goods. The invoice must be purchased from the consulate of the country to which the goods are being shipped and usually must be prepared in the language of that country. It is required by Philippines and it is to be certified by the authorized mission of the importing country in the exporting country. The consular invoice may be obtained by paying a prescribed fee. Mainly needed for the countries like Kenya, Uganda, Tanzania, Mauritius, New Zealand, Burma,. Iraq, Australia, Fiji, Cyprus, Nigeria, Ghana, Zanzibar, etc. It is prepared in the prescribed format and is signed/certified by the counsel of the importing country located in the country of export.

Some of the importing countries insist that the invoice is to be signed by the importing county's consular located in the exporter's country. Such invoices are known as consular invoice. The exporter has to.pay a certain fee to obtain the certificate/invoice. Such charges/fees vary from country to country. The main purpose to obtain consular invoice is to secure authentication of information contained in the invoice. Once the invoice is signed by the consular of the country, the importer gets comfort and confidence in respect of accuracy of information in respect of quality, source of goods, volume, and grade.

Normally, on arrival of the goods, it is necessary to convince the customs authorities. of the importing country that the goods stated in the invoice and the actually imported goods are one and the same. If the customs authorities get suspicious or not convinced, they open the packages of the imported goods. If this happens, considerable delay takes place. The importer is put to hardship by delayed receipt of goods. To avoid all these problems, importer insists on the exporter to obtain the consular invoice from the consulate stationed in the exporter's country. The consulate invoice is, generally, prepared in three copies. One copy is retained by the consulate office, the second copy is sent to the customs of the importing country and the third copy is given to the exporter to forward the same along with other documents through the banker for collection/negotiation.

This information also facilitates in assessing import duties and also would be useful for statistical purposes.

In order to obtain consular invoice, the exporter is required to submit three copies of invoice to the Consulate of the importing country concerned. The Consulate of the importing country certifies them in return for fees. One copy of the invoice is given to the exporter while the other two are dispatched to the customs office of the importer's country for the calculation of the import duty. The exporter negotiates a copy of the consular invoice to the importer along with other shipping documents.

Significance of Consular Invoice

1. Significance to the Exporter
   (i) Once the invoice is signed by the consulate of the importing country, the exporter is reasonably assured that there are no import restrictions in the importer's country for the goods and that there would be no problem in realization of export proceeds or foreign exchange;
   (ii) It enables prompt clearance from the customs of exporter's country for shipping the goods.
   (iii) It facilitates quick clearance of goods from the customs in exporter's as well as importer's country.
   (iv) 'Certification' of goods by the consulate of the importing country indicates that the importer has fulfilled all procedural and licensing formalities for import of goods.
   (v) It also assures the exporter of the payment from the importing country.
2. Significance to the Importer
   (i) In the importer's country, the customs do not normally open the packages. It helps the importer to get speedy delivery of goods.
   (ii) Lot of unnecessary hardship which importer faces once the packages are opened is avoided.
   (iii) It facilitates quick clearance of goods from the customs at the port destination and therefore, the importer gets quick delivery of goods.
   (iv) The importer is assured that the goods imported are not banned for imported in his country.
3. Significance to the Customs
   (i) It makes the task of the customs authorities easy.
   (ii) It facilitates quick calculation of duties as the value of goods as determine by the consulate is considered for the purpose.

Customs Invoice

Countries like USA and Canada require customs invoice for their customs valuation. The exporter has to submit the invoice in the prescribed form in such cases. It is prepared on a special form being presented by the Customs authorities of the importing country. The Invoice Forms are generally available at the Consular Officer of the importing country and are required to be signed and witnessed after duly filling out the same. It facilitates entry of goods in the importing country at preferential tariff rate.

Legalized Invoice

Some countries require that commercial invoice should be legalized by their own embassy or consulate in the seller's country. Sellers produce their own invoices and have them stamped by the buyer's embassy. This is normally required in the Middle-East countries.

Like Mexico require legalized invoice. It is not very much different from consular invoice as far as the aim of exporting country is concerned. The only difference is that there is no prescribed form for obtaining the legalized invoice. This shows the seller's genuineness before the appropriate consulate or chamber or commerce/embassy. A nominal charge is collected by them from the seller for doing this. These Invoices are required by some of the Latin American Countries.

Certified Invoice

It is required when the exporter needs to certify on the invoice that the goods are of a particular origin or manufactured/packed at a particular place and in accordance with specific contract. Sight Draft and Usance Draft are available for this. Sight Draft is required when the exporter expects immediate payment and Usance Draft is.required for credit delivery.

Certificate of Origin

As the very name indicates, certificate of origin is a certificate that specifies the name of the country where goods are produced. This is absolutely necessary where the importing country has banned the entry of goods of certain countries to ensure that the goods from those countries are not allowed to enter in. At the time of arrival of the goods in the importer's country, this certificate is necessary for the customs to permit preferential tariff. Certain countries offer preferential tariff to goods produced and imported from India. In such a case, this is a must to the importer to claim preferential tariff and importer insists on this document from the exporter. This enables the importer's country to regulate the concessional tariff only to select countries and deny to the rest of the countries.

A certificate of origin can be obtained from Chamber of Commerce, Export Promotion Council and various trade associations which have been authorised by Government of India to issue. The agency from which certificate of origin is obtained should conform to the terms of letter of credit.

The importers in several countries require a certificate of origin without which clearance to import is refused. The certificate of origin states that the goods exported are originally manufactured in the country whose name is mentioned in the certificate. Certificate of origin is required when:

1. The goods produced in a particular country are subject to preferential tariff rates in the foreign market at the time of importation.
2. The goods produced in a particular country are banned for import in the foreign marke

Types of Certificate of Origin

1. **Non-Preferential Certificate of Origin:** Non-preferential certificate of origin is required in general by all countries for clearance of goods by the importer, on which no preferential tariff is given. It is issued by:
   (i) The authorised Chamber of Commerce of the exporting country.
   (ii) Trade Association of the exporting country.
2. **Certificate of Origin for Availing Concessions under GSP:** Certificate of origin required for availing of concessions under Generalized System of Preferences (GSP) extended by

certain countries such as France, Germany, Italy, BENELUX countries, U.K., Australia; Japan, U.S.A., etc. This certificate can be obtained from specialized agencies, namely:

(i) Export Inspection Agencies.
(ii) Joint Director General of Foreign Trade.
(iii) Commodity Boards and their regional offices.
(iv) Development Commissioner, Handicrafts.
(v) Textile Committees for textile products.
(vi) Marine Products Export Development Authority for marine products.
(vii) Development Commissioners of EPZs.

3. **Certificate for Availing Concessions under Commonwealth Preferences (CWP):** Certificate of origin for the purpose of Commonwealth Preference is also known as 'Combined Certificate of Origin and Value'. It is required by two member countries, i.e., Canada and New Zealand of the Commonwealth. For concession under Commonwealth preferences, the certificates or origin have to be submitted in special forms obtainable, from the High Commission of the country concerned.
4. **Certificate for Availing Concessions under other Systems of Preference:** Certificate of origin is also required for tariff concessions, under the Global System of Trade Preferences (GSTP), Bangkok Agreement(BA), and SAARC Preferential Trading Arrangement (SAPTA) under which India grants and receives tariff concessions on imports and exports. Export Inspection Council (EIC) is the sole authority to print blank Certificates of Origin under BA, SAARC, and SAPTA which can be issued by such agencies as EPCs, DCs of EPZs, EIC, APEDA, MPEDA, FIEO, etc.

Contents of Certificate of Origin

1. Name and logo of chamber of commerce.
2. Name and address of the exporter.
3. Name and address of the consignee.
4. Name and the number of vessel of flight.
5. Name of the port of loading.
6. Name of the port of discharge and place of delivery.
7. Marks and container number.
8. Packing and container description.
9. Total number of containers and packages.
10. Description of goods in terms of quantity.
11. Signature and initials of the concerned officer of the issuing authority.
12. Seal of the issuing authority.

Significance of the Certificate of Origin

1. Certificate of origin is required for availing of concessions under Generalized System of Preferences (GSP) as well as under Commonwealth Preferences (CWP).
2. It is to be submitted to the customs for the assessment of duty clearance of goods with concessional duty.
3. It is required when the goods produced in a particular country are banned for import in the foreign market.
4. It helps the buyer in adhering to the import regulations of the country.
5. Sometimes, in order to ensure that goods bought from some other country have not been re-shipped by a seller, a certificate of origin is required.

Certificate of value

Many countries require the exporter to complete and sign a certificate of value. In this document, the exporter states that the invoice contains a true and full statement of the price paid for the goods by the importer and that there is no other arrangement between the exporter and the foreign buyer about the purchase price. The purpose is to discourage "double invoicing", wherein the importer presents one invoice for customs duty calculation but, in fact, pays the exporter a larger sum based on the true invoice.

Often, no separate document is required for the statement of value. Consular invoices usually contain a space to make a declaration of value. Sometimes, a Chamber of Commerce or similar organization must certify the value of the goods before the certificate of value is acceptable to the Customs authorities in the importing country.

Packing list and note

Packing list may be shown on invoice or separately, and should contain item by item, the contents of cases or containers or of a shipment with its weight and description set forth in such a manner as to permit checks of the contents by the customs on arrival at the port of destination as well as by the recipient. The packing list is a relatively simpler document and the whole of the information can be reproduced from the master by making information not desired on the packing list. Special information, if any, can be given in the blank space in the lower third portion of the document. The exporter prepares the packing list to facilitate the buyer to check the shipment. It contains the detailed description of the goods packed in each case, their gross and net weight, etc.

Packing note should, include the packing note number, the date of packing, the name and address of the exporter, the name and address of the importer, the order number, date, shipment per S/S, bill of lading number and date, marking numbers, case number to which the note relates, and the contents of the goods in terms of quantity and weight.

The difference between a packing note and a packing list is that the packing note contains the particulars of the content is of an individual pack, while the packing list is a consolidated statement of the contents of a number of cases or packs.

Apart from the details in the packing note, a packing list should also include item wise details. Export packing list is considerably more detailed and informative than a standard domestic packing list, an export packing list itemizes the material in each individual package and indicates the type of package: box, crate, drum, carton, and so on. It shows the individual net, legal, tare, and gross weights and measurements for each package. Package markings should be shown along with the shipper's and buyer's references. The packing list should be attached to the outside of a package in a waterproof envelope marked "packing list enclosed".

The List is used by the Shipper or Forwarding Agent to Determine

1. The total shipment weight and volume, and
2. Whether the correct cargo is being shipped.

Contents of packing list

A packing Note contains the following details

1. Date of packing,
2. Number of packing note,
3. Number of case to which it relates to,
4. Contents of case in terms of quantity and weight,
5. Marking numbers,
6. Name of exporter,
7. Name of importer,
8. Importer's order number,
9. Number and date of bill of lading, and
10. Name of vessel/flight.

Cautions and Notes

Packing note and packing list are sent to the importer along with other documents. If any case contains any shortfall, importer can communicate to the exporter in which case there is shortage of goods for making good.

No particular form has been prescribed for both packing note/list. Normally, ten copies are prepared. Two copies are sent, in advance, to the buyer, one copy along with the documents, one to the shipping agent and the remaining are retained by the exporter.

Precaution is to be exercised that the details of the quantity in the packing note/list should conform to the quantity as in the Invoice and Bill of Lading/Airway Bill.

The packing list is a more detailed version of the commercial invoice but without price information. The type of each container is identified, as well as its individual weight and measurements. The packing list is attached to the outside of its respective container in a waterproof envelope marked "Packing List Enclosed", and is immediately available to authorities in both the countries of export and import.

A packing list is not required in all transactions, but is a standard requirement by the export or import laws of certain countries and by some buyers. A packing list helps the consignee at the point of delivery and warehouse personnel to identify which contents may be found in which packages. Also, if custom authorities require an inspection, it allows them to easily identify the specific package they wish to open.

Weight Certificate

It is a document issued by customs, certifying gross weight of the exported goods. In other words, document issued commonly by customs authorities of the exporting country, certifying the correct gross weight of the goods being shipped.

Freight is charged either on the basis of weight or measurement. When it is charged on the basis of weight, the weight declared by the shipper may be accepted. However, a certificate of measurement from the Indian Chamber of Commerce or other approved organisation may be obtained by the shipper and given to the shipping company for calculation of the necessary freight.

Certificate of Measurement

Freight is charged either on the basis of weight or measurement. When it is charged on the basis of weight, the weight declared by the shipper may be accepted. However, a certificate of measurement from the Indian Chamber of Commerce or other approved organisation may be obtained by this shipper and given to the shipping company for the calculation of the necessary freight. The certificate contains the name of the vessel, port and destination, of the description of goods,, the quantity, length, breadth, depth, etc., of the packages.

Certificate of Analysis and Quality

A certificate of analysis is required for seeds, grain, health foods, dietary supplements, fruits and vegetables, and pharmaceutical products. A document issued by a recognised organisation or governmental authority confirming the quality and composition of goods listed in the certificate. Certificates of analysis are often required by authorities in importing countries for animal and plant products for consumption and for pharmaceuticals.

Certificate of Inspection

Certificates of inspection are documents issued by governing bodies to confirm that something has been checked and found to comply with documented specifications. In the United States, local, state and federal governmental bodies issue certificates of inspection for multiple items. The certificates of inspection usually involve safety requirements and are issued to the owners of the inspected items as proof that guidelines have been met.

A certificate of inspection is useful to the importer in several situations; e.g., in a purchase conducted on the basis of documentary collection, or with a letter of credit, the documents are the only items that the bank will inspect before making payment on behalf of the importer, or before committing the importer to pay. There is no possible way of withdrawing payment if there is a problem with the merchandise, arid often no way to inspect the merchandise without first taking

delivery. A Certificate of Inspection provides evidence that there are no problems with the merchandise.

Some countries require Pre-Shipment Inspections (PSIs) and the submission of a Certificate of Inspection for all or some of their imports, and they generally have this requirement for reasons similar to the motivations of the importers. They want to protect their importers form unscrupulous exporters, but they also find it a convenient way to ensure the correct classification and valuation of the goods upon entry. Once classification and valuation are established by an independent inspection company in the. exporting country, it prevents the potential corruption and local customs officials and generally speeds up the process of customs clearance and the collection of duties.

Health Certificate

It is required for export of foodstuffs, marine products, hides, livestock, etc and includes health/veterinary/sanitary certification. Document issued by the competent country when agricultural or food products are being exported, to certify that they comply with the relevant legislation in the exporter's country and were in good condition at time of inspection, prior to shipment and fit for human consumption.

When animals, animal products or plant products are exported, the importing country usually requires a certificate of health or sanitary certificate. This document certifies that the exported goods are free from disease and insect pests or, in the case of food products; they have been prepared in accordance with prescribed standards. Such a certificate can be obtained from the Ministry of Agriculture. If the importing country requires that the documents accompanying the shipment be "legalized", the health certificate should also be submitted to the Consulate of that foreign country. For shipment of live animals and animal products (processed foodstuffs, poultry, meat, fish seafood, dairy products, and eggs and egg products).

Some countries require that health certificates be notarized or certified by a chamber and legalized by a consulate. Health certificates are issued by the U.S. Department of Agriculture's Animal and Plant Health Inspection Service.

TRANSPORT DOCUMENTS

As shipment is the most crucial condition for payment all letter of credit insist on lodgement of documentary evidence in support of exporter's contention of having shipped the goods. The various transport documents used in export trade are as follows:

- Transport Document
- Male's Receipt
- Shipping Bill
- Bill of Lading
- Airway Bill
- Postal Receipt
- Cart Ticket

- Dock Receipt and Warehouse Receipt
- Dock Receipt and Warehouse Receipt
- Destination Control Statement
- Multimodal Transport Document

Mate's Receipt

A mate's receipt is a receipt issued by\the commanding office of the ship when the cargo is loaded on the ship and contains information about the name of the vessel, berth, date of shipment, description of packages, mar and numbers, condition of the cargo at the time of receipt on board the ship, etc.

The mate receipt is first handed-over to the Port Trust authorities so that all the port dues may be paid by the exporter. After paying all the port dues, the merchant or the agent may collect the mate's receipt from the Port. Trust authorities the bill of lading is prepared by the shipping agent after the mate s has been obtained.

Contents of Mate's Receipt

1. Name and logo of the shipping line.
2. Name and address of the shipper.
3. Name and the number of vessel.
4. Name of the port of loading.
5. Name, of the port of discharge and place of delivery
6. Marks and container number.
7. Packing and container description.
8. Total number of containers and packages.
9. Description of goods in terms of quantity.
10. Container status and seal number.
11. Gross weight in kg. and volume in terms of cubic meters.
12. Shipping bill number and date.
13. Signature and initials of the Chief Officer.

Significance of Mate's Receipt

1. It is an acknowledgement of goods received for export on board the ship.
2. It is a transferable document It must be-handed over to the shipping company in order to get the bill of lading.
3. Bill of lading, which is the title of goods, is prepared on the basis of the mate's receipt.
4. It enables the exporter to clear port trust dues to the Port Trust Authorities.

Shipping Bill

This is a customs document. The shipping bill is the main document on the basis of which the Customs permission for export is given. The shipping bill contains particulars of the goods exported vessel, master or agents, flag, the port at which goods are to be discharged, the country of final destination, the exporter's name and address, etc. It also contains details of the packages and the goods, such as number and description, marks and number, quantity details about each case, f.o.b. prices, real value as defined in the Sea Customs Act, whether Indian or foreign merchandise to be re-exported, total number of packages, their total weight and value, etc.

Shipping Bill is the principal document required by the customs authorities. It is only after the Shipping Bill, is stamped by the customs that cargo is allowed to be carted to Port sheds and Docks. It is used for export by sea or air or even for transportation from one port to another within the country. The shipping bill must be prepared according to the category of the export goods. The following three forms of the shipping bill are available with the Customs authorities:

1. **Dutiable Shipping Bill:** It is for goods, for which there is export duty.
2. **Free Shipping Bill:** It is for goods, for which there is no export duty.
3. **Drawback Shipping Bill:** It is required for claiming the Customs drawback against goods exported.

Bill of Lading

Bill of lading (B/L) is a document which is issued by the shipping company or his agent acknowledging the receipt of cargo on board. This is an undertaking to deliver the goods in the same order and condition as received to the consignee or his agent on receipt of freight, the shipping company is entitled to. It is a very important document to the exporter as it constitutes document of title to the goods.

Each shipping company has its own bill of lading. The exporter prepares the bill of lading in the form obtained from the shipping company or agents of shipping company.

The goods can be consigned to order of the exporter, which means the exporter can authorise someone else to receive the goods on his behalf. In such a case, the exporter would discharge the bill of lading on its reverse. When the bill of lading is negotiated through the bank, it would be endorsed in favour of the bank that would endorse further to the importer, on receipt of payment.

Bill of lading is made in signed set of 2 originals, any one of which can give title to the goods. The shipping company also issues non-negotiable copies (unsigned) which are not documents of title to goods but serves the purpose of record only.

The reverse side of bill of lading contains the terms and conditions of the contract of carriage. The clauses on most of the bills of lading are common. A Bill of lading should be clean to facilitate the exporter to obtain the proceeds of export without difficulty.

When the export contract is C.I.F., the exporter makes payment of the freight and gets 'freight paid' bill of lading. On the other hand, if the contract is F.O.B., the freight has to be paid by the importer. In that case, the shipping company will issue a 'freight collect' bill of lading.

The bill of lading should give the details about the exporter, carrying vessel, goods shipped, port of shipment, destination, consignee (receiver) and the party to be notified on arrival of the goods at destination. B/Ls are made in sets, usually of two or three originals, any one of which gives titles to the goods.

Following are the purpose of Bill of Lading

1. **As a document of Title to Goods:** Bill of lading serves, as a document of title to the goods. A bona fide holder of bill of lading can get ownership of the goods. The ownership can be transferred by endorsement of the bill of lading.
2. **As a receipt from the shipping company:** Bill of lading is a receipt of goods delivered to the shipping company. It contains description and condition of the goods received by the shipping company.
3. **As a contract of Freightment (Transportation) of Goods:** Bill of lading is a written contract between the shipper (consignor) and the shipping company. It contains the terms and conditions of the contract of carriage. Under this contract, the shipping company undertakes to carry the goods in consideration of a price called freight.
4. **As a collateral security:** Bill of lading can be used as a collateral security for raising loan. Bill of lading is a document in writing signed on behalf of the owner of the ship in which goods are loaded acknowledging the receipt of the goods, and undertaking to deliver them at the end of the voyage, subject to the specified conditions.

Contents of Bill of Lading

1. Name and address of the shipper.
2. Name and address of the vessel.
3. Name of port of loading.
4. Date of loading of goods.
5. Name of port of discharge and place of delivery.
6. Quantity, quality, marks, and other description.
7. Number of packages.
8. Freight paid or payable.
9. Number of originals issued.
10. Name of the shipping company.
11. Voyage number and date.
12. Signature of the issuing authority.

Significance of Bill of Landing

1. **Significance to the Exporter**
   (i) It is an acknowledgment from the shipping company that the goods have been received for the purpose of shipment.

(ii) After receipt of B/L, it helps him to send the shipping advice to the importer.

(iii) If any damage occurs to the cargo during transit, he can hold the shipping company responsible, if he has received clean bill of lading.

(iv) A copy of bill of lading is required to be attached to the application form to claim the incentives.

(v) It is a contract of carriage between the exporter (shipper) and the shipping company.

2. Significance to the importer

(i) It is a document of title to the goods, which enables him to transfer the title by endorsement and delivery.

(ii) The exporter can send a non-negotiable copy of B/L as advance intimation of shipment to the importer.

(iii) It enables him to pay the freight amount as the B/L contains freight details.

3. Significance to the Shipping Company

(i) It helps the shipping company to collect the freight amount from the exporter (CIF contract) or importer (FOB contract).

(ii) Shipping company can protect itself from the wrongful claims of exporter/importer by incorporating condition of goods/packaging, at the time of receipt. In case the shipping company, inadvertently, omits to mention the adverse condition, at the time of receipt, advantage can be claimed by exporter/importer, by submitting wrongful claim.

Airway Bill

Air transport is widely used for moving valuables or urgently required goods. The document of transport used is an airway bill (air consignment note). It is non-negotiable; so it does not carry the same validity as a bill of lading for sea transport.

Airway bill is also called air consignment note. It is a receipt issued by an airline for the carriage of goods. As each shipping company has its own bill of lading, so each airline has its own airway bill.

An airway bill is a non-negotiable transport document covering transport of cargo by air from airport-to-airport. The airway bill is issued by the air carrier (or by a freight forwarder or logistics company). In some instances, the document may be filled-out by the exporter/seller/consignor, but then signed by an agent of the airline.

Contents of Airway Bill

1. Name of the airport of departure and destination.
2. The names and addresses of the consignor, consignee and the first carrier.
3. Marks and container number.
4. Packing and container description.
5. Total number of containers and packages.
6. Description of goods in terms of quantity.

7. Container status and seal number.
8. Amount of freight paid or payable.
9. Signature and initials of the issuing carrier or his agent.

Importance of Airway Bill

1. It is a contract between the airlines or his agent to carry goods to the destination.
2. It is the document of instructions for the airline handling staff.
3. It acts as a customs declaration form.
4. Since, it contains details about freight it also represents freight bill.

Risk covering documents/insurance documents

Insurance documents are ones, issued by the issuer, certifying that the insurer and the insured have signed an insurance contract covering the goods to be transported. If the goods under the contract do incur damages or even losses in transit, the insured can lodge a claim against the insurance documents. Insurance is a guarantee of financial protection against the risk of loss or damage with regard to a specified contingency or peril. There are a number of types of insurance used in international trade. These include coverage against risk of loss or damage to cargo, damage to foreign production facilities, and kidnapping and ransom insurance for foreign-based personnel.

Basic principles of insurance

There are three basic principles which apply to export/import insurance:

1. **Insurable interest:** Different parties may have an insurable interest at any one time (i.e., the exporter, the importer, or a bank). Insurable interest may pass from party-to-party during a transaction depending upon the terms of sale. For example, the terms of sale may require that ownership of the goods transfer from the exporter to the importer at the ship's rail.
2. **Utmost good faith:** When taking-out an insurance policy, the insured must disclose any "material circumstance" that may influence the judgment of the insurer in establishing a rate (price) for a specific policy. The fact that a product is dangerous or fragile is an example of a material circumstance. Since the insurer does not usually inspect the goods or the specific vessel or airplane being used, this responsibility rests with the insured. Failure to disclose any material circumstance entitles the insurer to decline payment on a policy.
3. **Indemnity and subrogation:** This means that the insurer will undertake to compensate the insured for any financial loss the insured may have suffered due to loss or damage. Subrogation is the right of the insurer to collect damages from a negligent third party and this right is automatically assigned to the insurer by the insured in the policy

Insurance policy

This is a written legal contract between the insurer and the insured containing all terms and conditions of the agreement. It shows full details of the risks covered, and is also called formal

insurance documents. Insurance policy certifies that goods transported have been insured under an open policy and is not actionable with little details about the risk covered. It is necessary that the date on which the insurance becomes effective is same or earlier than the date of issuance of the transport documents. Document setting out full details of insurance in force. A policy may refer to a single consignment and be sent with the other commercial documents. Also, if submitted under a LC, the insured amount must be in the same currency as the credit and usually for the bill amount plus 10 per cent. The requirements for completion of an insurance policy are as follows:

1. The name of the party in the favour of which the documents have been issued.
2. The name of the vessel or the flight details.
3. The place from where insurance is to commerce typically the sellers warehouse or the port of loading and the place where insurance cases usually the buyer's warehouse or the port of destination.
4. Insurance value that specified in the credit.
5. Marks and numbers to agree with those on other documents.
6. The description of the goods, which must be consistent with that in the credit and on the invoice.
7. The name and address of the claims settling agent together with the place where claims are payable.
8. Countersigned where necessary.
9. Date of issue to be no later than the date of transport documents unless cover is shown to be effective prior to that date

Types of Insurance policies in exports

The types of marine insurance policies

1. **Voyage Policy:** It is a policy in which the subject matter is insured for a particular voyage irrespective of the time involved in it. In this case, the risk attaches only when the ship starts on the voyage.
2. **Time Policy:** It is a policy in which the subject matter is insured for a definite period of time. The ship may pursue any course it likes, the policy would cover all the risks from perils of the sea for the stated period of time.
3. **Mixed Policy:** It is a combination of voyage and time policies and covers the risk during particular voyage for a specified period of time.
4. **Valued Policy:** It is a policy in which the value of the subject mailer insured is agreed upon between the insurer and the insured and it is specified in the policy itself.
5. **Open or Unvalued Policy:** It is the policy in which the value of the subject matter insured is not specified. Subject to the limit of the sum assured, it leaves the value of the loss to be subsequently ascertained.
6. **Floating Policy:** It is a policy which only mentions the amount for which the insurance is taken-out and leaves the name of the ship(s) and other particulars to be defined by

subsequent declarations. Such policies are very useful to merchants who regularly dispatch goods through ships.

7. **Wagering or Honour Policy:** It is a policy in which the assured has no insurable interest and the underwriter is prepared to dispense with the insurable interest. Such policies are also known as 'Policy Proof of Interest (PPI)'.
8. **Builder's Risk Policy:** This policy is issued for more than one year. This covers the risk of damage to vessels from the time its construction commences until its trail is completed.
9. **Port Risk Policy:** This policy covers all the risk of a vessel while it is standing at a port for particular period of time.

INSURANCE COVER NOTE

Insurance often also called "broker's cover note". Document issued by insurance companies or insurance brokers in lieu of insurance policies or insurance certificates which serves as proof of usual insurance notification and represents cover approval. Cover notes may be accepted under letters of credit only when they are expressly permitted.

An insurance cover note is offered by an insurance company to the policy holder or customer that is based on a number of information about the features of an insurance policy and is evidencing the issuance of a particular policy to the policyholder. An insurance cover note is basically based on information including the name of the policyholder, the insured risk, to coverage that is offered by the policy and the total amount of insurance in a. brief manner. In many places, an insurance cover note is also known as a certificate of insurance. These notes are usually sent out on the same day the policy is accepted and usually takes about 24 hours in sending out.

An insurance cover note is important enough because it helps you in understanding the type and coverage of your purchased insurance policy. Fo example, if you want to purchase a home insurance policy, you have to choose the property protection policy or the home liability insurance. Both have their own coverage and charges. An insurance policy cover note also specifies the renewal period or the validity date of an insurance policy. When the specific period of insurance cover notes become close to over, the insurance company then sends notification to the policyholder to renew the policy and sent out a new insurance cover note or certificate to the purchaser for the next period of times.

Guidelines of making an insurance cover note

Insurance cover notes are created by the officials of an insurance company and each company has its own format and preferences by writing an insurance cover note. Usually, an insurance cover note is based on the following information.

1. Date and information about the company and insured
2. Terms regarding an insurance cover note
3. Information regarding the type and validity of an insurance policy
4. Information about the cancellation of the policy.

Insurance Certificate

For each consignment ah insurance certificate is issued, cross-referencing the policy. An insurance certificate is a document issued to the insured certifying that the insurance has been affected. It contains the same details as an insurance policy except that version of provisions is abbreviated. If a documentary credit requires an insurance policy, issuing bank will refuse an insurance certificate for payment. It is a document which indicating the type and amount of insurance coverage in force on a particular shipment. It is used to assure the consignee that insurance is provided to cover loss of or damage to cargo while in transit.

The insurance document is issued by an insurance company or its agent, which may include a carrier, freight forwarder, and customs broker or logistics firm. If the seller provides insurance, the insurance certificate states the type and amount of coverage. This instrument is negotiable.

Key elements of insurance certificate

Documentary letter of credit transactions, the insurance document includes the following elements

1. Appears on its face to be issued and signed by an insurance carrier, underwriter or agent for same.
2. Covers the risks specified in the documentary letter of credit.
3. Indicates that the coverage is effective at the latest from the date of loading of the goods on board a transport vessel or the taking in charge of the goods by the carrier, as indicated by the transport document (bill of lading, etc.).
4. Specifies coverage for atleast 110 per cent of either:
   (i) The CIF or C1P value of the shipment, if such can be determined from the various documents on their face, other wise
   (ii) The amount of the payment, acceptance or negotiation specified in the documentary credit; or
   (iii) The gross amount of the commercial invoice.
5. Is presented as the sole original, or if issued in more than one original, all originals.
6. The insurance currency should be consistent with the currency of the letter of credit.

OFFICIAL DOCUMENTS

Export Declaration forms

Official documents are documents required for the purpose of official (regulatory) authorization to export Official documents are either submitted to the appropriate authority for legalization or arc issued by a appropriate authority. Without local authorization, you will not be permitted to ship your goods out the country.

It is usually necessary for the exporter wishing to ship goods abroad to fill out a form called an export declaration. This form required by the government whenever the value of the shipment exceeds

a certain minimum amount or whenever a duty drawback is claimed. It is available at local customs offices.

This document is also used for statistical purposes so that the government authorities know exactly what had been exported from the country in each month and year and to which country. The information required include a description of the goods, their quantity, their value and destination, and whether the goods are originated ii the exporting country or are of foreign origin being re-exported.

The Reserve Bank ensures that the foreign exchange proceeds of goods are repatriated to Indian through the follow-up of export declaration forms. All exports from India should be declared on any of the following export declaration forms as is applicable.

1. **GR Form:** For exports to all countries otherwise than by post.
2. **PP Form:** For exports to all countries by parcel post, except when made on 'value payable' or 'cash o delivery' basis.
3. **VP/COD Form:** For exports to all countries by parcel under arrangements to realize proceeds through th postal channel on 'value payable' or cash on delivery' basis.

Every exporter in India should obtain a code number from Reserve Bank. The application prescribed for obtaining the code number can be sent to be Reserve Bank directly by the exporter or it may be routed through his banker. The code number allotted to an exporter should be used by all their offices/branches in India. The code number should invariable be quoted in the export declaration forms for all exports made by the exporter or their offices/branches.

There are several forms which are submitted to the customs authorities in compliance of exchange control regulations. All exporters other than those exporting to Nepal and Bhutan are required to submit a declaration i the prescribed form duly supported by such evidence as may be prescribed or so specified and true in a material particulars which, among others, shall include the amount representing:

1. The full export value of the goods; or
2. If the full export value of the goods is not ascertainable at the time of export, the value which the exported having regard to the prevailing market conditions, expects to receive on the sale of goods in the over seal markets, and affirms in the said declaration that the full export value of the goods (whether ascertainable; the time of export or not) has been, or will within the prescribed period be, paid in ±e prescribed manner.

These are the major types of official documents that must be considered on the behalf of firms or individual who are interested in export trade.

- Official Documents
- GR/SDF Form
- PP From
- Cash on Delivery (COD) Form
- GP Forms
- Form C

- Forms AR-4/AR-4A
- SOFTEX Form
- Generalized System of Preferences

GR/SDF Form

One of the main functions of the Reserve Bank of India (RBI) is to control and monitor foreign exchange reserves of the country. Since exports directly relate to country's foreign exchange earnings, it becomes essential for RBI to regulate an export transaction.

The Reserve Bank of India has prescribed GR form (SDF), PP form, and SOFTEX forms to regulate exports transactions. The GR form contains the following:

1. Name and address of the exporter and description of goods,
2. Name and address of the authorized dealer through whom proceeds of exports have been or will be realized,
3. Details of commission and discount due to foreign agent or buyer,
4. An analysis of the full export value, giving breakup of FOB, Freight, Insurance, Discount, Commission, etc.,

Distribution/Disposal of Copies of GR Form

1. GR forms covering export of goods should be completed by the exporter in duplicate and both copies should be submitted to customs at the time of shipment.
2. Cisterns will verify all particulars of goods and their value as declared in the GR form.
3. After the shipment is over, the original Of GR form will be retained by the customs for onward submission to the Reserve Bank of India.
4. Duplicate copy of the GR will be returned to the exporter through his clearing agent.
5. An exporter is under obligation to submit this duplicate copy of GR, as soon as possible, but not later than 21 days from the date of shipment, to his authorized dealer (Banker).

Procedure for GR Form

The GR form should be completed in duplicate by the exporter and the complete set should be submitted to be customs authorities on shipping the goods. The customs authorities would scrutinise the form with special care to ensure: that the export is valid, the value declared is correct there is neither over-invoicing, nor under-invoicing, etc. When satisfied about these and other aspects, the customs would allow the export. Customs would give their running serial number on both the copies of the GR form. They would also certify the value declared by the exporter on both the copies of the GR form and record the assessed value. The first copy thus completed by the customs would be forwarded directly by them to the Reserve Bank. When the Reserve Bank receives the form, a record is made by it of the export taking place under the relative GR form number.

The duplicate of the GR form, certified by the customs, would be returned to the exporter. Within twenty-one days of shipment, the exporter should lodge the duplicate of GR form with relative

shipping documents and an extra copy of invoice with an authorized dealer. The shipping documents are either purchased or taken for collection by the bank. The details of export bills purchased or taken for collection should be sent by banks every fortnight in statement ENC, along with GR returns. When the Reserve Bank receives the statement from the bank, it is informed that steps are taken for receipt of export proceeds.

The duplicate copy of the GR form is retained by the bank. It is sent to the Reserve Bank after the bank receives full payment of the export bill. When the Reserve Bank receives the duplicate copy of the GR form duly signed by the bank, it is assured that full export proceeds for the particular transaction have been repatriated into India.

Mr. the GR form, the exporter declares the name of the bank through which he would be routing the export documents. In case of delay in submission of bills to the bank of duplicate copy of GR form, the Reserve Bank takes-up the matter with the bank mentioned in the form.

SDF

Some of the departments in customs are now computerized. To meet with the requirements of EDI System, the GR form is replaced by a new form known as Statutory Declaration Form (SDF). This is prepared in duplicate and submitted to customs at the time of shipment. The SDF bears cross reference of the shipping bill number. Over a period, it is estimated that the GR form will be replaced by SDF.

PP Form

When goods are exported by post, instead of the GR form, the exporter has to fill up a Post Parcel (PP) form in triplicate. This PP form needs to be signed by the banker on the original copy of the form. Therefore, an exporter has to first submit the form to his banker for the necessary counter signature. The bank will return the original form to the exporter for submitting it to the post office along with the parcel.

The concerned post office shall forward the PP form to the office of the Reserve Bank of India after the goods have been dispatched. The duplicate copy of the PP form will be kept by the authorized dealer to whom the exporter should submit relevant documents for collection/negotiation. The time limit prescribed is 21 days.

Procedure for PP Form

PP form is to be prepared by the exporter in duplicate. The postal authorities will allow export of goods by post only if the original copy of the forms has been countersigned by an authorized dealer or Reserve Bank, except where the Reserve Bank has specifically waived the requirements of countersignature in the case of the concerned exporter. PP form should, therefore, be first presented by the exporter to an authorized dealer for countersignature. The authorized dealer will verify that adequate steps are taken to ensure that export will verify that adequate steps are taken to ensure that export proceeds will be received in India. For example, the parcel should be addressed to the correspondent bank and not to the consignee. Or, export proceeds have been received in advance. Then, the authorized dealer will countersign the PP form and return the original to the exporter, who

should submit it to the post office with the postal packet. The duplicate copy of the PP form will be retained by the authorized dealer to whom the exporter should submit relevant documents together with an extra copy of invoice for negotiation, within the prescribed period of 21 days.

Cash on Delivery(COD) Forms

When "businesses conduct transactions over long distances, both parties want assurance that the deal will be completed successfully. The business wants to know that they will receive full payment for the transaction, and the buyer wants to know he will receive the product safely and on time. As a result, cash on delivery is a common practice for many items sold and transported to the buyer's door.

Cash on delivery, also known as collect on delivery, is a method of payment in which the buyer only pays for the goods once they have been successfully delivered to her. This allows the buyer to see and sometimes even inspect the product, although she does not receive it until she pays the full price already agreed upon with the company. In some ways, cash on delivery is a form of credit fulfilled upon delivery of the item.

Payment Options

Cash on delivery typically requires that the buyer pay in cash, which allows the business to know without doubt they will receive money for the product delivered. However, other reliable methods of payment are also accepted by some businesses, including certified checks. This is more common with large deliveries that require a high payment.

Purpose of COD Form

Buyers choose cash on delivery to help ensure the safety of their product. Some products may be fragile and become damaged or destroyed in transport. With cash on delivery, the buyer removes the danger of purchasing and paying for a damaged product. In other cases, he simply wants to receive the product before paying for it. Handing over payment when he is confident that the business has fulfilled their part of the deal.

Investors

When investors ask for cash on delivery, they want assurance that they will receive securities like bond and notes before they pay for them. In this case, cash on delivery is a contract that the investor will pay a full price for the bonds once they are in hand. Since bonds and other securities can sometimes be stolen, this adds an extra level of security to the transaction. The investor must pay in cash, not in other securities or any types of valuables - an important qualification for international trade especially.

Mail Services

For many types of cash on delivery, major delivery services are not involved - The companies deliver the products themselves. However, in certain cases mail services may be used. A decreasing number of mail companies allow parties to use cash on delivery, but some organizations, like the United States Postal Service (USPS) and UPS, still allow the method, and collect the moneys owed.

Procedure for VP/COD Form

In the case of VP/COD form, only one copy is required to be completed and submitted to post office along with the relative parcel at the time of dispatch

Procedure for VP/COD Form

In the case of VP/COD form, only one copy is required to be completed and submitted to post office along with the relative parcel at the time of dispatch.

The role of the Central Banking Authority in each country is very predominant and is of great value as it decides the financial and fiscal policies for the country and the financing pattern by the commercial banks while other financial institutions solely depend upon the government policies. Like central banks of other countries, the Reserve Bank of India performs the same function in monetary and fiscal areas. It maintains the external value of Indian rupee and holds foreign exchange reserves of the country. From time-to-time, depending upon the exigencies, Reserve Bank also conducts certain market operations arising out of its membership with IMF. The entire exchange control system is operated by Reserve Bank of India. It provides funds to commercial banks. In the form of their borrowings both against securities as well as bank's export finance portfolio. As in all other matters, the Reserve Bank of India is an apex institution providing finance for foreign trade, controlling the interest rate structure, extending the necessary market research and market intelligence, and feeding back the relevant information in the areas of socio-economic needs for development.

GP Forms

A GP form is a gate pass for the removal of excisable goods from a factory or warehouse. Form GP1 is used for the removal of excisable goods on payment of duty and form GP2 is used for the removal of excisable goods without payment of duty.

Form C

Form C is to be used for applying for rebate of duty on the excisable goods (other than vegetable, non-essential oils and tea) exported by sea. It is to be submitted in triplicate to the Collector of Central Excises.

Forms AR-4/AR-4A

These forms are meant for applying for the removal of excisable goods for export by sea/post. Form ARA is used for applying for excise inspection at the factory and form AR-4A is used when goods are to be exported under a claim for rebate of excise duty or under bond.

SOFTEX Form

It is an export declaration form utilized in case of exports of software to be sent in non-physical form. This form is prepared in triplicate and submitted to Dept of Electronics, Govt, of India.

The declaration in form SOFTEX in respect of export of computer software and audio/video/television software shall be submitted in triplicate to the designated official of Department

of Electronics, Government of India at the Software Technology Parks of India (STPI) or at the Free Trade Zones (FTZs) or Export Processing Zones (EPZs).

After certifying all three copies of the SOFTEX form, the said designated official shall forward the original directly to the nearest office of the Reserve Bank and return the duplicate to the exporter. The triplicate shall be retained by the designated official for record.

GSPS certificate

Generalized System of Preferences (GSPS) certificate of origin issued by the Commodity Inspection Bureau is the export trade is an important part of the official documents. GSP exports of manufactured goods in developed countries to developing countries in general and semi-manufactured goods, non-discriminatory, non-reciprocal tariff preferences of a system.

Generalized system of preferences referred to as GSP, the developed countries to developing countries exports of finished and semi-finished products (including some primary products) in general, non-discriminatory, non-reciprocal tariff preferences of a system.

The main objectives of GSP are to increase the export earnings of developing countries, industrialized, and developing countries to accelerate economic growth in developing countries.

Role of the GSP

As a benefit of GSP to developing countries in international tax policy, in China's foreign trade has played an invaluable role in, mainly as follows:

1. To improve our exports in international market competitiveness, expand exports;
2. Is conducive to improving the foreign investment environment, attract foreign investment;
3. Will help to speed up the localization of Chinese export products, increased level;
4. Can promote our tourism retail sales growth and the promotion of tourism development;
5. In a developing country tax savings, promote international exchange.

Giving countries the GSP

Currently, there are 32 GSP preference-giving countries which are EU-15 countries (France, Britain, Ireland, Germany, Denmark, Italy, Belgium, the Netherlands, Luxembourg, Greece, Spain, Portugal, Austria, Sweden, Finland), Switzerland, Norway, Turkey, Japan, Canada, Australia, New Zealand, Russia, Ukraine, Belarus, Kazakhstan, Czech Republic, Slovakia, Poland, Hungary, Bulgaria, and the United States. Apart from Hungary, Bulgaria and the United States, other countries grant GSP treatment to China.

GSP rules of origin

GSP rules of origin are the preference-giving countries on exports from GSP beneficiary countries the conditions necessary treatment requirements are an important part of the GSP and the core. In order to ensure that the GSP tariff preferences for developing countries only the production, harvesting and manufacturing, and-shipment of products from developing countries, to the benefit of

all States to develop the appropriate rules of origin for export products of beneficiary countries to measure can I get the GSP origin?

GSP Rules of Origin, Consists of Three Parts

1. Origin criteria: Origin criteria preference-giving countries were on the original product concept's definition. The original product origin criteria are divided into two main categories: complete origin of products and the origin of products containing imported ingredients.

Origin of products is completely full use of domestic raw materials or components produced entirely by the beneficiary countries, manufacturing products.

The origin of products containing imported ingredients is the use of all or part of the import (including the country of origin unknown) of raw materials or components produced, manufactured products, such raw materials or components in the beneficiary countries through the full processing and production, the nature and characteristics to the "substantial transformation".

How to determine whether the import content of "substantial transformation", the preference-giving countries with different standards, usually measured by two criteria, namely, the percentage of processing standards and criteria.

(i) Processing standards: It is based on the import content of manufactured goods in the number of HS items whether in the production process to determine whether changes in the standards through substantial transformation; namely - the general conditions. If the imported components and finished products present different numbers, has changed, then through a substantial transformation; if the same is not been substantive reform. In this basic principle, some preference giving countries also provides certain additional conditions, in these conditions are met, identified through a substantial transformation before. Can refer to the specific conditions related to preference-giving countries, the "process list".

Processing standards used to benefit the state-owned 19-15 European Union countries, Switzerland, Norway, Turkey, and Japan.

(ii) Percentage of Standard: Percentage of import content standards (or their components) accounted for the value of finished products to determine whether the percentage rate of transformation through the substantive standard. Preference giving countries with different percentages, calculated on the basis not the same. Applications should be specific reference to countries in developing standards.

Percentage of countries using the standard 13 - Canada, Australia, New Zealand, Russia, Ukraine, Belarus, Kazakhstan, Czech Republic, Slovakia, Poland, Hungary, Bulgaria, the United States.

(iii) Donor-Country Content: Some of the provisions giving countries, beneficiary countries to benefit from the country by imported raw materials and spare parts processing and assembly, then export to preference-giving countries, which benefit from the country to import raw materials and spare parts referred to as donor-country content, in calculating the import content, it can account for the beneficiaries of their constituents.

Implementation of donor-country content of giving state-owned - 15 European Union countries (France, United Kingdom, Ireland, Germany, Denmark, Italy, Belgium, the Netherlands, Luxembourg, Greece, Spain, Portugal, Austria, Sweden, Finland), Switzerland, Turkey, Japan, Canada. New Zealand, Russia. Ukraine, Belarus, Kazakhstan, Poland.

(iv) Cumulative Origin: It is benefit products in determining the origin of qualifications, to several or all beneficiary countries (or regions) as a unified economic region in the unified economic region of production of value-added processed products made, can be a beneficiary of their accumulated components.

Currently, our application is that the cumulative global, globalization of benefits accrued to the State -Canada, Australia, New Zealand, Russia, Ukraine, Belarus, Kazakhstan, Poland.

2. Direct Transport Rule: It is the beneficiary of the original product to be shipped directly from the beneficiary countries to benefit the country, which aims to ensure delivery to giving countries the product is shipped, the original beneficiary countries export products, to avoid passing through a third country may for re-processing and is for packages.

3. Documentary Evidence/Written Proof: Where the beneficiary country exports GSP treatment must hold to prove compliance with relevant standards to benefit the country of origin and GSP certificate of origin to prove their compliance with the rules to benefit the direct evidence of transport file.

CHAPTER SUMMARY

Documents required for an international sale can vary significantly from transaction to transaction, depending on the destination and the product being shipped. International market involves various types of trade documents that need to be produced while making transactions. Each trade document is differ from other and present the various aspects of the trade like description, quality, number, transportation medium, indemnity, inspection and so on. So, it becomes important for the importers and exporters to make sure that their documents support the guidelines as per international trade transactions. A small mistake could prove costly for any of the parties.

The word ***"Document"*** comes from the Latin word ***'Documentum'*** meaning ***'Official Paper'*** The word also carries meanings of ***"Proof and Evidence".*** Therefore, a document is an official paper that serves as proof or evidence of something

Financial Documents

Financial documents are the documents related to the financial aspect of the transaction and the payment export trade. Financial documents in an export contract are as follows:

Financial Documents

- Letter of credit
- Bill of Exchange
- Trust Receipt
- Letter of Hypothecation

- Bank Certificate of Payment
- Bill of Exchange

Bill of exchange refers to an unconditional written order prepared by an exporter asking the importer to pay the specified sum of money to a specified person at a specified time. The specified amount is represented by amount of the invoice; the specified person here refers to the banks and the specified time is a matter negotiation between the exporter and the importer. The exporter may agree to supply goods to the import against immediate payment or payment to be made after the expiry of an agreed period of credit. (The period credit is known as Usance period). In case the payment is to be made by the importer immediately or demand to get the documents then the Bill of Exchange is known as Sight Bill of Exchange or Sight Draft international trade, Bill of Exchange is also known as a Draft). But if the payment is to be made after a certain period of time, then the bill of exchange is known as Usance Bill of Exchange or Usance Draft.

Parties to a Bill of Exchange

There are five important parties to a bill of exchange:

1. **Drawer:** The drawer is the person who has issued the bill. In an export' transaction, exporter draws the bill as money is owed to him.
2. **Drawee:** The drawee is the person on whom the bill is drawn. Exporter draws the bill on the importer who is the drawee. Drawee is the debtor who owes money to the exporter (creditor).
3. **Payee:** The payee is the person to whom the money is payable. The bill can be drawn by the exporter payable to the drawer (himself) or his banker.
4. **Endorser:** The endorser is the person who has placed his signature on the back of the bill signifying that he has obtained the title for the bill on his own account or on account of the original payee.
5. **Endorsee:** The endorsee is the person to whom the bill is endorsed. The endorsee can obtain the payment from the drawer.

Commercial Documents

Commercial documents are required for effecting physical transfer of goods and their title from the exporter to the importer and the realization of export sale proceeds. Out of the sixteen commercial documents in the export documentation framework as many as fourteen have been standardized and aligned to one another. These are proforma invoice, commercial invoice, packing list, shipping instructions, intimation for inspection, certificate of inspection of quality control, insurance declaration, certificate of insurance, mate's receipt, bill of lading or combined transport document, application for certificate origin, certificate of origin, shipment advice and letter to the bank for collection or negotiation of documents. However, shipping order and bill of exchange could not be brought within the fold of the Aligned Documentation System. The major commercial documents used in export trade are as follows:

- Proforma Invoice
- Commercial Invoice
- Consular Invoice
- Customs Invoice
- Legalized Invoice
- Certified Invoice
- Certificate of Value
- Packing List and Note
- Certificate of Weight
- Certificate of Measurement

REVIEW QUESTIONS

1. What is the meaning of Export Trade Documents and Explain in detail the needs of it.
2. Discuss in detail all Export Trade Documents
3. Explain in detail the types of Financial Documents.

♦ ♦ ♦

9

MONETARY AND NON MONETARY EXPORT INCENTIVE SCHEMES BY GOVERNMENT OF INDIA

Chapter Outline

- Introduction
- Government Organisations Promoting
- Significance of Export Promotion
- Export Promotion Schemes
- ECGC Schemes
- Chapter Summary
- Review Questions

INTRODUCTION

Governments have many different policies, programmes and activities to help develop competitive products and increase export sales. Export promotion has been defined as "those public policy measures which actually or potentially enhance exporting activity at the company, industry , or national level". Although many forces determine the international flow of goods and services, export promotion is one of the principal opportunities that governments have to influence the volume and types of goods and services exported from their areas of jurisdiction.

Government of India, like in almost all other nations, has been endeavoring to develop exports. Export development is important to the firm and to the economy as a whole. Government measures aim, normally, at an overall improvement of the export performance of the nation for the general benefit of the economy. Such measures help exporting firms in several ways.

Export promotion strategy promotes only the industries that have potential for developing and competing with foreign rivals. Since the goal is to trade abroad, there becomes competition, which in turn remedies the returns to scale. The main goal of the export promotion is to prepare the "potential" industries for competition with the foreign rivals. So the industries at their childhood must be protected for a while.

SIGNIFICANCE OF EXPORT PROMOTION

1. **Earning of foreign exchange:** Export promotion leads to expansion of goods for the foreign market. These goods earn foreign exchange that can be used to facilitate development.
2. **Greater utilisation of resources:** Export promotion industries have a wide market for their produce for both domestic and foreign markets. They are therefore able to produce for a greater capacity. Production for export enables them to increase utilisation of locally available resources that would otherwise be idle.
3. **Full utilisation of plant capacity:** Due to the fact that export promotion industries have a wide market, they are able to fully utilise the existing plant capacity. In this way, they can take advantage of large scale production. This will lead to lower production costs.
4. **Addition of value to primary exports:** By establishing export oriented industries, a country is able to process its primary products instead of exporting them in their raw form. This adds value to primary exports, hence increasing foreign exchange earnings.
5. **Creation of employment:** Generation of employment opportunities is a major consideration in any industrialisation strategy. In this regard, export oriented industries absorb labour, thereby helping to reduce the problem of unemployment in a country. For example, people will be employed directly in a particular export promotion industry, as well as indirectly in allied industries such as transport and insurance.
6. **Efficiency in production:** Since export promotion industries are exposed to competition from foreign producers, they are likely to strive for greater efficiency in production and

higher quality of goods. This will ensure their competitiveness both in the domestic and foreign markets.

7. **Economic development of country:** A well-articulated export promotion strategy enables a developing country, regardless of the size of its domestic market to establish plants of economically efficient size and to maintain long production runs.

Stages of export promotion

An exporter needs guidance and assistance at different stages of his export effort. For this purpose, the government of India has set up several institutions whose main functions are to help the industry and trade engaged in Exports. Institutions engaged in export effort fall in six distinct stags:

The Department of Commerce in the Ministry of Commerce and Industry stands at the top as an apex body. This is the main organization that formulates and guides India's trade policy. At the second stage, there are advisory bodies to ensure that export problems are comprehensively dealt with after mutual discussions between the Government and the Industry. At the third stage Commodity specific organizations find their place to deal with problems relating to Individual commodities and or groups of commodities. The fourth stage consists of service institutions which facilitates and assist the exporters to expand their operations and reach out more effectively to the world markets. The fifth stage consists of Government trading organizations specifically set up to handle export/import of specified commodities and to supplement the efforts of the Private enterprise in the field of export promotion and import management. Agencies for export promotion at the state level constitute the sixth stage.

Table 9.1: Showing Export Promotion Stages of Institutions

Stages	Bodies	Responsibilities
I	Department of Commerce	Framing of Trade Policy
II	Advisory Bodies	Coordinating discussions between Industry and Government for bringing in required changes.
III	Commodity Organizations	Assist the export effort of specific product group
IV	Service Organizations	Facilitate and assist exporters to expand markets.
V	Government Trading Organizations	Handle export import of Specific commodity
VI	State Export Promotion Agencies	Facilitate export promotion from states.

GOVERNMENT ORGANIZATIONS PROMOTING EXPORTS

Government has established or sponsored a number of organizations to provide different types of assistance to the exporters. Apart from the Organizations established exclusively for export promotion, there are also a number of other institutions which assist the export sector. Matters related to foreign trade are dealt with by eight divisions in the Department of Commerce namely

1. Administatarive and General division,
2. Finance division,
3. Economic division,

4. Trade Policy division,
5. Foreign Trade Territorial division,
6. Export Products division,
7. Services division and
8. Industries division.

Governments have many different policies, programs and activities to help develop competitive products and increase export sales.

Example:

(a) Government of India had offered an amount of ₹ 5500 Crore for duty drawback to over Central and State taxes. This Draw back scheme covers Value Added Taxes, Central Sales Taxes and Electricity Duty. It help us to reduce the cost of production due to it our products will be very competitive in the International Market.

(b) Recently Government has allowed Duty Free Import of Raw Sugar. The Department of Industrial Policy and Promotion has extended the concessional duty on import of raw sugar provided that the importer shall convert the raw sugar in to white/refined sugar with in a period not exceeding two months from the date of filing of bill of entry or the date of entry inwards whichever is later.

(c) The Central Government has levied the definitive anti dumping duty on import of "slabstock polyol" from Thailand as the designated authority convinced that

1. The subject goods have been exported to India from Thailand below the associated normal value resulting in dumping,
2. the domestic industry has suffered material injury in respect of the subject goods, and
3. The material injury has been caused by the dumped imports from Thailand. The anti dumping duty imposed under this notification shall be effective for a period of 5 years and shall be paid in Indian Currency.

EXPORT PROMOTION SCHEMES

Foreign Trade Policy 2015-20 and other schemes provide promotional measures to boost India's exports with the objective to offset infrastructural inefficiencies and associated costs involved to provide exporters a level playing field. Brief of these measures are as under:

1. Exports from India Scheme

(i) Merchandise exports From India scheme (MEIS)

Under this scheme, exports of notified goods/products to notified markets as listed in Appendix 3B of Handbook of Procedures, are granted freely transferable duty credit scrips on realized FOB value of exports in free foreign exchange at specified rate (2-5%). Such duty credit scrips can be used for payment of custom duties for import of inputs or goods, payment of excise duty on domestic procurement, payment of service tax and payment of custom duties in case of EO default.

Exports of notified goods of FOB value upto ₹ 25,000 per consignment, through courier or foreign post office using e-commerce shall be entitled for MEIS benefit.

(ii) Service exports from India scheme (SEIS)

Service providers of notified services as per Appendix 3E are eligible for freely transferable duty credit scrip @ 5% of net foreign exchange earned.

2. Duty exemption & remission schemes

These schemes enable duty free import of inputs for export production with export obligation. These scheme consists of:-

Advance authorization scheme

Under this scheme, duty free import of inputs are allowed, that are physically incorporated in the export product (after making normal allowance for wastage) with minimum 15% value addition. Advance Authorization (AA) is issued for inputs in relation to resultant products as per SION or on the basis of self declaration, as per procedures of FTP. AA normally have a validity period of 12 months for the purpose of making imports and a period of 18 months for fulfilment of Export Obligation (EO) from the date of issue. AA is issued either to a manufacturer exporter or merchant exporter tied to a supporting manufacturer(s).

Advance authorization for annual requirement

Exporters having past export performance (in at least preceding two financial years) shall be entitled for Advance Authorization for Annual requirement. This shall only be issued for items having SION.

Duty free import authorization (DFIA) scheme

DFIA is issued to allow duty free import of inputs, with a minimum value addition requirement of 20%. DFIA shall be exempted only from the payment of basic customs duty. DFIA shall be issued on post export basis for products for which SION has been notified. Separate schemes exist for gems and jewellery sector for which FTP may be referred.

Duty drawback of customs/central excise duties/service tax

The scheme is administered by department of revenue. Under this scheme products made out of duty paid inputs are first exported and thereafter refund of duty is claimed in two ways:

(i) All Industry Rates: As per Schedule

(ii) Brand Rate: As per application on the basis of data/documents

2.5 Rebate of service tax through all industry rates

Refund of service tax paid on specified output services used for export of goods is available at specified all industry rates.

EPCG SCHEME

Zero duty EPCG scheme

Under this scheme import of capital goods at zero custom duty is allowed for producing quality goods and services to enhance India's export competitiveness. Import under EPCG shall be subject to export obligation equivalent to six times of duty saved in six years. Scheme also allows indigenous sourcing of capital goods with 25% less export obligation.

Post Export EPCG Duty Credit Scrip Scheme

A Post Export EPCG Duty Credit Scrip Scheme shall be available for exporters who intend to import capital goods on full payment of applicable duty in cash.

EOU/EHTP/STP & BTP SCHEMES

Units undertaking to export their entire production of goods and services may be set up under this scheme for import/ procurement domestically without payment of duties. For details of the scheme and benefits available therein FTP may be required.

OTHER SCHEMES

Towns of export excellence (TEE)

Selected towns producing goods of ₹ 750 crores or more are notified as TEE on potential for growth in exports and provide financial assistance under MAI Scheme to recognized Associations.

Rebate of duty on "Export Goods" and "Material" used in manufacture of such goods

Rebate of duty paid on excisable goods exported or duty paid on the material used in manufacture of such export goods may be claimed under Rule of 18 of Central Excise Rules, 2002.

Export of goods under Bond i.e. without payment of excise duty

Rule 19 of Central Excise Rules 2002 provides clearance of excisable goods for exports without payment of central excise duty from the approved factory, warehouse and other premises.

Market Access Initiative (MAI) Scheme

Under the Scheme, financial assistance is provided for export promotion activities on focus country, focus product basis to EPCs, Industry & Trade Associations, etc. The activities are like market studies/surveys, setting up showroom/warehouse, participation in international trade fairs, publicity campaigns, brand promotion, reimbursement of registration charges for pharmaceuticals, testing charges for engineering products abroad, etc. Details of the Scheme is available at www.commerce.nic.in

Marketing development Assistance (MDA) Scheme

Financial assistance is available for exporters having an annual export turnover upto ₹ 30 crores for trade fairs, buyer seller meets organized by EPC's/Trade promotion organizations. MDA guidelines available at www.commerce.nic.in

Status Holder scheme

Upon achieving prescribed export performance, status recognition as one star Export House, two Star Export House, three star export house, four star export house and five star export house is accorded to the eligible applicants as per their export performance. Such Status Holders are eligible for various non-fiscal privileges as prescribed in the Foreign Trade Policy.

In addition to the above schemes, facilities like 24 × 7 customs clearance, single window in customs, self assessment of customs duty, prior filing facility of shipping bills etc are available to facilitate exports.

Case study on Anti-dumping Duty of India and other countries

India holds the distinction of initiating the largest number of anti-dumping cases amongst all WTO members. Under WTO regulations, anti-dumping measures are usually taken to protect the domestic industry. However, critics argue that India has been mostly interpreting and applying the law to protect vested interests and negate competition. And that by initiating an ever increasing number of anti-dumping cases, the country is hurting its downstream industries and in turn competitiveness. Is it time to review and fine tune India's approach towards anti-dumping measures?

If you've been closely following trends in foreign trade in recent years, you would have noticed that anti-dumping initiations (and impositions) across many countries have been on the rise. Dig into some numbers and research and you'll realize that India has been leading the way in this regard! Nothing surprising, you'd reckon. For this is a clear sign of how countries are trying to protect their domestic industry. And India is supposed to be no different. What surprised us though was when one of our readers (who happens to be an importer of jute bags) told a senior researcher at TDB Intelligence Unit (during an educational workshop conducted by TDB at Chennai), that he desires and has decided to continue importing jute bags from Bangladesh even after the imposition of anti-dumping duty by India on imports of jute and its products from Bangladesh and Nepal. We were intrigued by his seemingly carefully thought out intent. It got us curious about anti-dumping measures initiated and enacted by India so far. Were these measures actually protecting the domestic industries or adversely affecting the competitiveness of our finished products? And were India's anti-dumping laws, knowingly or unknowingly, favoring the big manufacturers at the cost of the smaller ones, those you'd popularly term MSMEs. We needed answers, and thought our readers would do well with a good dose on anti-dumping initiations.

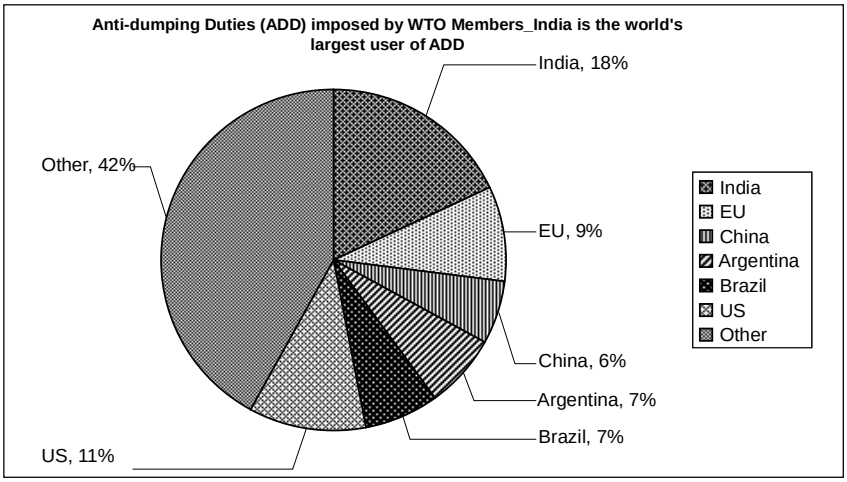
The Origin

The word 'dump' is over 700 years old. It is said to have been derived from a Danish word called 'dumpe', which means 'to throw down in a large mass'. But it wasn't until the 1930s that the word 'dump' was used in a business sense. Today, WTO defines the word 'dumping' as "a situation of international price discrimination, where the price of a product when sold in the importing country is less than the price of that product in the market of the exporting country."

The act of dumping is said to be the result of industrialization, which was pioneered by the western nations. And so, it's not surprising to discover that the western countries were also the first to add the prefix 'anti' to the word 'dumping'. Canada was the first country to take anti-dumping measures (in 1904), against American steel companies that were dumping steel at a discriminatory

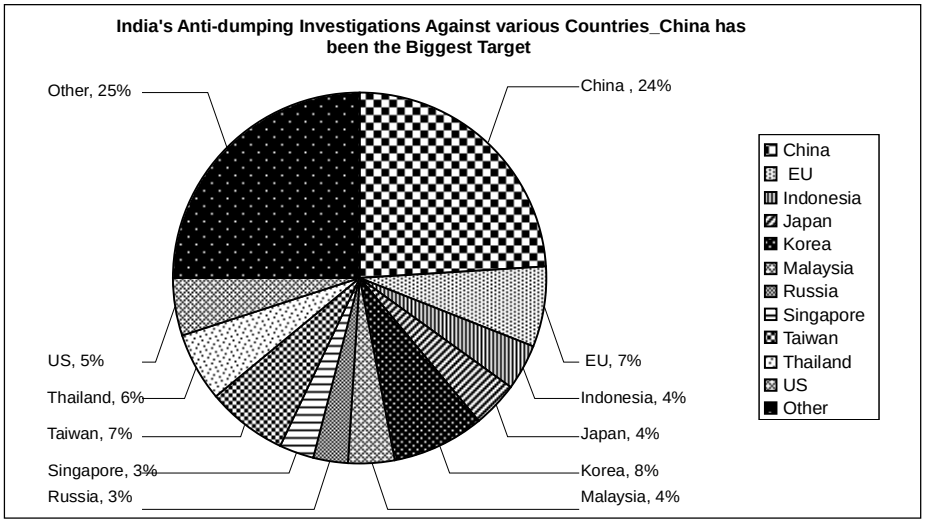
price. And soon, the practice of using anti-dumping duties (ADDs) as a way to protect domestic industries was adopted by other countries including Australia, UK, New Zealand and more. However, anti-dumping laws were formalized across WTO members only under Article VI of GATT in 1994. This article explicitly "authorizes the imposition of a specific ADD on imports from a particular source, in excess of bound rates, in cases where dumping causes or threatens injury to a domestic industry, or materially retards the establishment of a domestic industry." While it may seem strange that WTO - the body that is supposed to promote free trade - is also the body that formalized anti-dumping, by 1995, it was evident that free trade in certain cases was hurting the domestic industry in many countries. So far so good. The problems with the WTO structure of anti-dumping though started unraveling when members started interpreting the laws to suit their domestic industry.

Chart 1



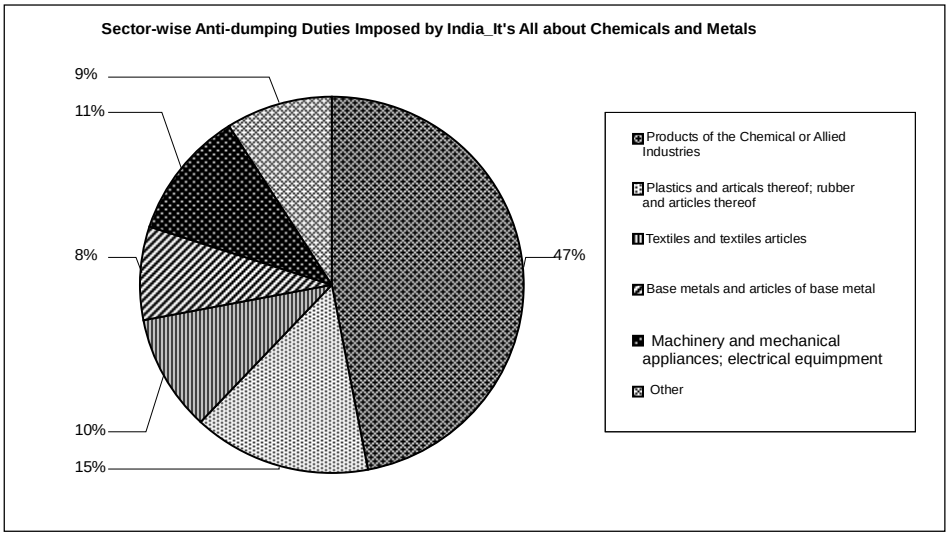
Source: TDB Intellignece Unit & WTO; break up till June 2016

Chart 2



Source: TDB Intellignece Unit & WTO; break up till June 2016

Chart 3



Source: TDB Intellignece Unit & WTO; break up till June 2016

Sore Thumb

As dumping is said to occur when the goods are exported by a country to another country at a price lower than its normal value, the whole procedure of arriving at what should ideally constitute the 'normal value' is a bone of contention among different firms and countries, with each contesting the other's version. Going by Article VI of GATT 1994, an anti-dumping process can be initiated (by the importing country) in case the price of the product from the exporting country is less than the comparable price of such product, when destined for consumption in the domestic market of the exporting country. In the absence of such domestic price, either the highest comparable price for the like product for export to any third country in the ordinary course of trade or the cost of production of the product in the country of origin plus a reasonable addition for selling cost and profit is taken. This definition presents enough scope for concerned stakeholders to hold diverging opinions on what should ideally be termed 'comparable price' or 'product under consideration' or 'like article', among various other aspects relating to the determination of 'individual margins for exporters or producers'. And that is the reason why a number of anti-dumping investigations around the world have seen countries and firms up in arms against one another on these counts. But before we get into the problems of how these interpretations are hurting free trade, let us look at the scenario in India.

Canada was the first country to use anti-dumping measures, in 1904, against American steel companies that were dumping steel at a discriminatory price into Canada.



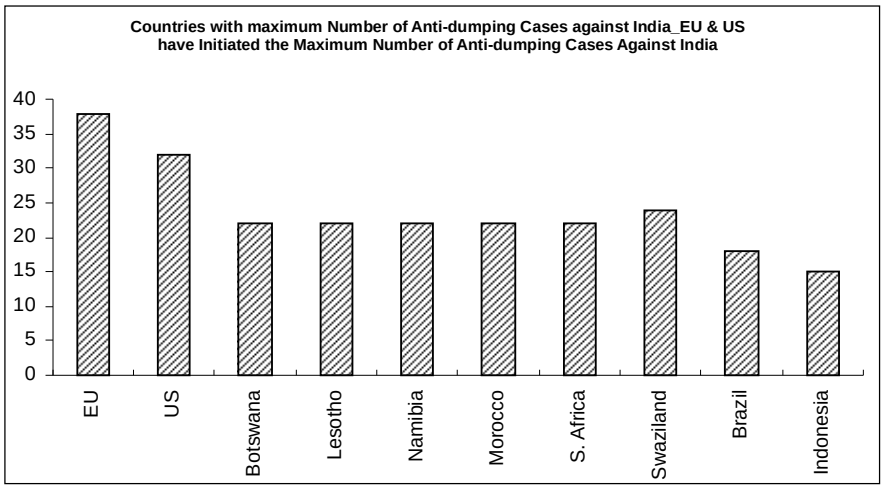
Fig. 9.1

India and Anti-Dumping

It was in 1992 that India imposed the first anti-dumping duty – on imports of PVC resin originating from Argentina, Brazil, Mexico, South Korea and US. Interestingly, even before 1992, India had an anti-dumping clause mentioned in the Customs Tariff Act, 1975 (Section 9A Anti-dumping duty on dumped articles – The Customs Tariff Act, 1975). So why didn't India initiate any case before 1992? Experts hold that India already had a highly protectionist trade regime, right from its independence till 1991. Prakash Narayanan, Director - Contracts & Legal Services at Bombardier, in his book, 'Anti-dumping in India – Present State and Future Prospects,' mentions, "Combined with restrictive licensing and quantitative restrictions, there was no need for anti-dumping.

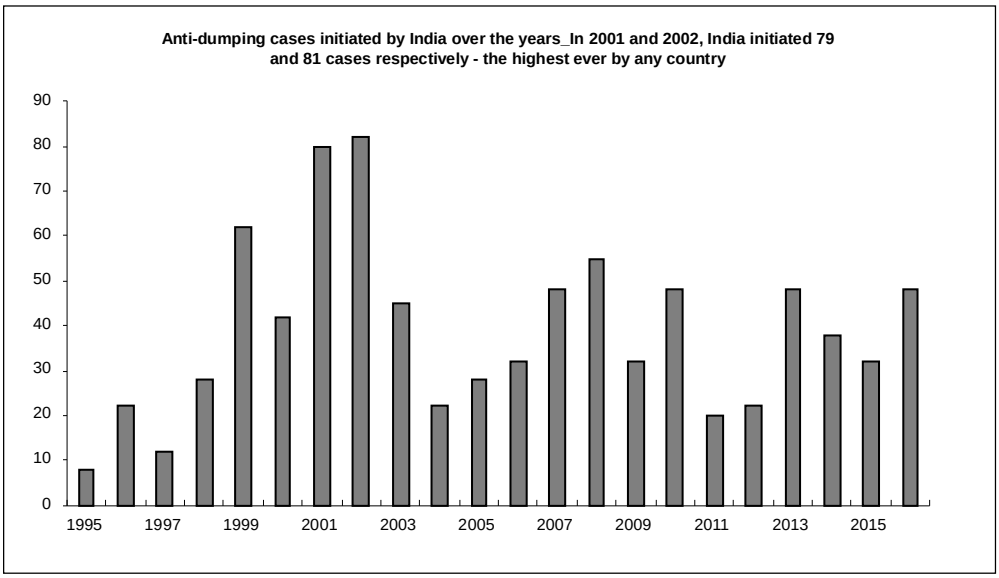
On the customs tariff side, the import-weighted average tariff for all imports was as high as 87%, for consumer goods as high as 153% and for manufactured goods 92%." According to Directorate General of Anti-Dumping and Allied Duties (DGAD) annual report, between 1992 and 1995, India initiated only nine anti-dumping cases. But in 1995, coinciding with the creation of WTO, India amended Section 9A and the Centre was given power to impose ADDs when it deemed necessary. And ever since, India has initiated 818 anti-dumping cases - the most by any country! Dr. Biswajit Dhar, Member, Board of Trade, Ministry of Commerce, GoI, explains, "India has been labeled as the largest user of anti-dumping law and criticised for misusing the law. But look at the economic environment in India. Import tariffs in India are relatively higher than that of its peers. And as there is less scope for increasing tariffs, India has been compelled to levy more dumping duties than other developing countries to safeguard the interests of its domestic industry." On the other hand, only 208 anti-dumping cases have been filed against India. However, there are 1,170 cases against China, followed by 384 cases against Korea and 273 against US. According to many economists though, India has not benefited from the 818 Anti dumping Duties(ADD) it has initiated and the 599 that it has imposed – whereas other countries have immensely benefited from their carefully selection impositions of ADDs. Rather, India has earned the name of a protectionist state. But has India really turned into a protectionist state, as accused?

Chart 4



Source: TDB Intellignece Unit & WTO; break up till June 2016

Chart 5



Source: TDB Intellignece Unit & WTO; break up till June 2016

Protectionism

By definition, WTO anti-dumping agreement is aimed at protecting domestic industries. But US, EU, China and a few other countries have of late, accused India of misusing the anti-dumping agreement. In a report titled, 'Trends and Impacts of India's Anti-dumping Enforcement', Robert M. Feinberg of the US International Trade Commission, reveals that "India has filed roughly 20% of all global anti-dumping cases, quite disproportionate to its share of global imports of 2%." The numbers indicate protectionist tendencies, and M. S. Pothal of M. S. Pothal & Associates, a Delhi-based law

firm agrees to some extent. He says, "Protectionism exists everywhere, but one reason why India has filed the highest number of anti-dumping cases is because other developing countries aren't aware of the process. But they will catch up soon. While that may be true, a large number of cases may be an indicator of a deeper malaise – that India doesn't have the commercial intelligence or the expertise to take other remedial measures like imposition of countervailing duties which is applicable on subsidised imports. India has also tried using local content requirements (LCRs) regulations to help the domestic industry, specifically in the case of solar module installations to thwart solar panel imports from US. US had initiated a dispute in 2013 at WTO because it considered that India's domestic content requirements were inconsistent with WTO rules that prohibit discrimination against imported products. In September 2016, India lost its appeal at WTO having failed to overturn the US complaint that India had discriminated against importers in the Indian solar power sector. This gives credence to the criticism that India lacks the expertise that developed nations have when it comes to protecting the domestic industry while being compliant with WTO norms. Experts also believe that India, as an economy, has not been able to benefit from the large number of anti-dumping measures that it has taken, primarily because the present methodology for initiating anti-dumping measures favour the big firms and not the industry as a whole. Aradhna Aggarwal, Professor of Indian Studies, Department of International Economics and Management, Copenhagen Business School, says, "Despite initiating a large number of cases, India has not benefited from them. ADD has become a firm-oriented movement. Perhaps, India needs to be more careful while selecting cases."

Questions

1. What is Protectionism ?
2. What is the trend of other countries in Protectionism against India
3. Whether India has benefited a lot from ADD? If not Why?
4. What is the trend of Anti dumping cases initiated by India?

ECGC SCHEMES

In order to provide export credit insurance support to Indian exporters, the Government of India had set up the 'Export Credit Guarantee Corporation of India Limited (ECGC).

Functions of ECGC

- Provides a range of credit risk insurance covers to exporters against loss in export of goods and services,
- Offers guarantees to banks and financial institutions to enable exporters obtain better facilities from them,
- Provides Overseas Investment Insurance to Indian companies investing in joint ventures abroad in the form of equity or loan.

ECGC Provides

- Offers insurance protection to exporters against payment risks
- Provides guidance in export—related activities

- Makes it easy to obtain export finance from banks/financial institutions
- Assists exporters in recovering bad debts
- Information on credit-worthiness of overseas buyers

The covers issued by ECGC can be divided broadly into four groups:

1. **Standard policy:** Shipments (Comprehensive Risks) Policy, which is commonly known as the Standard Policy is ideally suited to cover risks in respect of goods exported on short term credit; i.e. credit not exceeding 180 days. The policy covers both commercial and political risks from the date of shipment.
2. **Other specific policies:** Specific Policies are designed to protect Indian firms against payment risks involved in (a) exports on deferred terms of payment (b) services rendered to foreign parties and (c) construction works and turnkey Projects undertaken abroad. These policies are issued separately for each specific contract, and cover risks normally from the date of contract.

   ECGC provides for an insurance cover named as Construction Works Policy to provide cover to an Indian contractor who executes a civil construction job abroad.
3. **Financial guarantees:** Financial Guarantees are issued to banks in India to protect them from risks of loss involved in their extending financial support at pre-shipment and post-shipment stages. These also cover a host of non-fund based facilities that are extended to exporters.

   Export performance guarantee

   Export Performance Guarantee is an insurance cover for banks, which issues various kinds of guarantees on behalf of exporters in order to facilitate export transactions.
4. **Special schemes**

   Transfer Guarantee meant to protect banks which add confirmation to Letters of Credit opened by foreign banks, Insurance cover for Buyers Credit and Lines of Credit, and Exchange Fluctuation Risk Insurance.

ECGC Whole Turnover Post — Shipment Guarantee Scheme

The Whole Turnover Post-shipment Guarantee Scheme of the Export Credit Guarantee Corporation Ltd. (ECGC) provides protection to banks against non-payment of post-shipment credit by exporters. Banks may, in the interest of export promotion, consider opting for the Whole Turnover Post-shipment Policy. The salient features of the scheme may be obtained from ECGC.

As the post-shipment guarantee is mainly intended to benefit the banks, the cost of premium in respect of the Whole Turnover Post-shipment Guarantee taken out by banks may be absorbed by the banks and not passed on to the exporters.

Where the risks are covered by the ECGC, banks should not slacken their efforts towards realization of their dues against long outstanding export bills.

Overseas investment insurance

ECGC has evolved a scheme to provide protection for Indian investments abroad. Any investments made by way of equity capital or bank loan for the purpose of setting up or expansion of overseas projects will be eligible for cover under investment insurance.

The investments may be either in cash or in the form of export of Indian capital goods and services. The cover will be available for the original investment together with annual dividends or interest receivable.

The risks of war, the action by the state or an authority of taking property from its owner for public use or benefit and restriction on remittances are covered under the schemes. As the investor would be having a hand in the management of the joint venture, no cover for commercial risks would be provided under the scheme. For investment in any country to qualify for investment insurance, there should preferably be a bilateral agreement protecting investment of one country in the other. ECGC may consider providing cover in the absence of any such agreement provided it is satisfied that the general laws of the country afford adequate protection to the investments. The period of insurance cover would not normally exceed 15 years. In case of projects involving long construction periods, cover may be extended for a period of 15 years from the date of completion of the project subject to a maximum of 20 years from the date of commencement of the investment. Amounts insured shall be reduced progressively in the last five years of the insurance period.

ECGC's schemes for project exports

Export of capital goods on deferred payment terms and execution of turnkey projects, construction works contracts as also rendering of services abroad are collectively referred to as project exports. As these transaction are not of repetitive nature and they involve medium/long terms credit, ECGC's insurance cover for such transactions are provided on a case to case basis under specific Policies. Normally these contracts are of very high value and involve longer credit period. The country/political risks involved in such transactions are unpredictable in view of long credit period involved. Although in most cases the overseas buyers are the government or semi government organizations, there is a need for ECGC cover to safeguard the payment risks. In many cases these contracts are funded by International Financial Institutions and payments are secured under UC or bank guarantee. There are cases where even government or central bank guarantees are available safeguarding payments. However, the elements of political risk such as war, civil disturbances, exchange transfer delay etc. are existent in all these cases despite having payment security as stated above. In order to protect such exporters ECGC has the following types of covers.

1. For covering supply contracts and Turnkey Projects Specific Contract/Shipments policy can be taken. This policy can be for covering only political risks or for covering comprehensive risks ie. both commercial and political risks

2. For covering construction contract, a Construction Works policy can be obtained. This policy can be for either political risks alone or for Comprehensive Risks. The Comprehensive Risks Policy provides protection against commercial risks such as Insolvency of Buyer, protracted default, non-acceptance of goods shipped in addition to covering political risk of war, civil war, exchange transfer delay etc. The political risk policy on the other hand provides protection against political risk policy.

3. For covering services contract, which involves only technical and/or professional services, a services policy can be obtained. This also can be either for political or comprehensive risks. In addition to the policy covers, which are issued to exporters, ECGC also extends its guarantee support to banks in India against both funded and non funded facilities extended to Project Exporters. The types of guarantees issued by Indian bank are:

1. **Funded**
   (a) Packing Credit
   (b) Post Shipment
   (c) Overdraft
   (d) Rupee Loan
2. **Non - Funded**
   (a) Bid Bond
   (b) Advance payment
   (c) Performance guarantee
   (d) Retention Money guarantee
   (e) Overseas Lending Finance guarantee ECGC's counter guarantee can be obtained by banks in India to protect them against any loss that they may sustain owing to invocation of the above guarantees.

Risk Covered: insolvency of the exporter/protracted default of the exporter

Percentage of Loss: 75% TO 90% Covered

Rate of Premium 2 0.80 Paise per ₹ l00/- p.a. & 0.95 paise per ₹ 100% p. a.

As per RBl's recent directive, no pre-bid approval from authorised dealer, Exim Bank or Working Group is required to be taken by Project exporters. Only post-award approval is required to be taken. However, it would be in the interest of Project exporters to obtain 'ln - Principle' clearance from their bankers and ECGC assuring them of support in the event of their securing the contracts.

ECGC's approval of project exports and services contracts is based on the following aspects

(i) The capacity of the project exporter to carry out large value contracts - technical, professional and managerial, and their past experience in the line of business.

(ii) Country to which the exports are to be made - stability of political set-up/government, soundness of economy, payment records, relations with IMF. World Bank & other international financial institutions & donor countries.

(iii) Overseas contract/project - value, type of project, whether cleared by local authorities, profitability;

(iv) Buyer/employer - private/government;

(v) Payment terms & security, rate of interest for deferred receivables;

(vi) ECGC's underwriting policy on the country and its experience, whether any transfer delay experienced.

(vii) Berne union experience - whether the credit period offered is in line with Berne union understanding.

(viii) Reinsurance back-up available or not

(ix) Whether need for covering the contract under National Export Insurance account set-up by Government of India.

Buyer's credit/line of Credit cover

Financial institution in India extends Buyer's credit/lines of Credit to overseas buyers/institutions to facilitate export of goods & services from India. Institutions like Exim Bank, SIDBI etc. often seek ECGC for Buyers Credit/Line of Credit cover. Buyers Credit/Line of Credit cover can be obtained either for covering political risks or for comprehensive risks. Factors weighing approval of Buyers Credit proposals are:

(a) Competence and capacity of exporter in executing the contract

(b) Commercial justification of the contract

(c) Economic viability of the overseas Project for which credit is required to be offered.

(d) Credit worthiness, standing and financial position of foreign buyers and general economic conditions of the Buyers country. Lines of Credit are generally extended by Exim Bank of India to Financial Institutions/Governments in Overseas Countries facilitating export of-consumer goods and capital goods.

Overseas investment insurance cover

Oil provides cover for the investments made by Indian corporates abroad in joint venture or their wholly owned subsidiary (WOS) either in the form of equity or loan. Government of India or RBI should approve the joint venture. The basic principle is that the investment should emanate from India and benefit of dividend/interest there from should accrue to India. The investment should not in any way conflict with the policy of both our government and the overseas government. Normally, there should be a bilateral agreement between India and the host country for promotion and protection of Indian investment. In case there is no such agreement the Corporation should be satisfied that the existing laws of the host country adequately safeguard Indian investment.

Types of Investment

The overseas investment may be made either by way of equity or by way of loans

Equity

Any contribution made to the enterprise in return for shares either by cash remittances or by way of export of capital goods or services can be covered. Any fees payable towards technical know-how, consultancy or management services etc. and agreed to be converted into capital will be considered for cover at the discretion of the Corporation.

Loans

Loans advanced by way of a formal agreement but not tied to export of goods and supplies are eligible for cover. Any 'suppliers/buyers' credits and lines of credit extended to support sale of goods or services from India may be covered under the appropriate insurance schemes of the Corporation and not under investment insurance.

Dividend and Profit

In case of equity the investor can choose to cover the original investment as well as his share of retained earnings and dividends declared, to the extent they are eligible for repatriation. Cover on account of original investment, retained earnings, dividend receivable and any additional investment will be subject a ceiling of 150% of the original investment calculated as in the proceeding paragraphs. In case of loan, the insurance will cover the principal as well as interest actually earned.

Portfolio Investment

Any investment in shares of overseas concerns not related to setting up, development and expansion of overseas Projects will not be eligible for cover under the investment insurance.

Additional Investment: Additional investment can be covered subject to a ceiling of 50% of the original investment. Any additional investment out of retained earnings should have been made by formal capitalization and for the purpose of expansion for development of the enterprise. If the additional investment is made out of retained profits, which are not eligible for repatriation such as investment will not be eligible for cover. lnitially cover is issued for 3 years. On expiry of the 3 years it is at the option of the exporter to renew the cover/review of the JV/WOS by ECGC. The duration of insurance cover shall not normally exceed l5 year but extension can be given upto 20 years for longer projects. The amount of investment eligible for cover shall be to the full extent during the first l0 years of cover. Percentage of cover is 90 - can be reduced. The amount of investment eligible for cover will be reduced to 90%, 80%, 70%, 60% and 50% respectively of the original investment during the H1". l2l", 13th, 14th and l5th years of insurance. Oll provides cover for original investment retained earning, dividend receivables and additional investment upto 50% of the original investment. Cover for dividend receivables may not be given in case of risky countries; cover only for original investment. covers only political risks of war, expropriation and restrictions on remittances.

Premium Rate

Base rate 2.5% of the investment value. Actual premium rate will be depend on size of Investment. country of the investment, previous experience of the importer etc.

The exporter has to furnish proposal form along with fee of ₹ 0l % of the investment amount subject to ceiling of ₹ 25,000/- if cover is agreed application fee paid shall be adjusted towards premium payable. In case, the application for insurance is rejected, half the fee paid shall be refunded. Premium is taken up front. Income from the premium is allocated over the tenor of the cover extended. Installment facility is provided by ECGC for collecting premium after analyzing and approving the proposal. ECGC enters into agreement with the exporters for providing cover mentioning the terms

and conditions along with the maximum liability. The exporters have to submit annual report about the progress and working of the Project.

New Initiatives

ECGC has since revised its premium structure providing substantial reduction in the rates both for short term as well as for medium and long term contracts. This will go a long way in providing cost effective credit insurance support to project exporters which in turn will enable them to compete effectively for international tenders. In order to increase project exports and to encourage project exporters Govt. of India have initiated various steps. Institutions like ECGC and Exim Bank are being strengthened to provide adequate support to project exporters. The National Export Insurance Account (NEIA) has been set up by the Government of India to provide credit insurance support to exporters where ECGC is not in a position to do so due to its own underwriting constraints and where the export is strategically important in the long term interests of the country.

Construction Works Policy

Construction Works Policy is designed to provide cover to an Indian contractor who executes a civil construction job abroad.

Two types of policies have been evolved to cover contracts with (i) Government buyers and (ii) Private buyers. The former covers political risks in respect of contracts with Overseas Governments or where Government and the latter comprehensive risks guarantee the payments. In case of contracts with private employers, the policy may be issued to cover only political risks if the payments are guaranteed by a bank or covered by L/C.

The distinguishing features of a Construction Contract are that (a) the contractor keeps raising bills periodically throughout the Contract period for the value of work done between one billing period and another ; (b) to be eligible for payment, the bills have to be certified by a consultant or supervisor engaged by the Employer for the purpose and (c) that, unlike bills of exchange raised by suppliers of goods, the bill raised by the contractor do not represent conclusive evidence of debt but are subject to payment in terms of the Contract which may provide, among other things, for penalties or adjustments on various counts. The scope for disputes is very large. Besides, the Contract value itself may only be an estimate of the work to be done, since the Contract may provide for cost escalation, variation contracts, additional contracts, etc. It is therefore, important that the Contractor ensures that the Contract is well drafted to provide clarity of the obligations of the two parties and for resolution of disputes that may arise in the course of execution of the contract. Conditions of Contract (International) prepared by the Federation International Des Ingenious Conseils (FIDIC) jointly with the federation International du Batiment et des Travaux Publics (FIBTP).

The construction works policy of ECGC is designed to protect the contractor from 85% of the losses that may be sustained by him due to the following risks

1. Insolvency of the Employer (when he is a non Government entity)
2. Failure of the Employer to pay the amounts that become payable to Contractor in terms of the Contract. including any amount payable under an arbitration award:

3. Restrictions on transfer of payments from the Emp1oyer's country to India after the Employer has made the payments in local currency;
4. Failure of the Contractor to receive any sum due and payable under the Contract by reason of war, civil war, rebellion etc;
5. the failure of the Contractor to receive any sum that is payable to him on termination or frustration of the Contract if such failure is due to its having become impossible to ascertain the amount or its due date because of war. civil war, rebellion etc;
6. imposition of restrictions on import of goods or materials (not being the Contractor's plant or equipment) or cancellation of authority to import such goods or cancellation of export licence in India, for reasons beyond his control; and
7. Interruption or diversion of voyage outside India, resulting in his incurring in respect of goods or materials exported from India, of additional handling, transport or insurance charges which cannot be recovered from the Employer.

Risks not Covered

The Construction Work Policy excludes from its purview losses which may be sustained due to the following causes:

1. Failure of the Contractor and/ or the Employer (where the Employer is not a government) to obtain, issue or deliver any authority necessary under the law of India or the Employer's country for execution of the Project and to make payment thereof;
2. Risks which can normally be insured with commercial insurers;
3. Insolvency, default or negligence of any agent, seller or sub- contractor:
4. Execution of any works or incurring of any expenses by the Contractor after the Employer has been in default in making any payment for a period of l20 days unless, on an application made by the Contractor for the purpose within 90 days of such default, the Corporation has agreed to his continuing execution of the contract despite the said default of the Employer;
5. Execution of any works or incurring of any expenses by the Contractor after the estimated date for completion of the contract unless. at the request of the Contractor, the Corporation has agreed to a change in such date.

Premium

Premium rate will be dependent on the classification of the Employer's country and the payment terms and will be quoted by the Corporation on request. The rate will be applied on the Estimated Contract value to arrive at the amount of premium payable to the Corporation and this amount of premium is payable in advance. The Contractor is obliged to notify the Corporation if the estimated contract value undergoes any change and the premium will be adjusted accordingly.

Declaration

The Contractor is required to submit to the Corporation such periodical declarations as may be prescribed by it relating to the execution of the contract and the position of payments there under Ascertainment of Loss

When a loss arises due to any of the risks insured, the amount of loss shall be ascertained by the Corporation, after the Contractor files a claim under the Policy, in accordance with the provisions of clause 16 of the Policy. It should, however, be noted that, where the Contractor has been simultaneously executing certain other contracts also for the same Employer, all amounts paid by the Contractor shall be allocated to the amounts outstanding under all the Contracts in the chronological order of the due dates of payment of those amounts, irrespective of whether such other contracts have been insured by the Corporation or not.

Payment of Claim

If a claim is admitted under the Policy, the Corporation shall make payment of the amount direct to the Contractors bank in India which may have a right or lien over the receivables under the Contract. The payment shall be subject to the Contractor giving the Corporation an undertaking to the effect that he will take all steps, including such steps as may be suggested by the Corporation. to recover the dues from the Employer and to pass on the Corporation its share of the amounts so recovered.

The Contractor shall, if required to do so, support such an undertaking with a bank guarantee for an amount equal to the amount of claim. The amount of claim paid by the Corporation shall become refundable to the Corporation with interest if the Contractor fails to take steps for effecting recovery

Exchange rate for the purpose of Cover, Claim and Recovery

The liability of the Corporation under the Policy will be in terms of Indian Rupee. If the contract value is expressed in a foreign currency, it shall be converted into Indian Rupees at the rate specified in the Policy. the rate being approximately the same as the Bank Buying Rate of Exchange on the date of contract, for the purpose of determining the amount covered and the Maximum Liability of the Corporation under the Policy. The same exchange rate shall be used by the Contractor for the purpose of submitting periodical declarations to the Corporation. However, if the currency in which the Employer has to pay been devalued before a claim is paid by the Corporation; the amount claimed by the Contractor in Indian Rupees shall be based on the devalued rate. Recoveries will be reckoned, net of recovery expenses at the actual rate at which the amounts recovered were converted by the receiving bank into Rupees and such amounts shall be divided between the Corporation and the Contractor in the same ratio in which the loss was originally borne by the two, irrespective of whether or not such division results in the Corporation retaining an amount greater or lesser then the amount paid as a claim.

Note: The services offered by ECGC are in the nature of credit insurance products. It would be necessary for the interested persons to consult ECGC for ascertaining Specific terms of cover.

Specific Policies -For Supply Contracts

The Standard Policy is a whole turnover policy designed to provide a continuing insurance for the regular flow of an exporter's shipments for which credit period does not exceed 180 days. Contracts for exploit of capital goods or turnkey Projects or construction works or rendering services abroad are not of a repetitive nature and they involve medium/long-term credits. Such transactions are, therefore, insured by ECGC on a case-to-case basis under Specific policies.

All contracts for export on deferred payment terms and contracts for turnkey Projects and construction works abroad require prior clearance of Authorised Dealers, EXIM Bank or the Working Group in terms of powers delegated to them as per exchange control regulations (Kindly refer to 'Projects Exports Manual' of Reserve Bank of India. For details go to http://www.rbi.org). Applications for the purpose are to be submitted to the Authorised Dealer (the financing bank), which will forward applications beyond its delegated powers to the EXIM Bank. Proposals for Specific Policy are to be made to ECGC after the contract has been cleared by the Authorized Dealer, EXIM Bank or the Working Group. as the case may be.,

The Different Policies Are

1. Specific Shipment (Comprehensive Risks') Policy;
2. Specific Shipments (Political Risks) Policy;
3. Specific Contract (Comprehensive Risks) Policy;
4. Specific Contract (Political Risks) Policy.

Specific Shipments (Comprehensive Risks) Policy provides cover against all the risks covered under the Standard Policy for shipments to be made under the contract in question. It is the appropriate policy for an exporter to take if the payments are open to both commercial and political risks. Where the Commercial risks are absent, e.g. where the payments are guaranteed by a bank or by the Government of the overseas country, the exporter may opt for the Specific Shipments (Political Risks) Policy for which the premium rate will be lower than that for the Comprehensive Risks Policy.

Specific Contract Policy (which also can be for comprehensive or political risks) differs from Shipments Policy in that the former provides the exporter not only with the post shipment cover like the latter but also with some pre-shipment cover from the date of contract. In case shipments could not be made due to any of the risks covered or due to restriction on export of the goods from India, the loss in respect of unshipped goods will also be covered under Contract Policies. Premium rates for Contract Policies will be higher than that for Shipment Policies.

Terms of Payment

To be eligible for cover under specific policies, the terms of payment for the export contracts should be in line with customary practices in the international markets. At least, l5% of the contract value should be payable before shipment including an advance payment of at least 5%. The balance amount should be repayable in equal semi-annual installments commencing six months after the date of shipment. Where the contract provides for supply and erection of a complete plant, the first installment may fall due after six months from the date of commissioning of the plant. The credit period should not normally exceed 5 years. Longer credit period may be approved only in the case of

exceptionally large Projects if the circumstances of the case justify it. Adequate security should be obtained in the form of government guarantee or bank guarantee.

Applicable Premium Rates

The premium rates will depend on the country to which exports are to be made and the repayment period. To find out the premium payable for any particular contract, In order to be sure about the availability of the cover, exporters are advised to get inprinciple approval of ECGC and obtain the premium rates well before concluding contracts. If the terms and conditions of the contract undergo any change subsequently, ECGC, 'should be informed of the same, so that changes, if any, in the applicable premium rates can be ascertained.

When is the Premium to be Paid?

The entire premium is normally payable in advance. lnstalment facility may be granted for payment of a part of the premium if the contract value is very large and if the shipments are spread over a relatively long period, but the entire premium will have to be paid by the time the last shipment is made. Interest will be charged for the installment facility.

Export Performance Guarantee

Exporters are often called upon to execute bonds duly guaranteed by an Indian bank at various stages of export business. An exporter who desires to quote for a foreign tender may have to furnish a bank guarantee for the bid bond. If he wins the contract, he may have to furnish the bank guarantees to the foreign buyers to ensure due performance or against advance payment or in lieu of retention money or to a foreign bank in case he has to raise overseas finance for his contract. Further, for obtaining import licenses for raw materials of capital goods, exporters may have to execute an undertaking to export goods of specified value within a stipulated time, duly supported by bank guarantees. Bank guarantees are also furnished by exporters to the Customs, Central excise or Sales tax authorities for the purpose of clearing goods without payment of duty or for exemption from tax for goods procured for export. Exporters also furnish Guarantees in support of the export obligations to Export Promotion Councils, Commodity Boards, and the State Trading Corporation of India, the Minerals and Metals Trading Corporation of India or recognized Export Houses.

Export Performance Guarantee is an insurance cover for banks, which issues various kinds of guarantees on behalf of exporters in order to facilitate export transactions. The insurance is provided by ECGC with the objective of enabling exporters to obtain the required guarantee facility from banks on easy terms. The Guarantee, which is in nature of a counter guarantee to the bank, is issued to protect the bank against losses that it may suffer on account of guarantees given by it on behalf of export purposes.

1. Export Performance Guarantee (EPG) may be issued to a bank to cover any guarantee that it may issue in connection with an export transaction. A list of such guarantees is listed below.
    - Bid Bond or Bid Guarantee, which is required to be submitted along with bids for export contracts

- Performance Bond or Performance Guarantee which is issued to the foreign buyer for due performance of the contract
- Advance Payment Guarantee, which is issued to the foreign buyer against advance payment, received from the buyer
- Retention Money Guarantee issued to the foreign buyer in lieu of his retaining a portion of each payment as Retention Money
- Guarantee issued to an overseas bank for the purpose of enabling the foreign bank to extend foreign currency loan/advance to the Indian exporter for the purpose of executing an export contract. Guarantee issued to the Customs Authorities in India in lieu of Customs duty payable on imported raw material or components meant for manufacturing goods for export.
- Guarantee issued to Import Control Authorities in India in support of export undertakings given by the exporter who gets advance import license.
- Guarantee issued to Sales Tax authorities in lieu of payment of sales tax on goods meant for export.
- Guarantee issued to Export Promotion Council against allotment of export quota.
- EPG provides cover to the bank against the risk of loss involved in issuing the above types of guarantees. For the purposes of EPG, a loss will be deemed to have arisen when the bank is unable to recover from the exporter the money that it has had to pay to the beneficiary of the guarantee on his invoking it. The bank will have to ensure that

1. The guarantee was invoked by the beneficiary
2. The amount demanded by the beneficiary was paid by it strictly in accordance with the guarantee
3. The exporter was called upon to reimburse the bank with the said amount and,
4. The exporter has failed to discharge the debt so created

The risk insured under the EPG are the insolvency of the exporter and its protracted default. Normally a cover is extended upto 75% of loss but in the case of guarantees in connection with bid bonds, performance bonds advance payment and local finance guarantees and guarantees in lieu of retention money, the cover may be increased upto 90% subject to proportionate increase in premium.

While the premium rate for Guarantee issued to cover bond relating to exports on short-terin credit is 0.90% p.a. for 75% cover and l.08% p.a. for 90 % cover, it is lower for bonds, relating to exports on deferred credit and projects. The rate of premium is 0.80% p.a. for 75% cover and 0.95% for 90% cover. In case of Bid Bonds relating to exports on medium/long term credit, overseas projects, and projects in India financed by international financial institutions as well as supplies to such projects, ECGC is agreeable to issue Export Performance Guarantee on payment of 25% of the prescribed premium. The balance of 75% becomes payable to the Corporation by the bankers if the exporter succeeds in the bid and gets the contract

In order to reduce the cost of participating in global tenders for export of capital goods or projects, EPG to cover the related Bid Bond Guarantees are issued on payment of 25% of the premium due. No further premium is payable if the exporter is not declared successful in the bid. The balance

amount of the premium will have to be paid only if the exporter succeeds in the bid. EPG can be obtained either to cover a specified single guarantee or for all the guarantees that may be issued during a period of 12 months on account of a specified exporter. Where EPC is taken for a single guarantee, the bank is required to pay the full premium in advance. EPG for covering all the guarantees that may be issued over a l2 month period on behalf of a single exporter will be issued on payment of small Guarantee Fees. Thereafter, the bank will have to pay premium on the value of each guarantee, as and when it is issued. Exporters and Bankers can obtain proposal forms from the nearest branch of the Corporation.

Exports Treated under the GST Law

Under the GST Law, export of goods or services has been treated as:

Inter - State supply and covered under the IGST Act. Zero rated supply i.e. the goods or services exported shall be relieved of GST levied upon them either at the input stage or at the final product stage. The procedures relating to exports by manufacturer exporters been simplified in GST regime the procedures relating to export have been simplified so as to do away with the paper work and intervention of the department at various stages of export. The salient features of the scheme of export under GST regime are as follows:

The goods and services can be exported either on payment of IGST which can be claimed as refund after the goods have been exported or under bond or letter of Undertaking (LUT) without payment of IGST.In case of goods and services exported under bond or LUT, the exporter can claim refund of accumulated ITC on account of export. In case of goods the shipping bill is the only document required to be filled with the customs for making exports. Requirement of filling the ARE 1/ARE2 has been done away with.

The supplies made for export are to be made under self – sealing and self – certification without any intervention of the department officer. The shipping bill filed with the customs is treated as an application for refund of IGST and shall be deemed to have been filed after submission of export general manifest and furnishing of a valid return in form GSTR – 3 by the applicant.

For merchant exporters, the concept of merchant or manufacture exporter would become irrelevant under the GST regime. The procedure in respect of the supplies made for export is same for both merchant exporter and a manufacturer exporter. The supplies to a SEZ unit or SEZ developer are treated as zero rated supplies in the GST law. Supplies made to an SEZ unit or SEZ developers are zero rated. The supplies made to an SEZ unit or a SEZ developer can be made in the same manner as supplies made for export. Either on payment of IGST under claim of refund or under bond or LUT without payment of any IGST.

Supplies to SEZ unit or SEZ developer procure goods or services from an unregistered supplier. Supplies to SEZ unit or SEZ developer have been accorded the status of inter – State supplies under the IGST Act. Under the GST Law any supplier making inter – State supplies has to compulsorily get registered under GST. Thus anyone making a supply to a SEZ unit or SEZ developer has to necessarily obtain GST registration. Refund in respect of export of goods or service be granted during the GST regime

(a) In case of refund of tax on inputs used in exports. Refund of 90% will be granted provisionally within seven days of acknowledgment of refund application.Remaining 10% will be paid within a maximum period of 60 days from the date of receipt of application complete in all respects. Interest @ 6% is payable if full refund is not granted within 60 days.

(b) In the case of refund of IGST paid o exports. Upon receipt of information regarding furnishing of valid return in Form GSTR – 3 by the exporter from the common portal, the Customs shall process the claim for refund and an amount equal to the IGST paid in respect of each shipping bill shall be credited to the bank account exporter.Export of goods to Nepal or Bhutan fulfills the condition of GST Law regarding taking goods out of India. Hence, export of goods to Nepal and Bhutan will be treated as zero rated and consequently will also qualify for all the benefits available to zero rated supplies under the GST regime. However, the definition of export of services in the GST Law requires that the payment for such services should have been received by the supplier of services in convertible foreign exchange. Whether any supply has been categorized as deemed export by the government. Deemed export has been defined under Section 2 (39) of CGST Act, 2017 as supplies of goods as may be notified under section 147 of the said Act. Under section 147, the Government may, on the recommendations of the council, notify certain supplies of goods manufactured in India as deemed exports, where goods supplied do not leave India and payment for such supplies is received either Indian rupees or in convertible foreign exchange. However, till date, the government has not notified any supply as deemed export.

EOU is like any other supplier under GST and all the provisions of the GST Law will apply. However, the benefit of Basic Customs Duty exemption n imports will continue. The duty free imports under GST regime will be restricted to Basic Customs Duty, Exemption from the additional duties of customs, if any, under section 3 (1), 3 (3) and 3 (5) of the customs Tariff Act. 1975 and exemption from Central Excise duty will be available for goods specified under the Fourth Schedule to the Central Excise Act. IGST or CGST plus SGST will be payable by the suppliers who make supplies to the EOU will be eligible, like any other registered person, to take input Tax credit of the said GST paid its suppliers.

Whether any supply has been categorized as deemed export by Deemed export has been defined under section 2 (39) of CGST Act, 2017 as supplies of goods as may be notified under section 147 of the said Act. Under section 147, the Government may, on the recommendations of the council, notify certain supplies of goods manufactured in India as deemed exports, where goods supplied do not leave India and payment for such supplies is received either in Indian rupees or in foreign exchange. However, till date, the government has not notified any supply as deemed export.

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The duty free imports under GST regime will be restricted to Basic Customs Duty. Exemption from the additional duties of customs, f any, under section 3(1), 3(3) and 3(5) of the customs Tariff Act, 1975 and exemption from Central Excise duty will be available for goods specified under the Fourth Schedule to the Central Excise Act. IGST or CGST plus SGST will be payable by the suppliers

who make supplies to the EOU will be eligible, like any other registered person, to take input Tax Credit of the said GST paid by its suppliers.

Under the GST Law, IGST or CGST plus SGST will be payable by the suppliers who make supplies to the EOU. The EOU will be eligible, to take input Tax Credit of the said GST paid by its suppliers. The supplies from EOU will not be exempted from GST, except in the case of zero rated supplies defined under section 16 of the IGST Act, i.e. supplies made by EOU in the form of physical export or supplies to a SEZ Unit or SEZ developer for authorized operations.

Supply of goods from one EOU to another EOU will be treated as any other supply under GST Law. An EOU can send goods for job work as per section 143 of the CGT Act, 2017 and rule 45 of the CGST Rules, 2017 and the tax liability shall be discharged accordingly.

Practical Exercises

- M/s XYZ is engaged in export of goods only having exports of approx. ₹ 5 crores and no clearances for home consumption are affected. M/s XYZ was not required to e registered under Central Excise. Whether M/s XYZ would be required to get itself registered under GST?

Ans: Yes, because exports have been treated as inter – State supplies under IGST Law.

- We are engaged in the manufacture of exempted excisable goods for export. We availed input stage rebate used in the manufacture of exported gods. How would this case be dealt under GST law if our supply remains an exempt supply?

Ans: Under IGST law a person engaged in export of goods which is an exempt supply is eligible to avail input stage credit for zero rated supplies. Once goods are exported, refund of unutilized credit can be availed under section 16(3) (a) of GST Act, 2017 and section 54 of the CGST Act, 2017 and the rules made there under.

- We are merchant exporters dealing n various products. As per current procedure, we purchase goods from a particular factory against CT1/ARE1 so that no excise is levied on us. After goods are exported, we provide proof of export and form H (for sales tax exemption) to the concerned factory. How would GST impact us and what will be the process now?

Ans: Taxable event in the GST regime is supply of goods. Exports being inter – State supply, you the goods on the payment of IGST or CGST and SGST/UTGST as applicable. You may avail of input stage credit of the tax pad on goods and services and export the goods under bond/LUT Unutilized credit can be availed as refund. Alternatively you may export the goods on payment of integrated tax and refund of integrated tax would be available to you.

Impacts of export promotion scheme on implementation of GST

Duty drawback scheme under GST regime. Duty drawback scheme with certain notifications will continue under the GST regime. The changes in the said scheme as follows.

The Drawback shall be available only of customs duties on imported inputs and Central Excise duty on items specified in the Fourth Schedule to the Central Excise Act 1944 (Specified petroleum products tobacco etc.) used as inputs or fuel for captive power generation.As an export facilitation measure, for the transition period of 3 months, from July to September, 2017, Drawback at higher composite rates will continue to be granted subject to certain safeguards i.e. for claiming the higher rate of drawback, the exporter has to make declaration that no input Tax Credit (ITC) of CGST/IGST is claimed, no refund of IGST paid on export goods is claimed and no CENVAT credit is carried forward.In absence of such declaration, drawback will be restricted to the customs portion of drawback.

Drawback at a higher all industry rate (AIR) admissible if an exporter has not availed input Tax Credit of GST or refund of IGST paid on exported goods after 30th September 2017, drawback will be admissible only at lower rate determined on the basis of the custom duties paid on the goods imported for supplying goods for export goods is claimed and no CENVAT credit is carried forward.In absence of such declaration, drawback will restricted to the customs portion of drawback.

Draw back at a higher All Industry Rate (AIR) admissible if an exporter has not availed input Tax credit of GST or refund of IGST paid on exported goods after 30th September 2017, drawback will be admissible only at lower rate determined on the basis of the custom duties paid on the gods imported for supplying goods for export.

An exporter has stock of GST paid inputs as well as inputs from pre - GST period and if inputs from both lots are use in export goods, what shall be Drawback on such exports.During the transition period upto 30th September 2017, exporters can avail drawback at higher rate subject to the conditions that no input Tax Credit (ITC) of CGST/IGST is claimed, no refund of IGST paid on export goods is claimed and no CENVAT credit is carried forward.

Brand rate of Drawback may bemade admissible for Central Excise duty and Service Tax in respect of exports made prior to GST implementation, for which application is failed after 1st July 2017 for the exports made prior to 1st July 2017, application for fixation of brand rate as per the drawback scheme under the earlier law (defined as ‘existing law’ in section 2 (48) of the CGST Act, 2017) can be filed even after 1st July 2017.

Applications for fixation of brand rate used to be filed with jurisdictional Commissioner of Central Excise having jurisdiction over the factory where export goods were manufactured. Under GST regime, will there be any change regarding filing of application for fixation of brand rate.

With effect from 1st July 2017, applications for fixation of brand rate shall be filed with Commissioner of Customs having jurisdiction over place of export of goods i.e the port/Airport/ICD etc. Where Shipping Bill was filed. This shall be applicable even for exports made prior to 1st July 2017 for which application is yet to be filed. In case exports are from multiple places, application shall be filed with the Commissioner of Customs having jurisdiction over any one of the places of export of goods.

Change under the GST regime in respect of filling of application for fixation of brand rate of Drawback for supplies to SEZ units and SEZ Developers.Prior to 1st July 2017, applications for fixation of brand rate for supplies to SEZ units and SEZ Developers used to be filed with the jurisdictional Commissioner of Central Excise. With effect from 1st July 2017, applications for

fixation of brand rate will be required to be filed with the Commissioner of Central Excise. With effect from 1st July 2017, applications for fixation of brand rate will be required to be filed with the commissioner of Customs having jurisdiction over the principal place of business of the DTA supplier. This shall be applicable even for exports made prior to 1st July 2017 for which application for fixation of brand rate is yet to be filed. On re – export of imported goods, drawback of all duties paid at the time importation was admissible earlier, as per the rates prescribed in this regard.

Drawback under Section 74 of the Customs Act, 1962 is available for duties paid at the time of importation. Therefore, whatever duties/taxes are paid at the time importation of goods, Drawback of the same will be granted. Drawback of Basic Customs Duty plus Additional Duty of Customs (CVD) plus special Additional Duty (SAD) paid on the goods imported prior to 1st July 2017 will be paid even if the re – export is made after 1st July 2017. Similarly, in respect of the goods imported after 1st July 2017, Basic Customs Duty plus IGST plus Compensation Cess will be paid and Drawback of all of these would be paid on re-export of such imported goods.

Exports Treated under the GST Law

Under the GST Law, export of goods or services has been treated as:

Inter - State supply and covered under the IGST Act.

Zero rated supply i.e. the goods or services exported shall be relieved of GST levied upon them either at the input stage or at the final product stage.

The procedures relating to exports by manufacturer exporters been simplified in GST regime the procedures relating to export have been simplified so as to do away with the paper work and intervention of the department at various stages of export. The salient features of the scheme of export under GST regime are as follows:

The goods and services can be exported either on payment of IGST which can be claimed as refund after the goods have been exported or under bond or letter of Undertaking (LUT) without payment of IGST.

In case of goods and services exported under bond or LUT, the exporter can claim refund of accumulated ITC on account of export.

In case of goods the shipping bill is the only document required to be filled with the customs for making exports. Requirement of filling the ARE 1/ARE2 has been done away with.

The supplies made for export are to be made under self – sealing and self – certification without any intervention of the department officer.

The shipping bill filed with the customs is treated as an application for refund of IGST and shall be deemed to have been filed after submission of export general manifest and furnishing of a valid return in form GSTR – 3 by the applicant.

For merchant exporters, is the concept of merchant or manufacture exporter would become irrelevant under the GST regime. The procedure in respect of the supplies made for export is same for both merchant exporter and a manufacturer exporter. The supplies to a SEZ unit or SEZ developer are treated as zero rated supplies in the GST law. Supplies made to an SEZ unit or a SEZ developer are

zero rated. The supplies made to an SEZ unit or a SEZ developer can be made in the same manner as supplies made for export.Either on payment of IGST under claim of refund or under bond or LUT without payment of any IGST.

Supplies to SEZ unit or SEZ developer procures an goods or services from an unregistered supplier. Supplies to SEZ unit or SEZ developer have been accorded the status of inter – State supplies under the IGST Act. Under the GST Law any supplier making inter – State supplies has to compulsorily get registered under GST. Thus anyone making a supply to a SEZ unit or SEZ developer has to necessarily obtain GST registration.Refund in respect of export of goods or service be granted during the GST regime

(a) In case of refund of tax on inputs used in exports. Refund of 90% will be granted provisionally within seven days of acknowledgment of refund application. Remaining 10% will be paid within a maximum period of 60 days from the date of receipt of application complete in all respects.Interest @ 6% is payable if full refund is not granted within 60 days.

(b) In the case of refund of IGST paid o exports. Upon receipt of information regarding furnishing of valid return in Form GSTR – 3 by the exporter from the common portal, the Customs shall process the claim for refund and an amount equal to the IGST paid in respect of each shipping bill shall be credited to the bank account exporter. Export of goods to Nepal or Bhutan fulfills the condition of GST Law regarding taking goods out of India. Hence, export of goods to Nepal and Bhutan will be treated as zero rated and consequently will also qualify for all the benefits available to zero rated supplies under the GST regime. However, the definition of export of services in the GST Law requires that the payment for such services should have been received by the supplier of services in convertible foreign exchange.

➨ Whether any supply has been categorized as deemed export by the government.?

Ans: Deemed export has been defined under Section 2 (39) of CGST Act, 2017 as supplies of goods as may be notified under section 147 of the said Act. Under section 147, the Government may, on the recommendations of the council, notify certain supplies of goods manufactured in India as deemed exports, where goods supplied do not leave India and payment for such supplies is received either Indian rupees or in convertible foreign exchange. However, till date, the government has not notified any supply as deemed export.

EOU is like any other supplier under GST and all the provisions of the GST Law will apply. However, the benefit of Basic Customs Duty exemption n imports will continue.The duty free imports under GST regime will be restricted to Basic Customs Duty, Exemption from the additional duties of customs, if any, under section 3 (1), 3 (3) and 3 (5) of the customs Tariff Act. 1975 and exemption from Central Excise duty will be available for goods specified under the Fourth Schedule to the Central Excise Act. IGST or CGST plus SGST will be payable by the suppliers who make supplies to the EOU will be eligible, like any other registered person, to take input Tax credit of the said GST paid its suppliers.

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The supplies from EOU will not be exempted from GST, except in the case of zero rated supplies defined under section 16 of the IGST Act, i.e. supplies made by EOU in the form of physical export or supplies to a SEZ Unit or SEZ developer for authorized operations.

Practical Exercises

- Whether an EQU can clear goods to another EOU (inter – unit transfer)? And whether an EOU can send goods for carrying out job work on such goods? In such situations, how will the tax liability be discharged?

Ans: Supply of goods from one EOU to another EOU will be treated as any other supply under GST Law. An EOU can send goods for job work as per section 143 of the CGT Act, 2017 and rule 45 of the CGST Rules, 2017 and the tax liability shall be discharged accordingly.

- M/s XYZ is engaged in export of goods only having exports of approx. ₹ 5 crores and no clearances for home consumption are affected. M/s XYZ was not required to e registered under Central Excise. Whether M/s XYZ would be required to get itself registered under GST?

Ans: Yes, because exports have been treated as inter – State supplies under IGST Law.

- We are engaged in the manufacture of exempted excisable goods for export. We availed input stage rebate used in the manufacture of exported gods. How would o case be dealt under GST law if our supply remains an exempt supply?

Ans: Under IGST law a person engaged in export of goods which is an exempt supply is eligible to avail input stage credit for zero rated supplies. Once goods are exported, refund of unutilized credit can be availed under section 16(3) (a) of GST Act, 2017 and section 54 of the CGST Act, 2017 and the rules made there under.

- We are merchant exporters dealing in various products. As per current procedure, we purchase goods from a particular factory against CT1/ARE1 so that no excise is levied on us. After goods are exported, we provide proof of export and form H (for sales tax exemption) to the concerned factory. How would GST impact us and what will be the process now?

Ans: Taxable event in the GST regime is supply of goods. Exports being inter – State supply, you the goods on the payment of IGST or CGST and SGST/UTGST as applicable. You may avail of input stage credit of the tax pad on goods and services and export the goods under bond/LUT Unutilized credit can be availed as refund. Alternatively you may export the goods on payment of integrated tax and refund of integrated tax would be available to you.

Transition of Export Promotion Scheme on Implementation of GST

Duty Drawback Scheme under GST Regime

Duty drawback scheme with certain notifications will continue under the GST regime. The changes in the said scheme as follows.

The Drawback shall be available only of customs duties on imported inputs and Central Excise duty on items specified in the Fourth Schedule to the Central Excise Act 1944 (Specified petroleum products tobacco etc.) used as inputs or fuel for captive power generation.

As an export facilitation measure, for the transition period of 3 months, from July to September, 2017, Drawback at higher composite rates will continue to be granted subject to certain safeguards i.e. for claiming the higher rate of drawback, the exporter has to make declaration that no input Tax Credit (ITC) of CGST/IGST is claimed, no refund of IGST paid on export goods is claimed and no CENVAT credit is carried forward.In absence of such declaration, drawback will be restricted to the customs portion of drawback.

Drawback at a higher all industry rate (AIR) admissible if an exporter has not availed input Tax Credit of GST or refund of IGST paid on exported goods after 30th September 2017, drawback will be admissible only at lower rate determined on the basis of the custom duties paid on the goods imported for supplying goods for export goods is claimed and no CENVAT credit is carried forward. In absence of such declaration, drawback will restricted to the customs portion of drawback.

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➨ What will be the position in respect of re – export made after 1st July 2017, of the goods imported prior to 1st July 2017?

Ans: After 1st July 2017, IGST and Compensation Cess will also be payable on the imported goods. If such imported goods on which IGST and Compensation Cess were paid, are re – exported, whether Drawback of IGST and Compensation Cess will also be granted.Drawback under Section 74 of the Customs Act, 1962 is available for duties paid at the time of importation. Therefore, whatever duties/taxes are paid at the time importation of goods, Drawback of the same will be granted. Drawback of Basic Customs Duty plus Additional Duty of Customs (CVD) plus special Additional Duty (SAD) paid on the goods imported prior to 1st July 2017 will be paid even if the re – export is made after 1st July 2017. Similarly, in respect of the goods imported after 1st July 2017, Basic Customs Duty plus IGST plus Compensation Cess will be paid and Drawback of all of these would be paid on re-export of such imported goods.

CHAPTER SUMMARY

1. Merchandise Exports from India Scheme (MEIS)

(i) Under this scheme, exports of notified goods/products to notified markets as listed in Appendix 3B of Handbook of Procedures, are granted freely transferable duty credit scrips on realized FOB value of exports in free foreign exchange at specified rate (2-5%). Such duty credit scrips can be used for payment of custom duties for import of inputs or goods, payment of excise duty on domestic procurement, payment of service tax and payment of custom duties in case of EO default.Exports of notified goods of FOB value upto ₹ 25, 000

per consignment, through courier or foreign post office using e-commerce shall be entitled for MEIS benefit.

(ii) Service Exports from India Scheme (SEIS): Service providers of notified services as per Appendix 3E are eligible for freely transferable duty credit scrip @ 5% of net foreign exchange earned.

2. Duty Exemption & Remission Schemes

These schemes enable duty free import of inputs for export production with export obligation. These scheme consists of:-

Advance Authorization Scheme

Under this scheme, duty free import of inputs are allowed, that are physically incorporated in the export product (after making normal allowance for wastage) with minimum 15% value addition. Advance Authorization (AA) is issued for inputs in relation to resultant products as per SION or on the basis of self declaration, as per procedures of FTP. AA normally have a validity period of 12 months for the purpose of making imports and a period of 18 months for fulfilment of Export Obligation (EO) from the date of issue. AA is issued either to a manufacturer exporter or merchant exporter tied to a supporting manufacturer(s). Exporters having past export performance (in at least preceding two financial years) shall be entitled for Advance Authorization for Annual requirement. This shall only be issued for items having SION.

Duty Free Import Authorization(DFIA)Scheme

DFIA is issued to allow duty free import of inputs, with a minimum value addition requirement of 20%. DFIA shall be exempted only from the payment of basic customs duty. DFIA shall be issued on post export basis for products for which SION has been notified. Separate schemes exist for gems and jewellery sector for which FTP may be referred.

Duty Drawback of Customs/Central Excise Duties/Service Tax

The scheme is administered by Department of Revenue. Under this scheme products made out of duty paid inputs are first exported and thereafter refund of duty is claimed in two ways:

(i) All Industry Rates: As per Schedule

(ii) Brand Rate: As per application on the basis of data/documents

Rebate of Service tax through all Industry rates

Refund of service tax paid on specified output services used for export of goods is available at specified all industry rates.

EPCG Scheme

Zero duty EPCG scheme

Under this scheme import of capital goods at zero custom duty is allowed for producing quality goods and services to enhance India's export competitiveness. Import under EPCG shall be subject to export obligation equivalent to six times of duty saved in six years. Scheme also allows indigenous

sourcing of capital goods with 25% less export obligation. Other Export promotion schemes are namely Towns of Export Excellence (TEE), Rebate of duty on "export goods" and "material" used in manufacture of such goods, Export of goods under Bond i.e. without payment of excise duty, Market Access Initiative (MAI) Scheme, Marketing Development Assistance (MDA) Scheme, Status Holder Scheme.

REVIEW QUESTIONS

1. What do you mean by Export Promotion and what are the significance of Export Promotion.
2. Explain in detail all Export Promotion Schemes in India.
3. List out all the functions of ECGC.
   Discuss in detail the Funded and Non Funded Services of Export Credit Guarantee Corporation of India Limited.
4. List out and Explain the impacts of Export Promotion Schemes in India due to the implementation of GST.
5. What is EPCG Scheme? And Explain its Types.

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10

LETTER OF CREDIT

Chapter Outline

- Meaning and Mechanism of Letter of Credit
- Evaluation of Letter of Credit
- Types ofLetter of Credit
- Salient Features ofLetter of Credit
- Responsibilitiesand Liabilities of Parties
- Uniform Rules for Bank to Bank Reimbursements
- Chapter Summary
- Review Questions

Letter of credit is one of the important methods of payment in international trade. Letter of credit operations are governed by the provisions of the uniform customs and practice for documentary credits (UCP), a set of rules framed by the International Chamber of Commerce.

MEANING AND MECHANISM OF LETTER OF CREDIT

A documentary letter of credit is an arrangement whereby a bank, at the request and in accordance the instructions of a customer (importer), is to make payment to or to the order of a third party (exporter) or is to pay, accept or negotiate bills of exchange drawn by such third party or authorises payment or negotiation by another bank/against stipulated documents, provided that the sand conditions of the credit are complied. Simply stated, a documentary letter of credit is an arrangement whereby the bank undertakes to pay drafts drawn in accordance with the terms of the International Trade.

Any arrangement, however named or described, that is irrevocable and therefore constitutes a definite undertaking of the issuing bank to:

(a) pay at sight if the credit is available by sight payment;

(b) Incur a deferred payment undertaking and pay at maturity, if the credit is available by deferred-payment.

(c) Accept a bill of exchange (‘draft’) drawn by the beneficiary and pay. At maturity if the credit is available by acceptance; to the beneficiary, bank or other party that delivers documents under the credit to the issuing” bank or nominated bank, in accordance with the terms of the credit, the applicable provisions c these rules and international standard banking practice.”

Two major changes introduced by the current edition of UCP in the definition of letter of credit are:

(i) Reference to revocable letter of credit has been eliminated and all credits areirrevocable;

(ii) In addition to complying with the provisions of UCP, the parties are required to comply with international standard banking practice. A clear understanding of above definition will be facilitated if one understands how a letter of credit operates. A summary of stages in the operation of a letter of credit is given below.

Mechanism of a Letter of Credit

Fig. brings out clearly the operation of a letter of credit. A description of the stages mark” the chart is furnished below:

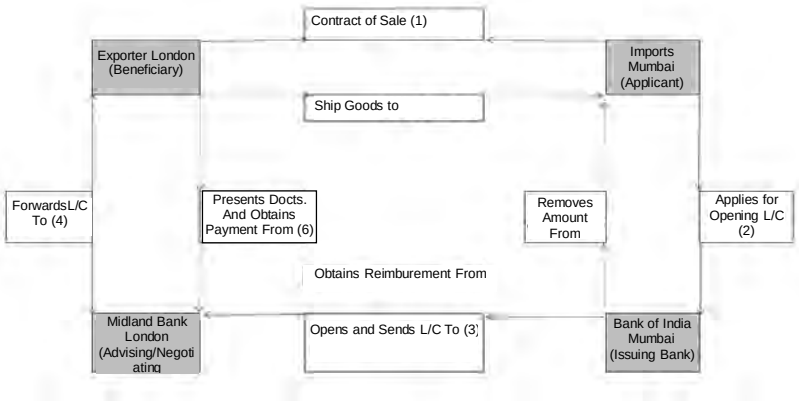


Fig. 10.1: Flow Chart of Letter of Credit operations

1. The transaction originates when the exporter in London and the importer in Mumbai enter into a contract of sale. The contract covers all important particulars such as the description, value and quantity of goods, the due date for shipment, method of payment etc. One of the stipulations is that a letter of credit should be opened in favour of the exporter,

2. The importer applies to his bank (Bank of India) requesting and authorising the bank to open a letter of credit in favour of the exporter and pay bills drawn by the exporter and the letter of credit. The application would stipulate the conditions, especially with regard to the documents to be submitted by the exporter along with the bill.

3. On the strength of the application from the importer, the bank issues a letter of credit which is addressed to the exporter and contains an undertaking by the bank that bill drawn under the credit would be paid by it provided the conditions stipulated there are met.

It should now be clearly understood that though the sale contract forms the basis of the letter of credit, the banks who deal with it are bound only by the stipulations in the credit: the contract of sale in no way affects them. Article 4 of UCP provides "A credit by nature is a separate transaction from the sale or other contract on which it may be based Banks are in no way concerned with or bound by such contract, even if any referent whatsoever to it is included in the credit."

4. Though the letter of credit is addressed to the exporter, it would normally be sent to the correspondent bank of Bank of India in London (Midland Bank) with a request to forward it to the beneficiary. The necessity arises because the exporter would not know the signature of the officials of Bank of India and hence he would not be in a position to satisfy himself about the genuineness of the credit. When it is sent to the Midland Bank which, in the capacity of a correspondent bank, is in possession of the signature of the officials of Bank of India, the signatures on the credit are verified before it is forwarded to the exporter.

5. Within the stipulated date of shipment, the exporter ships the goods to a port in the importer's country (Mumbai) and obtains bill of lading from the shipping company.

6. The exporter draws a bill of exchange on Bank of India along with the bill of lading and other documents required, presents them for negotiation to his bank (say. Midland Bank) Since it is a bill

under letter of credit and payment is assured, any bank in the exported country would be willing to pay against it.

7. The exporter's bank verifies the documents to make sure that they satisfy the condition stipulated in the letter of credit and pay the amount to the exporter. Then the documents are forwarded to Bank of India for payment.

8. On receipt of the documents and after verifying that they satisfy the requirements of the letter of credit, Bank of India makes payment to Midland Bank. The amount of the bill would be recovered by the bank from the importer and the documents would be deliver to him.

By this time it would have been understood that in credit operations "banks deal in documents and not with goods, services or performances to which the documents may relate" (Article 5). Though the seller under a letter of credit is assured of payment, the buyer has no guarantee that required goods have been exported. To overcome this difficulty the credit may specify some other documents to accompany the bill, viz., weight list, packing list, quality certificate, etc. As we see later- these documents do afford, but limited, protection to the importer.

Parties to a Credit

In the above credit, the importer is the applicant for the credit; Bank of India which issues the letter of credit is the issuing or opening bank, the exporter is the beneficiary under the credit. Midland Bank is the intermediary bank which acts as the advising bank while forwarding the letter of to the beneficiary and as negotiating bank while paying against the bill drawn under the letter of credit.

Under Article 2 of UCP, the letter of credit can be opened by the bank on behalf of the importer or on its own behalf. Hence the letter of credit can be opened by a bank for its own transact which case the applicant and the issuing bank can be the same party.

Article 3 states that for the purpose of the Articles of UCP, branches of a bank in different countries are considered another bank. Hence a letter of credit opened by a branch of a bank in the importer's country can be advised by a branch of the same bank in the exporter's country.

EVALUATION OFLETTER OF CREDIT

Advantages

A letter of credit offers advantages both to the exporter and the importer. The advantages accruing to either of the parties differ depending upon the nature of credit opened. However, there are common benefits accruing from the use of credit of whatever type which are discussed below:

To the Exporter

1. The letter of credit provides the sort of assurance that an exporter likes before he embarks on manufacturing the goods for export. In an international deal, the exporter and the importer rarely meet and it is clinched only through exchange of correspondence. The exporter therefore, requires to ensure himself that on shipping the goods he will receive the payment promptly. There is always the risk of the importer failing to pay. The risk is greater if the antecedents of the importer are not known. The letter of credit protects the exporter against failure of the importer to pay. A superior undertaking of a

bank under the letter of credit assures the exporter that when the documents are tendered as per the terms of the credit, payment would be made to him. Thus it also helps the seller to expand the business by enabling him to conclude deals which in the absence of credit he would be hesitant to do.

2. The bank which issues the credit would take care to see that the goods covered by the letter of credit would be permitted to be imported under the exchange regulations. Even in case there is a subsequent change in government policies, the government would think twice before restraining the bank from executing its commitment under the letter of credit

3. The letter of credit helps easing the financial burden of the exporter temporarily. The exporter can easily discounts the bills under a letter of credit with his bank. As such bills carry an undertaking to pay by a bank, bills drawn under letter of credit are readily discounted by banks. Thus the exporter gets payment immediately on shipping the goods. Moreover, the strength of the letter of credit, the exporter may raise loans from his bank for the procurement and processing of raw materials and their export (pre-shipment finance).

All the advantages mentioned above are in addition to those available under a bill transaction. For instance, the exporter does not lose his right over the goods till the issuing bank pays against the documents.

To the Importer

1. The letter of credit enables the importer to purchase materials (especially in seller's market) without making full advance payment. Further, on the strength of the superior credit of the bank, he is able to finalize contracts which the seller may not agree to rely only on the importer.
2. If he takes certain safeguards, like calling for packing certificates, etc. the quality and quantity of the goods consigned is assured.
3. Provided the buyer has a big credit with his bank, he may get goods released by the bank under trust (without payment) and pay for them on sale.

Disadvantages/Limitations

A letter of credit is not a cent per cent safe deal either for the exporter or for the importer. To the exporter, the undertaking of the issuing bank is only conditional. The documents tendered should strictly comply with the requirements of the credit. It is the bank that would decide if the documents are as per the terms of the credit; any slight variation or non-fulfillment or excess detail in the documents tendered give scope for the bank to claim that the documents are not as per the terms of the credit. Moreover the credit does not protect the exporter from the governmental action that may deter payment.

To the importer, the major disadvantage is that it does not ensure that he would be receiving the goods of the specific condition and order. In letter of credit transactions, all parties deal with documents and not in goods. He stands committed to reimburse the issuing bank when documents as required are tendered to him. But this does not ensure the receipt of proper goods. Inspite of the attachments of special documents like packing list, etc. the risk of falsification of documents still remains. But it should be understood that the limitations do not in any way undermine the advantages

that accrue from using letter of credit in international dealings. They do not point out the areas where parties cannot find protection by using letter of credit; nor do they get the desired protection by using any other method.

TYPES OF LETTERS OF CREDIT

A letter of credit may be a clean credit or a documentary credit. A documentary credit requires the documents of title to goods and other documents to accompany the bill drawn under the credit. No such documents are necessary for a clean letter of credit.

Under a clean letter of credit, the documents of title to goods (bill of lading, for example) are sent by the exporter to the importer direct. Only the bill of exchange drawn on the importer is offered to the bank for purchase. Neither the exporter nor the bank retains control over the goods covered by the transaction. For the bank it remains an unsecured advance. For this reason, clean letter of credit is normally not found in commercial transaction. They are used for transfer of funds between banks. In exceptional cases they may be accepted from first class customers.

Almost all commercial letters of credit (issued for financing foreign trade) are documentary credits. Therefore, the UCP deals only with documentary credits. A documentary credit may be classified under the following types depending upon the particular provisions it contains:

1. Payment, Acceptance and Negotiation Credits
2. Revocable and Irrevocable Credits
3. Confirmed and Unconfirmed Credits
4. With Recourse and Without Recourse Credits
5. Fixed and Revolving Credits
6. Transferable Credits
7. Back-to-back Credits
8. Red Clause and Green Clause Credits
9. Standby Credits.

Payment, Acceptance and Negotiation Credits

Article 6(b) stipulates: "A credit must state whether it is available by sight payment, deferred payment, acceptance or negotiation." Thus a letter of credit may be—

(a) Payment credit (or, sight payment credit);
(b) Negotiation credit;
(c) Acceptance credit; or
(d) Deferred payment credit.

1. Payment Credit

A payment credit provides that payment will be made to the beneficiary against the documents to be submitted by him. The documents are not accompanied by a bill of exchange if there is one, it is

drawn on the paying bank. In certain countries even sight drafts attract stamp duty. To avoid stamp duty the parties may agree for a payment credit. Therefore payment credits normally avoid drawing bills of exchange.

In a payment credit the issuing bank nominates a bank in the exporter's country as the paying bank. If the paying bank accepts its nomination, its position is that of an agent of the issuing bank. When the documents under the credit are presented to it, it pays the beneficiary. It gets reimbursement the issuing bank for the amount paid.

2. Negotiation Credit

In a negotiation credit, the documents are accompanied by a sight draft {bill of exchange). The bill of exchange may be drawn on the issuing bank or any other bank stipulated in the credit. The bank which negotiates documents under the credit purchases the bill of exchange and pays the amount to the beneficiary who tenders the documents. The negotiating bank is reimbursed by the issuing bank.

A credit must not be issued or made available by a draft drawn on the applicant. This provision stresses the point that the obligation to pay under a letter of credit is primarily that of the issuing bank. Article 6(a) stipulates that a credit must the bank with which it is available or whether it is available with any bank. Thus a credit may be a

(i) restricted credit or

(ii) open credit.

(i) Restricted Letter of Credit. The issuing bank may restrict the negotiation of documents under the letter of credit to a specified bank in the exporter's country. The letter of credit contains a provision: "Negotiation under this credit restricted to ... Bank" (name of the bank). The expo may submit the documents for negotiation to the bank specified in the credit. If the exporter's bank is not the negotiating bank under the credit, it may still purchase the documents, depending upon the credit enjoyed by the customer with his bank. The exporter's bank which purchases the documents has to present them to the negotiating bank, to whom the credit is restricted, to obtain payment.

Where a letter of credit is restricted to another bank, the exporter's bank does not readily agree to purchase the documents under the credit because (i) it is not a foreign exchange transaction for the bank; it has to present the documents to the bank nominated in the credit and obtain payment in Indian rupees; (n) it is not a negotiating bank and, therefore, does not enjoy the privileges of negotiating bank under Uniform Customs and Practice.

Restriction of letter of credit may be resorted to by the opening bank under instructions from the applicant of the credit, or it may be done to confine business to a favoured bank of the same group or a correspondent bank. If the beneficiary wishes to negotiate the documents through his own banker, he may require suitable amendment of the credit removing the restriction.

(ii) Open Letter of Credit. The letter of credit contains an open invitation to bank to negotiate documents under the credit. The commitment of the issuing bank may read as follows: "We hereby engage with drawers and/or bona fide holders that drafts drawn and negotiated in conformity with the terms of this credit will be duly honoured on presentation."

3. Acceptance Credit

An acceptance credit calls for a usance bill of exchange of a specified period to be drawn under credit. For instance, the letter of credit may require the exporter to draw '90 days' bill. The advantage under an acceptance credit is that the buyer need not pay immediately; he pays only on the due. of the bill. The seller gets the bill accepted by the bank and, in case he is in need of funds, discounts it with his bank. Thus the seller can also get payment immediately. The duty of the issuing bank under this credit is not only to see that the bill is accepted but also to ensure payment on maturity.

If the bill is drawn on the accepting bank in the exporter's country, the accepting bank will accept the bill and return it to the beneficiary. The documents are forwarded to the issuing bank. If the beneficiary is in need of funds, he may discount the bill with any other bank or finance house. Since it is a banker's acceptance, the bill will be discounted readily by other banks and at favourable rates.

On receipt of documents, the issuing bank will deliver them against Trust Receipt or on clean basis. It may also hold them until the steamer arrives, arranges clearance and then stores the goods under its control. A loan against pledge of goods may be given for the importer to pay for the goods on maturity of the bill to be repaid by the sale proceeds of the goods.

4. Deferred Payment Credit

A deferred payment credit carries an undertaking of the issuing bank to pay or to arrange for payment on the date(s) determinable in accordance with the stipulations of the credit. It is like an acceptance credit with the exception that no drafts are drawn. It is thus considered inferior to acceptance credit from the beneficiary's point of view because he does not get a banker's acceptance which he could discount and raise finance.

Deferred payment credit may be used where the beneficiary wishes to allow the importer time to pay for the documents. The documents will be delivered to the Importer immediately. This type of credit is also used to finance import of plant and machinery and capital goods on deferred payment basis. The exporter in such cases can ask the importer to—

(i) Effect remittance of the agreed advance payment, and to submit a 'Deferred Payment Guarantee' from his bank for the deferred instalments, or

(ii) open a deferred payment letter of credit providing for advance payment against shipping documents and payment of deferred instalments as and when due.

Deferred payment letter of credit is easier to operate and, therefore, the exporter may prefer this to deferred payment guarantee.

Revocable and Irrevocable Credits

Till the 1993 revision, UCP recognized two types of credits: (i) revocable credits, and (ii) irrevocable credits.

1. Revocable Credit

A revocable credit is one which can be cancelled or amended by the issuing bank at any time without nor notice to the beneficiary. The cancellation, or amendment, however; takes effect against the bank which has negotiated bills under the credit only on receipt of notice of such cancellation, or

amendment. The issuing bank is liable for bills negotiated conforming to the terms and conditions of the credit before the notice of revocation is received by the negotiating bank.

Since there is no definite undertaking by the issuing bank in a revocable credit, there is not much of a benefit under the credit to the exporter. If the credit is advised to him by the opening bank direct, it may be cancelled by the issuing bank at any time without prior notice. Therefore, till he receives, payment from the issuing bank the exporter is not sure whether the credit is current. He would find it difficult to negotiate the bill with any bank in his country. The bank in the exporter's Country is not aware if the credit is cancelled and hence runs the risk of payment being refused by the issuing bank and hence would be reluctant to negotiate the bill.

If the credit is advised through a bank, generally there would be a clause under which the 'issuing bank binds itself liable to reimburse the negotiating bank on any bills negotiated before the notice of cancellation is received by it. Therefore, such bills have better reception from the negotiating banks. Still, the exporter has the risk that the credit may be cancelled at any time after he procures goods but before he presents the bill for negotiation.

When a confirmed credit is amended, the confirming bank may extend its confirmation W amendment and shall be irrevocably bound as at the time of its advice of the amendment confirming bank may, however, choose to advise an amendment to the beneficiary without extend its confirmation and if so, must inform the issuing bank without delay and inform the beneficiary in its advice [Article 10(b)]. Forwarding the amendment by the confirming bank is taken to signify its acceptance of the amendment

As per Article 2, branches of a bank in different countries are considered another bank 1 a letter of credit opened by a bank can be confirmed by its branch in the exporter's country.

Advised or unconfirmed credit

When the advising bank does not add its confirmation, but merely forwards the credit to its beneficiary, the credit remains unconfirmed. It is an advised credit. The advising of the credit through a bank serves in such a case to get the signature of the issuing bank on the credit authenticated by the advising bank and the correctness of its contents as received. There is no additional undertaking by the advising bank. Article 9 specifies that by advising the credit, the advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit and that the advice accurately reflects the terms and conditions of the credit received. An advising bank advises the credit and any amendment without any undertaking to honour or negotiate.

Second advising bank. The beneficiary of a credit may desire that the credit be advised through a specific bank. The issuing bank normally utilizes the services of its correspondent bank as the advising bank. Where the advising bank of a credit is other than the bank specified by the beneficiary. it may become necessary for the credit to be advised through two banks. For instance, the beneficiary of a credit may specify that the credit be advised through Axis Bank, Mumbai. The issuing Bank, Bank of America, may initially advise through its own correspondent bank, ICICI Bank, Mumbai ICICI Bank would forward the credit to Axis Bank, Mumbai for advising to the beneficiary. Here Axis Bank will be the second advising bank. The position of the second advising bank is similar to that of the advising bank.

Article 9(c) states: "An advising bank may utilise the services of another bank ("second advising bank") to advise the credit and any amendment to the beneficiary. By advising the credit or amendment, the second advising bank signifies that it has satisfied itself as to the apparent authenticity of the advice it has received and that the advice accurately reflects the terms and conditions of the credit or amendment received."

With Recourse and Without Recourse Credits

The bill of exchange drawn under a letter of credit may indicate that it is drawn without recourse to the drawer. Unless the credit authorises drawing a 'without recourse' bill of exchange, it is proper to present such a bill of exchange.

The exporter's intention in drawing a without recourse bill of exchange is to ensure that irv the documents are rejected by the issuing bank or payment is not made by the issuing bank for any reason, he should not be called upon to pay back the amount he received earlier on negotiation of documents.

As per Article 7, the undertaking of the issuing bank is to pay (sight bill) or accept and pay (usance bill) when the stipulated documents are presented and they constitute a complying presentation. It means, the issuing bank has opportunity to scrutinise the documents presented to verify if the requirements of credit are met. In case of any discrepancy, it need not pay. If the issuing bank honours the bill, it can be assumed that the documents were without flaw. The issuing bank cannot claim payment as it was done under mistake. In case of presentation to the confirming bank, where the bill is drawn on it, its position is same as that of the issuing bank. If the bill is drawn on the issuing bank, and the confirming bank negotiates it, it is expected to negotiate the documents without recourse to the drawers, provided the documents tendered are in conformity with the terms of the letter of credit. Therefore, if the documents tendered by the beneficiary are in conformity with the credit terms, there is no need to draw the bill without recourse if the credit is confirmed. Normally the documents are not sent by the beneficiary directly to the issuing bank; he negotiates them with a bank in his country. In the case of confirmed credit, the confirming bank's undertaking is to honour bills without recourse and, therefore, the beneficiary is safe, irrespective of what transpires between the confirming bank and the issuing bank.

If the letter of credit is unconfirmed, the situation differs between a payment credit and negotiation credit. In a payment credit, the paying bank acts as an agent of the issuing bank. If the documents are accepted by it as conforming to the terms of credit, it has no recourse against the drawer. If it wants to have recourse, it should pay under reserve, i.e., reserving the right to get back the money from the beneficiary if the documents are rejected by the issuing bank. Gutteridge and Megrah opine that the position should be the same in the case of a restricted letter of credit because the negotiating bank in that case is also acting as an agent of the issuing bank.

The position is different in the case of a negotiation credit which contains an open invitation for any bank to negotiate. In such a case, the negotiating bank acts on its own and is, therefore, a principal vis-a-vis the beneficiary. The condition under Article 10 that the bank should negotiate without recourse does not apply to a negotiating bank. Therefore, if the negotiating bank is not reimbursed by the issuing bank, it can have recourse against the beneficiary for whom it has negotiated the bill.Similarly, "where the documents, apparently what they should be, are in fact not and the

beneficiary (trot fraudulent) is himself responsible for the discrepancy, the bank should be able to recover themoney he has paid against them as paid in mistake of fact, unless he has expressly contracted not to have recourse."

But there is a difference between the credit being a 'without recourse credit and drawing the bill of exchange 'without recourse'. Where a bank is willing to waive its recourse it usually does so not by authorising the beneficiary to draw without recourse but by the intimation that the credit is 'without recourse' credit .

A credit can be transferred only if it is expressly designated as transferable by the issuing bank Terms such as 'divisible', 'fractionable,' 'assignable' and 'transmissible' to not render the credit transferable.

Who can effect the transfer? In the case of payment credit or acceptance credit, the paying bank or the accepting bank, as the case may be, is authorised to effect the transfer. In the case of a freely negotiable credit, transfer can be effected by the bank specifically authorised in the credit a transferring bank.

The transferring bank shall be under no obligation to effect such transfer except to the extent' and in the manner expressly consented to by such bank. However, the credit can be transferred only on the terms and conditions, specified in the original credit except in respect of amount, period of; validity, insurance, etc. as.detailed above.

At the time of making a request for transfer and prior to transfer of credit, the first beneficiary must irrevocably instruct the transferring bank whether or not the right to refuse to allow i transferring bank to advise amendments to the second beneficiary. If the transferring bank consents to the transfer under these conditions, it must, at the time of transfer, advise the second beneficiaries of the first beneficiary's instructions regarding amendments.

If a credit is transferred to more than one, second beneficiary refusal of an amendment by one? or more of them does to invalidate the acceptance by the other second beneficiary with re whom the credit will be amended accordingly. With respect to the second beneficiary who rejected the amendment, the credit will remain unamended.

Bank charges in respect of transfers are payable by the first beneficiary unless otherwise specified. The transferring bank shall be under no obligation to affect the transfer until such charges are

Under UCP, the transferable credit is governed by Article 38. The salient features of this lengthy Article are included in the above discussion.

Back-to-Back Credit

Where the beneficiary under a letter of credit is an intermediary procuring goods from suppliers and likes the suppliers to get the benefit under the credit, it is done by transferring the credit, in favour of the suppliers. But transfer of the credit is possible only if it is authorized by theitself. The problem is solved by the beneficiary requiring his bank (who may or may not be intermediary bank for the credit) to open another letter of credit in favour of the supplier on the original credit. Such an ancillary letter of credit is known as the back-to-back credit or credit or credit and counter credit.

A back-to-back letter of credit is often an inland letter of credit. It is different from the on0 credit except that the original credit forms the security based on which the bank undertakes support the back-to-back credit. The supplier (beneficiary of the back-to-back credit) ships g00^ the importer or supplies goods to the exporter and presents the documents to the bank as is sp in the credit. It is intended that the exporter would substitute his own documents and ship g to the importer, if necessary, and present documents for negotiation under the original credit, liability under the back-to-back credit would be adjusted out of these proceeds.

The following points may be kept in mind by the bank while opening a back-to-back credit'

1. The terms and conditions of the back-to-back credit should be exactly as that of original letter of credit except for curtailment in:
   (a) the amount of the credit. This would leave margin of profit for the exporter, and
   (b) the validity and shipment dates. This would leave sufficient time for the exporter to prepare and substitute his documents and arrange for shipment to importer if the goods are supplied by the supplier to him. Only then the bank can get reimburse; under the original credit.
2. Though it is not necessary that only an intermediary bank under the original credit; open a back-to-back credit, it would be better that such credits are opened only when bank is also a negotiating bank. This would avoid the risk of the documents substituted the exporter being rejected by the negotiating bank as not fulfilling the conditions credit.
3. The original credit should be an irrevocable credit.

A back-to-back credit has certain features in common with a transferable credit as mentioned below.

(a) There is an authority from the issuing bank for the transfer of benefit under the credit the case of a transferable credit. No such authority is there under a back-to-back .

(b) In a transferable credit the second credit is only an extension of the first credit. The back to back credit has an existence independent of the original credit.

(c) Following from the above, under the transferable credit the negotiating bank can receive the documents submitted by the second beneficiary to the issuing bank in case the beneficiary fails to submit his own documents (i.e., invoice, etc.) on first demand negotiating bank. Under a back-to-back credit submission of documents submitted second beneficiary is not possible.

Red Clause and Green Clause Credits

Also known as 'packing' or 'anticipatory' credit a red clause letter of credit contains a clause p in red, authorising the negotiating bank grants advances to the exporter for the purchase. 'Processing, packing and arranging for movement of goods up to the port for shipment. The additional cost with interest and other charges, is recoverable from the bills that would be tendered under the credit and only the balance would be paid to the exporter.

The amount of the advance should be less than the amount of the letter of credit, so remains fully secured by the obligation of the opening of bank. The opening bank remains liable for the advance. If

the exporter does not tender bills by the expiry date of credit, the bank shouldgive a notice on the exporter and also intimate the opening bank.

At the time of advising the credit and advancing under the credit the bank should following precautions:

(a) The credit rating of the issuing bank should be verified. It should be kept in mind case the advance fails recourse has to be had to the issuing bank.

(b) If the credit requires certain documents to be taken or goods to be charged in favour bank or drafts to be obtained on the issuing bank, such formalities should be com before the advance is made

Foreign Trade Contracts and DOC

(c) If the beneficiary is not its customer, identification of the borrower is necessary before advance is made. A report from the beneficiary's bank may be obtained.

(d) To cover exchange fluctuations the borrower may be advised to book a forward contract for the amount of the credit. This would help keep the advance granted fully covered 1 the amount of the credit. The amount of advance should be less than the amount of t credit.

(e) An undertaking that he would tender documents under the credit before the due date should be obtained from the beneficiary.

An extension of the red clause credit is the green clause credit which not only permits" pre shipment advances but also covers storage in the name of the bank. Both red and green clause credits are used extensively in Australian wool trade.

SALIENT FEATURES OF A LETTER OF CREDIT

1. Operative Instrument

A letter of credit may be issued by: (a) airmail, or (b) telecommunication (telex/cable).

When established by airmail, the standard format of the bank (on security paper) is filled in with the relevant details, signed by the authorized signatories of the bank and mailed to the advising bank.

Where the letter of credit is to be issued by telecommunication, full details of the credit are cabled/telexed to the advising bank. The communication is sent as a SWIFT message which ensures authenticity and speed. Messages other than SWIFT messages are authenticated by the Test Code relevant between the issuing bank and the advising bank. Opening of a letter of credit by telecommunication is routinely done now.

Article ll

(a) (i) of UCP 500 stated: "When an issuing bank instructs an advising bank by an authenticated tele transmission to advise a credit, the tele transmission will be deemed to be the operative credit instrument, and no mail confirmation should be sent. Should a mail confirmation tolerance not to exceed 10% more or 10% less than the amount, the quantity or the unit price to which they refer.

(b) A tolerance of 5% more or 5% less than the quantity of the goods is allowed, provided the credit does not state the quantity in terms of a stipulated number of packing units or individual items and the total amount of the drawings does not exceed the amount of the credit.

(c) Even when partial shipments are not allowed, a tolerance not to exceed 5% less than amount of the credit is allowed, provided that the quantity of the goods, if stated in the credit, is shipped in full, and a unit price, if stated in the credit, is not reduced. This provision does not apply when provisions (a) or (b) above is applicable or when the stipulates a specific tolerance.

RESPONSIBIITIES AND LIABILITIES OF PARTIES

The parties involved in a credit operation are:

(a) Applied (importer)

(b) Beneficiary (exporter)

(c) Issuing bank (opening bank)

(d) Nominated bank (intermediary bank) which may be:

(i) Advising bank

(ii) Confirming bank

(iii) Negotiating bank

(iv) Accepting bank

(v) Paying bank

(vi) Reimbursing bank.

The responsibilities and obligations of the above parties are outlined below bearing in mind, provisions of the UCP.

1. Applicant

(i) Since the credit is based on the sale contract between the exporter and the importer, the latter has a duty to the exporter to see that the credit opened is as per the terms of the sale contract. However, once a credit is issued, it stands by itself whether or not it is in accordance with the sale contract.

(ii) A letter of credit is not regarded as absolute payment unless the exporter strips expressly or implied that it should be so. Therefore, if the exporter has fulfilled his obligation under the contract, but the issuing bank fails before payment is made to him, the importer remains liable to the exporter for the amount.

(iii) The obligations between the importer and the issuing bank are governed by the application cum-agreement submitted by the importer to the bank. Such instructions for the issuance of credits as well as his instructions for any amendments thereto must be complete and precise.

(iv) The issuing bank utilizing the services of another bank or banks for the purpose of giving, effect to the instructions of the applicant does so for the account and at the risk of the

applicant. The issuing bank is not liable if the instructions it transmits are not carried out, even if the issuing bank itself took the initiative in the choice of such other bank(s) [Article 37(a) and(b)].

(v) He is liable to pay charges, including commissions, fees, costs and expenses incurred by the issuing bank in connection with the letter of credit. Where a credit stipulates that such charges are for the account of the beneficiary and charges cannot be collected, he remains ultimately liable for the payment thereof.

(vi) The applicant is liable to indemnify the banks against all obligations and responsibilities imposed by foreign laws and usages [Article 37(d)].

(vii) Under the application-cum-agreement for opening the credit, the applicant agrees that he reimburses the issuing bank, the goods that are covered by the documents shall s charged to the bank.

2. Beneficiary

(i) The beneficiary has the obligation to make export as per the contract and produce documents as required by the credit. He cannot avail himself of the contractual relations existing between the banks or between the applicant for the credit and the issuing bank [Article 4].

(ii) If the documents tendered are accepted by the negotiating bank, but later found to defective due to some latent defects or falsification, he should reimburse the negotiating bank unless the negotiation was made without recourse.

(iii) In a transferable credit, if he requires it to be transferred, he should pay the charges of the transferring bank.

3. Advising Bank

(i) By advising the credit, the advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit and that the advice accurately reflects the terms and conditions of the credit received [Article 9(b)].

(ii) If a bank requested to advise a credit elects not to do so, it must so inform, without delay, the issuing bank [Article 9(g)].

(iii) If a bank requested to advise a credit cannot satisfy itself as to the apparent authenticity of the credit, it must without delay so inform the issuing bank. If it elects nonetheless to advice the credit, it must inform the beneficiary that it has not been able to satisfy itself as to the apparent authenticity of the credit [Article 9(f)]. The responsibilities with respect to advising amendments are same as that for advising edits.

4. Confirming Bank

(i) When a bank in the exporter's country adds its confirmation to the credit, it gives an additional undertaking to the beneficiary, in addition to that of the issuing bank, to negotiate documents under the credit. Therefore, the relationship of the confirming bank with the beneficiary is similar to that of the issuing bank.

(ii) As to the relation of the confirming bank with the issuing bank, the position is same as that of the negotiating bank.

5. Paying Bank

Paying bank is a bank in the beneficiary's country nominated in the letter of credit to make payment inst documents to be tendered under the credit. As already discussed, when the paying bank .accepts its nomination in the credit, it is liable to pay against documents tendered provided they satisfy the requirements of the credit. The payment is without recourse to the drawers, unless the payment is made under reserve. As regards the responsibilities for scrutiny of documents, etc. its position is similar to that of the negotiating bank.

6. Accepting Bank

Accepting bank is the bank nominated in the letter of credit to accept usance bills drawn under the credit; If the bank so nominated accepts the nomination, its responsibility to the beneficiary is not only to accept the drafts drawn, but also to make payment on their due dates. See under Negotiating for the relation with issuing bank.

7. Negotiating Bank

(i) Unless the negotiating bank is nominated in the credit and it accepts the nomination or it is the confirming or paying bank, no bank can be compelled by the beneficiary to negotiate documents under the credit. A bank, under an open credit, may accept on its own to negotiate documents.

(ii) The negotiating bank must examine all documents presented with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit. Compliance of the stipulated documents on their face with the terms conditions of credit, should be determined by international standard banking practice. The negotiating bank should accept documents tendered only if they conform to the terms and conditions of the credit. In documentary credits all parties concerned deal in documents and not in goods. Therefore, he cannot ensure correctness of the goods shipped but can only see that the documents on their face appear to be as required by the credit.

(iii) If the negotiating bank finds any discrepancies in the documents tendered, but still negotiates, it may require the beneficiary to execute an indemnity in favour of the bank. But such indemnity cannot be transferred to the issuing bank without the consent of the beneficiary.

8. Issuing Bank

(i) The issuing bank is primarily responsible for payment under the credit to the beneficiary. This is clearly stated in Article 7(a), which reads:

Provided that the stipulated documents are presented to the nominated bank or to the issuing bank and that they constitute a complying presentation, the issuing bank must honour if the credit is available by:

(ii) sight payment, deferred payment or acceptance with the issuing bank;

(iii) sight payment with a nominated bank and that nominated bank does not pay

(iv) deferred payment with a nominated bank and that nominated bank does not incur its deferred payment undertaking, or having incurred its deferred payment undertaking, does not pay at maturity;

(v) acceptance with a nominated bank and that nominated bank does not accept a draft drawn on it or, having accepted a draft on it, does not pay at maturity;

(vi) negotiation with a nominated bank and that nominated bank does not negotiate.

(vii) Credits and any amendments thereto issued by the bank must be complete and clear. The Issuing bank should discourage any attempt by the applicant to include, as an integrated part of the credit, copies of the underlying contract, preformed invoiced [Article 4(b)].

(viii) The issuing bank should nominate the bank which is authorized to pay or to accept drafts or to negotiate, unless the credit allows negotiation by any bank. By nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing bank author 'nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank [Article 12(b)]. An issuing bank undertakes to reimburse a nominated bank that has honored or negotiated a complying presentation and forwarded the documents to the issuing bank. Reimbursement for the amount of a complying presentation under a credit available by acceptance or deferred payment is due at maturity, whether or not the nominated bank prepaid or purchased before maturity. An issuing bank's undertaking to reimburse a nominated bank is independent of the issuing bank's undertaking to the beneficiary. [Article 7(c)]

(ix) If a bank uses the services of an advising bank to have the credit advised to the beneficiary, it must also use the services of the same bank for advising any amendments (Article).

(x) If a nominated bank determines that a presentation is complying and forwards the documents to the issuing bank, whether or not the nominated bank has honoured or negotiated, the issuing bank must honour or negotiate, or reimburse that nominated bank, even when the documents have been lost in transit between the nominated bank and the issuing, bank [Article 35].

(xi) Upon receipt of the documents, the issuing bank must determine, on the basis of the documents alone, whether or not they appear on their face not to be in accordance with terms, and conditions of the credit (complying presentation) [Article 14(a)]. When the issuing bank determines that a presentation is complying, it must honour [Article 15(a)]. If the documents appear on their face not to be in compliance with the terms and conditions of the credit, the issuing bank may refuse to take up the documents [Article 16(a)]. The issuing bank shall have a reasonable time not exceeding five banking days following the day of presentation to determine whether the presentation is complying [Article 14(b)].

(xii) If the issuing bank determines that the documents appear on their face not to be in compliance with the terms and conditions of the credit, it may in its sole judgment approach the applicant for a waiver of the discrepancies. This does not however extend the period of seven days available for scrutiny and communicating the decision [Article 16(b)].

(xiii) If the issuing bank decides to refuse the documents, it must give notice to that effect without delay by telecommunication or, if that is not possible, by other expeditious means,

without delay but not later than the close of the fifth banking day following the day of receipt of documents. Such notice shall be given to the bank from which it received the documents, or to the beneficiary, if it received the documents directly from him. Such notice must state the discrepancies in respect of which the issuing bank refuses the documents and must also state whether it is holding the documents at the disposal of, or is returning them to the presenter. The issuing bank shall then be entitled to claim from the remitting bank refund of any reimbursement which may have been made to that bank [Article 16].

9. Reimbursing Bank

The issuing bank may indicate in the credit the name of a bank, from whom the paying/negotiating bank can obtain reimbursement. The documents are sent to the bank; the negotiating/paying bank simultaneously makes a claim with the reimbursing bank for the negotiation/payment effected. Normally the reimbursing bank would be the bank with whom the issuing bank maintains an account. Article 13 governs the relationship between the reimbursing bank and the issuing bank which reproduced below

(a) If a credit states that reimbursement is to be obtained by a nominated bank ("claiming bank") claiming on another party ("reimbursing bank"), the credit must state if the reimbursement is subject to the ICC rules for bank-to-bank reimbursements in effect on the date of issuance of the credit,

(b) If a credit does not state that reimbursement is subject to ICC rules for bank-to-bank reimbursements, the following apply:

  (i) An issuing bank must provide a reimbursing bank with a reimbursement authorization that confirms to the availability stated in the credit. The reimbursement authorization should not be subject to an expiry date.

  (ii) A claiming bank shall not be required to supply a reimbursing bank with a certificate of compliance with the terms and conditions of the credit.

  (iii) A issuing bank will be responsible for any loss of interest, together with any expenses incurred, if reimbursement is not provided on first demand by a reimbursing bank in accordance with the terms and conditions of the credit.

  (iv) A reimbursing bank's charges are for the account of the issuing bank. However if the charges are for the account of the beneficiary, it is the responsibility of the issuing bank to so indicate in the credit and in the reimbursement authorization, If a reimbursing bank's charges are for the account of the beneficiary, they shall be deducted from the amount due to a claiming bank when reimbursement is made if no reimbursement is made, the reimbursing bank's charges remain the obligation of the issuing bank.

(c) An issuing bank is not relieved of any of its obligations to provide reimbursement if reimbursement is not made by a reimbursing bank on first demand.

UNIFORM RULES FOR BANK-TO-BANK REIMBURSEMENTS

Reimbursement Arrangement

The procedure involved in arranging for reimbursement under a letter of credit may be stated as follows:

1. The issuing bank indicates in the credit that the reimbursement claim under the credit is subject to URR. It also issues the reimbursement authorization to the reimbursing bank authorizing the latter to reimburse a claiming bank, or to accept and pay drafts drawn on the reimbursing bank.
2. If the reimbursing bank is not prepared to act for any reason whatsoever under the reimbursement authorization, it must so inform the issuing bank without delay.
3. The issuing bank may request the reimbursing bank to issue reimbursement undertaking to the claiming bank. Except as provided by the terms of its reimbursement undertaking a reimbursing bank is not obligated to honour a reimbursement claim.
4. The calming bank which pays incurs deferred payment undertaking accepts a draft or negotiates under a credit a presents a reimbursement claim to the reimbursing bank.
5. The reimbursing bank will have reasonable time, not exceeding three business days to process the claim. Where the claim conforms to the reimbursement undertaking, it will reimburse the claiming bank. Generally the charges of the reimbursing bank are on account of the issuing bank.

ReimbursementAuthorization

Reimbursement authorisation is the instruction/authorization issued by the issuing bank to the reimbursing bank to a reimburse a claiming bank. The authorization may also be to accept and pay a time draft drawn on the reimbursing bank.

Important provisions in URR regarding reimbursement authorisation, are as follows:

1. A reimbursement authorization is separate from the credit to which it refers. A reimbursing bank is not concerned with or bound by the terms and conditions of the credit, even if any reference to them is included in the reimbursement authorisation .
2. The reimbursement authorisation must be issued in the form of an authenticated tele transmission or a signed letter. When a credit is issued by tele transmission the issuing bank should advise the reimbursement authorization by authenticated tele transmission . The teletransmission will be deemed the operative instrument and any subsequent mail confirmation will be disregarded.
3. A copy of letter of credit should not be sent to the reimbursing bank. Multiple authorizations should not be carried in one carried in one teletransmission or letter, unless agreed to by the reimbursing bank.
4. Issuing bank shall not require a certificate of compliance with the terms and conditions of the credit in the reimbursement authorization.

5. The authorisation, must state:
   (i) Credit number,
   (ii) Currency and amount,
   (iii) Additional amounts payable and tolerance, if any,
   (iv) Claiming bank, and
   (v) Parties responsible for charges.

   In case of freely negotiable credits, as also where no claiming bank is mentioned, reimbursement will be to any climbing bank. if the reimbursing bank is to accept and pay a time draft, information about (i) tenor of the draft, (ii) drawer and (iii) party responsible for acceptance and discount charges should additionally be indicated .
6. If the claiming bank has to give pre- notification of the claim to the issuing bank, or if the be uncorrected in the letter of credit, not in the reimbursement authorization.
7. The issuing bank may issue a reimbursement amendment or cancer a reimbursement authorisation, at any time by sending notice to the reimbursement bank, provided reimbursement undertaking has not been issued. It must reimburse the reimbursing bank for reimbursements made prior to the receipt of notice of amendment or cancellation. Where reimbursement undertaking has already been issued, the authorization cannot be amended or cancelled without the agreement of the reimbursing bank.

Reimbursement undertaking

Reimbursement Undertaking is the separate irrevocable undertaking of the reimbursing bank, issued upon the authorization or request of the issuing bank, to the claiming bank named in the reimbursement authorisation, to honour have been compiled with. The important provisions relating to reimbursement undertaking are:

1. An authorization or request by the issuing bank to the reimbursing bank to issue a reimbursement undertaking is irrevocable.
2. If the reimbursement authorization authorizes the issue of reimbursement undertaking by the reimbursing bank, in addition to the details mentioned under reimbursement authorization, it must also specify the latest date for presentation of a claim including any usance period. The reimbursement undertaking should indicate all the details mentioned already under reimbursement authorization.
3. If the latest date for presentation of a claim falls on a day on which the reimbursing bank is closed the latest date for presentation of claim shall be extended to the first following day on which the reimbursing bank is open.
4. When the issuing bank amends its authorisation the reimbursing bank amend its undertaking to reflect such amendment. If it chooses not to issue its reimbursement undertaking amendment, it must so inform the issuing bank without delay While the issuing bank will be bound by the amendment too authorization as from the time of its issue, the terms of the original authorization will remain in force for the reimbursing bank until it

receives acceptance or rejection from the claiming bank to its amendment to the reimbursement undertaking.

5. An amendment to the reimbursement undertaking is not valid unless accepted by the claiming bank.

Reimbursement Claim

Reimbursement Claim is the request for reimbursement from the claiming bank to the reimbursing bank. Important provisions in this regard are:

1. The reimbursement claim must be in the form of a tele-transmission, unless specifically prohibited by the reimbursement authorization, or an original letter. If a claim is made by tele-transmission, no mail confirmation is to sent. If sent, the claiming bank will be responsible for any consequence that may arise from a duplicate reimbursement.
2. A reimbursing bank has the right to request that a reimbursement claim be authenticated and, in such case, the reimbursing bank shall not be liable for any consequences resulting from any delay incurred.
3. The claim must clearly indicate the credit number, issuing bank principal amount claimed additional amount if any, and charges. It should not be copy of the claiming bank's advice of payment, etc. to the issuing bank. Multiple claims should not be included under one tele-transmission or letter. The claim must comply with the terms and conditions of one reimbursing undertaking, if one issued.
4. when a time draft is to be drawn on the reimbursing bank, the claiming bank must forward the draft with the claim along with details of (i) general description of the goods, services or performance (ii) country of origin, (iii) place of destination or performance, and (iv) if the transaction covers shipment of merchandise, date of shipment and place of shipment.
5. The reimbursing bank will have a maximum of three banking days following the day of the reimbursement claim to process the claim. If the reimbursing bank decides not of reimburse, it must give notice to that effect by tele transmission, or if that is not possible, by other expeditious means, without delay but not later than the period mentioned above to the claiming bank by the issuing bank.
6. Where a reimbursing bank has not issued a reimbursement undertaking and a reimbursement is due on a future date, the reimbursement claim must specify the predetermined future date. The claim should not be presented more than three banking days prior to such due date. If the claim should not be earlier, the reimbursing bank may disregard such claim and inform the claiming bank. It the due date is more than three banking days following the day of receipt of the claim, the reimbursing bank has no obligation to provide notice of non – reimbursement until such due date, or the close of the third banking day following the receipt of the claim and pre-debit notification period, whichever is later .
7. A reimbursement banks assumes no liability or responsibility if it hours a reimbursement claim indicating that a payment was made under reserve or against an indemnity and shall disregard such indication.

8. Unless otherwise agreed to by the reimbursing bank and the claiming bank, the reimbursing bank will effect reimbursement only to the claiming bank.
9. Reimbursing bank charges are for account of the issuing bank. Where the charges are for the account off another party the issuing bank should indicate so in the original credit and in the reimbursement authorization. In such cases they will be deducted when the reimbursement claim is honoured.

PRACTICAL PROBLEMS

Case Study I

Problem 2.

You had transferred a transferable letter of credit in full to an export house at the request in the beneficiary. The transferee presented the shipping documents through his banker and you have observed certain discrepancies in terms of the original letter of credit but you have been advised that certain amendments had been received by the transferee through his banker. How will you handle these documents bearing in mind that the letter of credit is governed by Uniform Customs and Practice for Documentary Credits.

Solution. The position of the bank is that of an advising bank. The relationship is not charged by the mere fact that it has affected the transfer of the credit as required by the beneficiary. According of Article 9 of UCP, an advising bank that is not a confirming bank advises the credit without any undertaking honour or negotiate. By advising the credit, the advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit and that the advice accurately reflects the terms and conditions of the credit. It may negotiate documents under the credit if it so desires but the beneficiary cannot compel the bank to do so.

In order that any amendment of a letter of credit already established reaches the beneficiary through the same channel though which the original credit was advised, so that all the concerned parties may know of the amendment, Article 9 says that a bank utilizing the services of an advising bank to advise the credit must use the same bank to advise the credit must use the same bank to advise any amendment thereof. In the present case, the issuing bank routed the amendment through a bank other than the advising bank. Therefore, the advising bank is not bound by such amendment. The situation reinforces the right of the advising bank to refuse to negotiate documents under the credit.

In case the bank desires to accommodate the beneficiary, it may agree to take the documents on collection basis provided they are otherwise in order. This handling of documents will be purely at the discretion of the advising bank and the transaction will not be governed by the provisions of Uniform Custom and Practice for Documentary Credits.

Case Study II

Problem 3

As a negotiating bank you have negotiated an export bill for a valued customer under reserve and against an indemnity from the customer or certain discrepancies as noticed in the documents in terms

of the relative letter of credit and have forwarded the documents to the issuing bank with suitable advice.

The issuing bank informs you after passage of about 3 months that the documents are not acceptable to the openers and that to protect the goods and avoid demurrage they have cleared and stored the goods to your order and seek further instructions.

Discuss the action of the opening bank with reference to the liabilities and responsibilities detailed in the Uniform Customs and Practice Documentary Credits.

What stand would you take as a negotiating bank in the matter?

Solution: While negotiating a bill under a letter of credit the negotiating bank would see if the documents strictly satisfy the terms and conditions of the credit. In case any discrepancy in the documents is noticed it may be refuse to negotiate the bill. But if the beneficiary is a valued customer of the bank and is willing to execute an indemnity in favour of the bank, it may negotiate the documents and make payment under reserve. It means the bank retains the right of recourse against the beneficiary and he beneficiary agrees to pay back amount received by him together with other expenses that may be incurred, if he documents are rejected by the issuing bank.

Obtaining an indemnity is only between the negotiating bank and the beneficiary. It does not affect the relation between the negotiating bank and the issuing bank which is governed by Articles 7 and 12 of the UCP.

The negotiating bank can get reimbursement from the issuing bank only when the documents tendered are in order and are in strict compliance with the terms and conditions of the credit. Presentation of documents with discrepancy is at a valid tender. However, Articles 14 and 16 provide that the issuing bank shall have a time not exceeding five banking days following the day of receipt of the documents to examine the documents. If at considers that the documents are not in accordance with the terms and conditions of the credit, it should without delay notify the negotiating bank of its claim and also either hold the documents at the displacement at the disposal of the negotiating bank or return them. The issuing bank may in its sole judgment approach the applicant for the waiver of the discrepancies. This does not, however extends the time available for communicating non-acceptance. If there is delay in taking these actions by the issuing bank, it forfeits its right the reject the documents Therefore,the present case after an inordinate delay of the three months the issuing bank cannot make any claim. If the bank had not accepted the documents, it was unwarranted on its part to clear the goods and store them, though it was done to protect the interest of the negotiating bank.

The claim of the issuing bank cannot be accepted.

Case Study III

1. You are heading the International division of a Bank in India. You receive an irrevocable letter of credit from a corresponding bank in UAE covering export of textiles from India to Dubai. The Letter of Credit requires you to add your confirmation and also contains a clause that you may extend pre shipment finance facilities up to USD 500000 if required by the exporter. The Letter of credit is for USD 700000 and valid for 6 months.

The Customer in whose favour the letter of credit received is banking with you only for the past three months. He has applied for credit facilities of ₹ 5000000 which is under process. The Branch has recommended that the party is worthy of the limit asked for. The Correspondent bank has regular transactions with the bank in relation to remittances from UAE. This is the first time the letter of credit transaction has been communicated.

Questions

1. What is the implications of the request to your bank?
2. What factors you will consider in examining the proposal?
3. If you consider the proposal favourably, what procedures you will follow and what precautions you will take in executing it.

1. You wish to import special steel from China. The Contract with the Chinese exporters require you to open an irrevocable letter of credit which is transferable and confirmed under the Uniform Customs and Practice for Documentary Credit.

Your Finance Department advises that opening a transferable letter of Credit is offset with risks and confirmation of the credit will add cost to you which is unwarranted.

Chinese exporters are not willing for any change in the terms of the contract. Their quote is 5% cheaper than the next best price you have obtained. However, this is a new source of supplies and you have relied on the market reports in evaluating them. The Import is imminent and any delay beyond 15 days in placing the order will jeopardize your production schedule.

Questions

1. What is your decision on this tricky issue?

CHAPTER SUMMARY

- A letter of credit is a conditional undertaking by a bank, on behalf of its importer customer, to pay the exporter against specified export documents. Worldwide the Uniform Customs and Practices Documentary Credits (UCP) issued by the International Chamber of Commerce governs the rules relating to letter of credit. It is made an integral part of the transaction by specific mention in the letter of credit.
- To the exporter, letter of credit offers the following advantages:
  (a) assured payment against credit risks in International Trade
  (b) compliance with exchange control regulations of importing country, and
  (c) facilitate borrowing
- To the importer, the advantages are:
  (a) enabling purchase of goods without advance remittance,
  (b) through prescribed needed documents ensuring quality and quantity of goods, and
  (c) facilitating import finance.

- A letter of credit does not afford protection against government action and falsification of documents. A payment credit provides that payment will be made to the beneficiary against the documents to be submitted by him. The documents are not accompanied by bill of exchange.
- A negotiation credit requires the documents to be accompanied by a sight bill of exchange. A negotiation credit may be restricted or open. The documents drawn under a restricted letter of credit can be negotiated in the exporter's country only with the bank specified in the credit. An open credit provides for negotiation by any bank in the exporter's country.
- Acceptance credit calls for usance bill of exchange of specified period to be drawn on the credit. The bill of exchange will be drawn on the issuing bank.
- A deferred payment credit carries an undertaking by the issuing bank to pay on dates determinable in accordance with the stipulations of the credit.
- A revocable credit can be amended or cancelled by the issuing bank at any time without prior notice to the beneficiary. An irrevocable credit contains a definite Undertaking by the issuing bank and cannot be amended or cancelled without the concurrence of all parties. Most credits are irrevocable credits. When the credit is silent on this point, it is irrevocable.
- A confirmed credit contains an additional undertaking by a bank in the exporter's country (or a third country), in addition to the undertaking of the issuing bank, to pay against documents drawn under the credit. An advised credit is an unconfirmed credit, which bears the undertaking only that of the issuing bank.
- Generally the terms with recourse and without recourse are used to refer to the bills of exchange under the letter of credit being drawn with or without recourse. In a letter of credit the issuing bank makes payment without recourse. A negotiation bank negotiates the bill with recourse, which means that if payment is not made by the issuing bank, it can recover the amount from the exporter. A fixed or non-revolving credit is available for negotiation only up to the limit mentioned in the credit. A revolving credit is available again and again for negotiation, so long as the outstanding is within the limit mentioned and subject to other conditions of total entailment, if any.
- A transferable credit can be transferred to a third party. The beneficiary of the original credit is the first beneficiary and the person to whom it is transferred becomes the second beneficiary of the transferred credit. Transfer can be effected for full value or in parts.
- A back to back letter of credit is a new letter of credit issued on the security of the original credit. The applicant for the new credit is the beneficiary of the original credit and the beneficiary is the person to whom the back to back credit is issued.
- A red clause letter of credit authorizes the bank in the exporter's country to make advances to the exporter for the purpose of purchase and processing of goods for exports. A greed clause letter of credit, in addition, provides for storage of goods.
- A standby or guarantee credit is a substitute for bank guarantees. The transaction covered is the performance of a contract by the applicant

REVIEW QUESTIONS

1. Describe the meaning and Mechanism of Letter of Credit
2. Explain in detail the advantages and Disadvantages to Exporters and Importers due to Letter of Credit Usage.
3. Elaborate the details of different types of Letter of Credit.
4. Describe the Uniform rules for Bank to bank Reimbursements.

   Practical Case Studies in Letter of Credit

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GLOSSARY

A

- **Acceptance (Acc.):** This term has several related meanings: (1) A time draft (or bill of exchange) that the drawee has accepted and is unconditionally obligated to pay at maturity. The draft must be presented first for acceptance — the drawee becomes the "acceptor" — then for payment. The word "accepted" and the date and place of payment must be written on the face of the draft (2) The drawee's act in receiving a draft and thus entering into the obligation to pay its value at maturity (3) Broadly speaking, any agreement to purchase goods under specified terms. An agreement to purchase goods at a stated price and under stated terms.
- **Acceptance credit:** Documentary credit which requires, amongst the documents stipulated, provision of a term bill of exchange The bill is then generally accepted by the bank on which it is drawn or discounted The practical result is that the beneficiary is paid promptly at a discount.
- **ACH:** *See Automated clearinghouse.*
- **Act of God:** Marine insurance term meaning an act beyond man's control, e.g., lightning, flood, earthquake, etc. The carrier is not legally responsible under most circumstances for such damage.
- **Act. Wt.:** Actual weight.
- **Actual total loss:** Marine insurance term. For insurance purposes, a missing ship is usually considered an actual total loss.
- **Ad valorem duty:** According to value, a rate of duty based upon a percentage of the appraised value of the imported merchandise. *See Duty.*
- **ADR:** See *Alternative dispute resolution.*
- **Advance against documents:** Loan made on the security of the documents covering the shipment.
- **Advance payment guarantee/bond:** Guarantee that advance payments will be returned if the party having received such payments does not perform its part of the contract.
- **Advised letter of credit:** Credit the opening of which the beneficiary is informed by a local bank.
- **Advising bank:** Bank, operating in the exporter's country, which handles letters of credit for a foreign bank by notifying the export firm that the credit has been opened in its favor. The advising bank fully informs the exporter of the conditions of the letter of credit without necessarily bearing responsibility for payment.

- **Advisory capacity:** Term indicating that a shipper's agent or representative is not empowered to make definitive decisions or adjustments without approval of the group or individual represented. Compare *Without reserve.*
- **After date (A/d):** Payment on a negotiable instrument, such as a bank draft, becomes due a specified number of days after presentation of the draft.
- **After sight:** Phrase indicating that the date of maturity of a draft or other negotiable instrument is due a specific number of days after presentation of the draft to the drawee or payee. Compare *At sight.*
- **Agent/agency agreement:** Agent is an independent person or legal entity which acts on behalf of another (the 'principal') In international transactions, generally refers to a sales representative who prospects on behalf of a foreign principal, earning commission on sales eventually concluded between the principal and the ultimate client See *Foreign sales agent.*
- **Agio:** Extra amount over and above the market price which is paid in countertrade transactions and results from the particular costs of countertrade.
- **AGR imports:** American goods returned.
- **Air waybill (AWB):** Bill of lading that covers both domestic and international cargo transported via air freight. This is a nonnegotiable instrument of air transport that serves as a receipt for the shipper, indicating that the carrier has accepted the goods listed and as a contract of carriage obligating the carrier to deliver the cargo to the airport of destination according to specified conditions as outlined on the lading itself and within the carrier's own tariff.
- **All-in:** Freight quotation including all charges, often in one lump sum rather than broken down.
- **All-risk clause:** Insurance condition stating that all loss or damage to goods is insured. It is the broadest kind of standard coverage, but it excludes damage caused by war, strikes, riots or inherent vice.
- **Alongside:** Side of a ship. Goods to be delivered "alongside" are to be placed on the dock or barge within reach of the transport ship's tackle so that they can be loaded aboard the ship.
- **Alternative dispute resolution (ADR):** General term for a variety of dispute-resolution mechanisms which may be used as alternatives to traditional litigation before governmental courts or tribunals. May be said to include such techniques as conciliation, mediation, arbitration, re-negotiation, and mini-trial.
- **Amendment:** Proposed change to a letter of credit.
- **American Arbitration Association (A.A.A.)**: Perhaps the world's largest arbitration forum and institution; the great bulk of cases handled under its rules and procedures are domestic US cases, although the A.A.A. does have specific rules for international cases.
- **AN:** Arrival notice.
- **Anti-diversion clause:** See *Destination control statement.*

- **Anti-dumping duty:** Duty assessed on imported merchandise that is subject to an antidumping duty order; assessed on an entry-by-entry basis in an amount equal to the difference between the United States price of that entry and the foreign market value of such or similar merchandise at the time the merchandise was sold to the United States.
- **Anti-dumping duty order:** Notice issued announcing the determination of dumping and providing for the imposition of antidumping duty to be collected by CBP.
- **Applicant:** In the documentary credit process, normally the buyer or importer, who applies (thus, the applicant) for a letter of credit in favor of the beneficiary, the seller.
- **Approval:** Written authorization, including a competent authority approval, from the Associate Administrator or other designated DOT official.
- **Arbitrage:** Process of buying foreign exchange, stocks, bonds, and other commodities in one market and immediately selling them in another market at higher prices.
- **Arbitrary:** Stated amount over a fixed rate to one point to make a rate to another point.
- **Arbitration:** Process of dispute resolution in which a neutral third party (arbitrator) renders a decision after a hearing at which both parties have an opportunity to be heard Arbitration may be voluntary or contractually required.
- **Arrival notice (AN):** Notice sent by the carrier informing the consignee, notify party, and also notify party of the arrival date of the cargo. Other pertinent information for shipment may be included, such as bill of lading number, weight, charges due and location of cargo.
- **Asian dollars:** U.S. dollars deposited in Asia and the Pacific Basin. Compare *Eurodollars.*
- **ATA carnet:** "Admission Temporaire/Temporary Admission." An international customs document for the temporary duty-free admission of goods into a country for display, demonstration, or similar purposes. ATA Carnets are issued by national chambers of commerce, which guarantee the payment of duties to local customs authorities should the goods not be ultimately re-exported. See *Carnet.*
- **At sight:** Phrase indicating that payment on a draft or other negotiable instrument is due upon presentation or demand. Compare *After sight* and *After date.*
- **Automated broker interface (ABI):** Part of the CBP Automated Commercial System, permits transmission of data pertaining to merchandise being imported into the United States. Qualified participants include brokers, importers, carriers, port authorities, and independent data processing companies referred to as service centers.
- **Automated clearinghouse (ACH):** Function within the CBP Automated Commercial System that combines the elements of bank lock box with electronic funds transfers replacing the payment of customs duties by either check or cash.
- **Automated commercial system (ACS):** Customs & Border Protection's Automated Commercial System is a joint public-private sector computerized data processing and telecommunications system linking customhouses, members of the import trade community, and other government agencies with the Customs computer.

- **Automated export system (AES):** The US Customs & Border Protection's system for filing and collecting electronic export information (EEI). See also *AESDirect* http://www.aesdirect.gov
- **Automated manifest system (AMS):** Module of the CBP Automated Commercial System into which international carriers electronically file cargo manifest data permitting CBP real-time visibility to cargoes inbound to the U.S.
- **Av.:** Average.
- **Aval:** Bank's guarantee to pay a bill of exchange An irrevocable, unconditional promise to pay on the due date The use of avals is common in the practice of forfeiting.
- **AWB:** See *Air waybill.*
- **Awkward cargo:** Cargo of irregular size that is either containerized or un-containerized. It requires prior approval, depending on the circumstances, before confirmation of booking.

B

- **Balance of payments:** Difference between a country's total imports and exports. If exports exceed imports, a favorable balance of trade exists; if not, a trade deficit is said to exist.
- **Banker's acceptance:** Draft drawn on and accepted by a bank Depending on the bank's creditworthiness, it can be a financial instrument that can then be discounted.
- **Back-to-back credit:** Commercial device under which a middleman uses a documentary credit to open a second credit in favor of a supplier. It should be distinguished from a transferable credit.
- **BAF:** See *Bunker adjustment factor.*
- **Bag:** Flexible packaging made of paper, plastic film, textiles, woven material or other similar materials.
- **Bank guarantee:** Assurance obtained from a bank by a buyer that the bank will pay the seller the stated amount of the guarantee should the buyer default on payment. A bank guarantee may not be issued in the U.S. by U.S. banks. See *Letter of Credit.*
- **Bank release:** Negotiable time draft drawn on and accepted by a bank which has added its own credit to that of the buyer.
- **Banker's draft:** Draft drawn by or on behalf bank itself. Regarded as cash, it is payable on demand and cannot be returned unpaid.
- **Barratry:** Negligence or fraud on the part of a ship's officers or crew resulting in injury or loss to the ship's owners.
- **Barter:** Trade in which merchandise is exchanged directly for other merchandise without use of money. Barter is an important means of trade with countries using currency that is not readily convertible.
- **Basic points:** One thousandths; 1/100 of 1%; i.e., 100 basis points is equal to 1%.
- **B/B:** Breakbulk (cargo).
- **B/D:** Bank draft.

- **Beneficiary:** The person in whose favor a letter of credit is issued or a draft is drawn.
- **Berne Union:** International Union of Credit and Investment Insurers.
- **Berth:** Location alongside a quay (pier) where a ship ties up to load or discharge cargo.
- **B/G:** Bonded goods. See *Bonded warehouse.*
- **Bill of exchange (B/E):** See *Draft.*
- **Bill of lading (B/L):** Document that establishes the terms of a contract between a shipper and a transportation company under which freight is to be moved between specified points for a specified charge. Usually prepared by the shipper and actuated by the carrier, it serves as a document of title, a contract of carriage, and a receipt for goods. Also see *Air waybill, Inland bill of lading, Ocean bill of lading,* and *Through bill of lading.* It may also be used as an instrument of ownership, which can be bought, sold or traded while the goods are in transit. To be used in this manner, it must be a negotiable "Order Bill of Lading."

  "Clean B/L" is issued when the shipment is received in good order. If damage or a shortage is noted, a clean bill of lading will not be issued.

  "On Board B/L" certifies that the cargo has been placed aboard the named vessel and is signed by the master of the vessel or his representative. On letter of credit transactions, an On Board B/L is usually necessary for the shipper to obtain payment from the bank. When all bills of lading are processed, a "ships manifest" is prepared by the steamship line. This summarizes all cargo aboard the vessel by port of loading and discharge.

  "Inland Bill of Lading" is also known as the "Waybill" on rail or the "Pro Forma B/L" in trucking. It's used to document the transportation of the goods between the port and the point of origin or destination. It should contain information, such as marks, numbers, steamship line, etc., to match with a dock receipt.
- **BIMCO:** Baltic and International Maritime Conference.
- **BIS:** Bureau of Industry and Security within the U.S. Department of Commerce. It is the agency responsible for regulatory control over the export of dual-use goods and conventional arms. It publishes and enforces the Export Administration Regulations of the U.S.
- **Blocks 23-25:** These blocks of information on the Canada Customs Invoice ask the preparer questions related to transport and packing charges for the shipment to Canada; the amount of the charges, and whether they have been included in the price/value of the goods or if they are being included separately in block 24.
- **BOLERO:** Originally a system for transmission of electronic bills of lading. In the process of being expanded by SWIFT into an electronic platform for transmission of all trade documents.
- **Bonded warehouse:** Warehouse authorized by a customs authority for storage of goods on which payment of duties is deferred until the goods are removed for entry into the commerce of the country or exported from the country.
- **Booking:** Arrangement with a steamship or airline company for the acceptance and carriage of freight on a common carrier. The equivalent of a reservation for cargo.

- **Box:** Packaging with complete rectangular or polygonal faces, made of metal, wood, plywood, reconstituted wood, fiberboard, plastic, or other suitable material. Alternate meaning: Slang term for an ocean container for cargo.
- **Breakbulk (BB):** Non-containerized cargo which is grouped or consolidated for shipment, and then later broken down, subdivided, or distributed at a further destination point.
- **Brokerage:** Fee paid to freight forwarder by the carrier for services performed.
- **Brussels tariff nomenclature (BTN):** See *Nomenclature of the Customs Cooperation Council.*
- **Bulk cargo:** Cargo that is not packed in any way as it is loaded and carried aboard a ship. It is neither marked nor counted by number. It is in a loose, unpackaged form. E.g., crude oil, coal, iron ore, grain.
- **Bulk freight:** Not in packages or containers, shipped loose in the hold of the ship. Grain, coal and sulfur are usually bulk freight.
- **Bunkers:** Ship's fuel carried in the ship's tanks to power the engines.
- **Bunker adjustment factor (BAF):** Surcharge levied in addition to the freight rate to compensate the carrier for differentials in the cost of purchasing fuel (bunkers) to power the ship's engines.
- **Bunker surcharge (BSC):** Extra charge by carrier to adjust for temporarily higher fuel costs. Also called fuel surcharge.
- **Buy-back (compensation):** Form of countertrade under which exporters of, e.g. heavy equipment, technology, or plant facilities agree to purchase a certain percentage of the output of the new facility once it is in production. See *Countertrade.*
- **Buying agent:** See *Purchasing agent.*

C

- **C:** Celsius or Centigrade.
- **Cabotage:** Law which requires coastal and intercoastal movement of goods to be carried aboard ships registered in the country that owns the coast.
- **C & F:** Older term of sale (Incoterm®) that is no longer in use.
- **CAD:** See *Cash against documents.*
- **CAF:** See *Currency adjustment factor.*
- **Call:** Demand for payment under a loan or guarantee. In the case of demand guarantees, the abusive resort to the guarantee (i.e. in the absence of non-compliance by the principal) is sometimes referred to as an unfair call.
- **CBD:** Cash before delivery.
- **Cargo aircraft only:** Aircraft that is used to transport cargo and is not engaged in carrying passengers. The terms cargo aircraft only, cargo-only aircraft and cargo aircraft have the same meaning.

- **Cargo NES or Cargo NOS (Cargo Not Elsewhere Specified or Cargo Not Otherwise Specified):** Carrier's tariff description for items not specifically listed in the tariff. Usually the highest rate.
- **Caribbean Basin Economic Recovery Act (CBERA):** Provides nonreciprocal tariff preference to eligible goods entered into the U.S. from developing countries in the Caribbean Basin in order to aid in their economic development.
- **CARICOM:** Caribbean Common Market includes 13 English speaking Caribbean countries. This common market was formed in 1973. *See Common Market.*
- **Carnet:** Customs document permitting the holder to carry or send merchandise temporarily into certain foreign countries (for display, demonstration, or similar purposes) without paying duties or posting bonds or undertaking the usual customs formalities typically required for the entry of goods.
- **Cartel:** Organization formed to regulate or control the production, pricing, or marketing practices of its members in order to limit competition and maximize market power.
- **Carriage and insurance paid (CIP) named point:** Exporter's price includes the cost of the merchandise, all shipping costs to the named point (inland city) and insurance.
- **Carriage paid to (CPT) and Carriage and insurance paid to (CIP):** Incoterms indicating that carriage, or carriage and insurance, are paid by the seller to the named place of destination. With either term, the buyer bears the risk of loss and damage while goods are in international transit. They may be used in place of CFR and CIF respectively as they accommodate all modes of transport.
- **Carrier certificate and release order (Carrier certificate):** Used to advise Customs of the details of the shipment, its ownership, port of lading, etc. By means of this document, the carrier certifies that the firm or individual named in the certificate is the owner or consignee of the cargo.
- **Cash against documents (CAD):** Payment for goods in which a bank, commission house, or other intermediary, transfers title documents to the buyer upon payment in cash.
- **Cash in advance (CIA):** Payment for goods in which the price is paid in full before shipment is made. This method is usually used only for small purchases, initial purchases, or when the goods are built to order.
- **Cash with order (CWO):** Payment for goods in which the buyer pays when ordering and in which the transaction is binding on both parties.
- **Category groups:** Payment for goods in which the buyer pays when ordering and in which the transaction is binding on both parties.
- **Certificate of free sale:** Document issued by a government entity stating that the goods specified thereon comply with the exporting country's laws for distribution and sale within that country. This document provides assurance to the importing country that the goods meet certain prescribed standards. Most often issued for food product, cosmetics, drugs, and medical devices.

- **Certificate of inspection:** Document certifying that merchandise (such as perishable goods) was in good condition immediately prior to its shipment.
- **Certificate of manufacture:** Documents used with letters of credit when drafts are paid/negotiated on presentation of a certificate stating that goods have been completed and are being held for shipment.
- **Certificate of origin:** Document, required by certain foreign countries for tariff purposes, certifying the country of origin of specified goods.
- **C & F:** See *Cost and freight.*
- **CFR:** See *Cost and freight.*
- **CFS:** See *Container freight station.*
- **CFS/CFS:** Cargo movement delivered loose at origin point, DEvanned by carrier at destination, and picked up loose at destination terminal.
- **CFS/CY:** Loose cargo received at origin point, loaded in a container by carrier, then delivered intact at destination.
- **Chamber of Commerce:** Association of business people organized to promote local business interests.
- **Charter party:** Written contract, usually on a special form, between the owner of a vessel and a "charterer" who rents use of the vessel or a part of its freight space. The contract generally includes the freight rates and the ports involved in the transportation.
- **Chassis:** Wheeled flatbed trailer on which to mount a cargo container for transport.
- **CHB:** Customhouse Broker
- **Chemical Weapons Convention:** Signed by some 160 nations, the CWC prohibits the development, production, stockpiling, distribution or use of chemical weapons.
- **Chemtrec:** Chemical Transportation Emergency Center; organization available on a 24-hour basis to provide emergency response information to anyone involved in hazardous chemical accidents. 800-424-9300
- **CIA:** See *Cash in Advance.*
- **C & I (Cost and Insurance):** Pricing term indicating that these costs are included in the quoted price.
- **CIF:** See *Cost, insurance & freight.*
- **CIF & C:** Cost, insurance, freight and commission. (also CIF & I – Cost, insurance, freight, and interest); and CIF & CI (Cost, insurance, freight, commission and interest). These are variants on the standard Incoterms 1990 term CIF and not covered by international standard definitions.
- **CIF & E:** Cost, insurance, freight, and (currency) exchange. A pricing term indicating that these costs are included in the quoted price. This is a variant on the standard Incoterms ® CIF and not covered by international standard definitions.
- **CIP:** Carriage and insurance paid to… (named point).

- **CISG**: U.N. Convention on the Contract for the International Sale of Goods. A U.N. convention developed to provide uniformity in structure, content, and application of international contracts between buyers and sellers for the sale of goods. When cited within a contract as the governing authority, the provisions of the convention are afforded the force of law. The CISG applies automatically to all contracts for the sale of goods between traders from two different countries that have both ratified the CISG, unless the parties to the contract expressly exclude all or part of the CISG or expressly stipulate a law other than the CISG.
- **Claim:** When used in marine insurance, means a demand made by a shipper or insurance company upon a carrier for payment of a loss sustained through its negligence.
- **Class:** National motor freight classification (NMFC) of the product being shipped. This classification is used only on the domestic Uniform Straight Bill of Lading form.
- **Claused bill of lading:** Claused (or foul) bill of lading contains notations or remarks as to defects in the goods and/or packaging. See *Bill of lading* and Clean *bill of lading.*
- **Cld.:** Cleared (through customs).
- **Clean bill of lading:** Receipt for goods issued by a carrier that indicates that the goods were received in "apparent good order and condition," without damages or other irregularities. Compare *Foul bill of lading.*
- **Clean draft:** Draft to which no documents have been attached.
- **Clean report of findings:** Certificate of inspection of goods and verification of selling price issued by an inspection company (usually required by the buyer's country).
- **CLP:** See *Container Load Plan.*
- **CMR:** International road transport convention.
- **COD:** Collect (Cash) on deliver; Carried on docket (pricing); Change of destination.
- **COFC (Container on flat car):** Containers moving on articulated flat cars without chassis.
- **Collecting bank:** In a documentary collection, the bank acting as an agent for the seller's bank in collecting payment or acceptance of a time draft from the buyer to be forwarded to the seller's bank (the remitting bank). See *Documentary collection.*
- **Collection papers:** All documents (commercial invoices, bills of lading, etc.) submitted to a buyer for the purpose of receiving payment for a shipment.
- **Commerce:** Trade or transportation in the jurisdiction of the United States within a single state; between a place in a state and a place outside of the state; that affects trade or transportation between a place in a state and place outside of the state; or on a United States-registered aircraft.
- **Commerce Control List (CCL):** List of dual use goods and conventional arms established within the Industrial List of the Wassenaar Arrangement. This list is found in Title 19, U.S. Code of Federal Regulations, Part 774 Supplement 1. Classification of a prospective export of commodity, technology or software within the CCL will determine the degree of export control the U.S. will exercise over the shipment.

- **Commercial attaché:** Commerce expert on the diplomatic staff of his or her country's embassy or large consulate.
- **Commercial invoice:** Priced list of goods shipped, identifying seller and buyer, and including sales and payment terms.
- **Commercial officer:** Embassy officials who assist U.S. businesses through arranging appointments with local business and government officials, providing counsel on local trade regulations, laws, and customs; identifying importers, buyers, agents, distributers, and joint venture partners for U.S. firms; and other business assistance. At large embassies, this position is filled by the International Trade Administration; at smaller embassies, this position is represented by State economic officers.
- **Commission agent:** See *Purchasing agent.*
- **Commodity jurisdiction:** Export jurisdiction of products is administered by the State Department's Office of Defense Trade Controls (DTC) if the commodities are defense articles, technical data, and services or by the Commerce Department's Bureau of Export Administration if the commodities are dual-use items. An exporter may request DTC to conduct a commodity jurisdiction (CJ) review if the exporter is uncertain as to whether an item is covered by the United States Munitions List (USML) or believes it has been inappropriately placed on the list. CJ procedures include deadlines for making a determination and the use of criteria assessing: (a) performance, (b) significant military or intelligence applicability, and (c) significant civilian applicability.
- **Common external tariff:** Uniform tariff adopted by a customs union (e.g. European Community) to be assessed on imports entering a region from countries outside the union.
- **Common market:** Common market (as opposed to a free trade area) has a common external tariff and may allow for labor mobility and common economic policies among the participating nations. The European Community is the most notable example of a common market.
- **Common carrier:** Individual, partnership, or corporation that transports persons or goods for compensation.
- **Commonwealth:** Free association of sovereign independent states that has no charter, treaty, or constitution. The association promotes cooperation, consultation, and mutual assistance among members. The British Commonwealth (with headquarters in London, England) is the most notable example.
- **Competent authority:** National agency responsible under its national law for the control or regulation of a particular aspect of the transportation of hazardous materials (dangerous goods).The Associate Administrator of the Pipeline and Hazardous Materials Safety Administration (PHMSA) is the Competent Authority for the United States.
- **Compound duty:** Combination of both a specific rate of duty and an Ad Valorum rate of duty. Whereas specific duties are based on factors such as weight or quantity, ad valorum duties are based on the value of the goods. See *Customs duty*.
- **Conditional free:** Merchandise free of duty under certain conditions, provided they are met.

- **Conference:** Group of steamship companies or shipping lines which have associated to offer regular service on specific routes at publicly announced prices.
- **Confirmed export letter of credit:** Letter of credit, issued by a foreign bank, the validity of which has been confirmed by another bank usually in the seller's country. An exporter presenting conforming documents against a confirmed letter of credit is assured of payment by the confirming bank, even if the buyer or the opening bank defaults. See *Letter of credit.*
- **Confirming bank:** In letter of credit transactions, the bank which adds its own irrevocable undertaking for payment in addition to that given by the issuing bank. Usually located in the exporter's country.
- **Conlinebill:** Liner bill of lading published by the Baltic and International Maritime Conference (BIMCO).
- **Connecting Carrier:** Intermediary carrier utilized to connect cargo to/from the mother vessel. Also known as "feeder service."
- **Consignee:** *In international export transactions:* the intended receiver of a cargo shipment. The named person or legal entity having the right to claim the merchandise from the carrier at destination, and generally recognized as the legal owner for customs purposes. *In international representation or distributorship relations:* the holder and reseller of merchandise, who receives payment in the form of commission or a discount as and when sales are made but does not have to purchase the goods in advance.
- **Consignment:** Delivery of merchandise from an exporter (the consignor) to an agent (the consignee) under agreement that the agent sell the merchandise for the account of the exporter. The consignor retains title to the goods until the consignee has sold them. The consignee sells the goods for commission and remits the net proceeds to the consignor.
- **Consolidator:** Company who combines small shipments to a common point for convenience and special rate to accommodate the customer.
- **Consolidation:** Air freight forwarder's system of combining many small shipments into one large shipment on a scheduled aircraft. (Slang: *Consol*)
- **Consortium:** Group of carriers pooling resources in a trade lane to maximize their resources efficiently.
- **Constructed Value:** Means of determining fair or foreign market value when sales of such or similar merchandise do not exist or, for various reasons, cannot be used for comparison purposes. The "constructed value" consists of the cost of materials and fabrication or other processing employed in producing the merchandise, general expenses of not less than 10 percent of material and fabrication costs, and profit of not less than 8 percent of the sum of the production costs and general expenses. To this amount is added the cost of packing for exportation.
- **Consul:** Government official residing in a foreign country who is responsible for representing the interests of his country and its nationals.
- **Consular declaration**: Formal statement, made to the consul of a foreign country, describing goods to be shipped.

- **Consular invoice:** Document, required by some foreign countries, describing a shipment of goods and showing information such as the seller, buyer, and value of the shipment. Certified by a consular official of the foreign country, it is used by the country's customs officials to verify the value, quantity, and nature of the shipment.
- **Consular officer:** Embassy officials who extends to their country's citizens and their property abroad the protection of their country's government. Responsibilities include maintaining lists of local attorneys, acting as liaison with police and other officials, having the authority to notarize documents.
- **Consularization:** Approval of export documents by a foreign consulate or other entity in the United States.
- **Consumption entry:** Type of customs entry admitting goods into the commerce of the United States. May be formal or informal.
- **Container freight station (CFS):** Where less-than-container-load ocean shipments are brought to be loaded into a container (export) or unloaded from containers and made available for customs clearance (import).
- **Container:** Vehicle designed to transport cargo of many types in continuous transportation. They are constructed as to not fail under stress or handling over a long period of time. Most ocean vessels can accommodate 20′ and 40′ length ocean containers for below deck storage and any size above deck. Containers may be ventilated, insulated, flat rack (open sided), reefer (refrigerated), vehicle rack, or open top.
- **Container load plan (CLP):** Document prepared to show all details of cargo loaded in a container, e.g. weight (individual and total), measurement, markings, shipper, the origin of goods and destination, as well as location of the cargo within the container.
- **Container services charges:** See *Terminal handling charges.*
- **Container yard (CY):** Storage area where full containers are received, stored, and made available for delivery.
- **Contingency insurance:** Insurance coverage taken out by one party to an international transaction to complement and fill in any gaps in the coverage taken out by the counterparty.
- **Containership:** Ocean vessel specifically designed to carry ocean cargo containers. It's fitted with vertical cells for maximum loading/discharge efficiency.
- **Conventional tariff:** Tariff established in agreements resulting from tariff negotiations under the GATT. See *GATT.*
- **Convertible currency:** Currency that can be bought and sold for other currencies at will.
- **Coordinating Committee on Multilateral Export Controls (COCOM):** Committee of all NATO countries (except Iceland) plus Japan created to coordinate and control exports of member countries, especially regarding high-tech equipment.
- **Correspondent:** Bank, Customs Broker, freight forwarder, etc. working with others in another city or country to expedite transactions.

- **Correspondent bank:** Bank that, in its own country, handles the business of a foreign bank.
- **Cost and freight (CFR):** Term of sale (*Incoterm*) indicating that the international freight is arranged by and charges for same are borne by the seller of the goods. The buyer bears the risk of loss and damage while goods are in international transit. Applies to only ocean and inland waterway modes of transport.
- **Cost, insurance & freight (CIF):** Term of sale (*Incoterm*®) indicating that the international freight is arranged by and charges for same are borne by the seller of the goods. The seller also arranges and purchases insurance for the goods while in-transit. The buyer bears the risk of loss and damage while goods are in international transit. Applies to only ocean and inland waterway modes of transport.
- **Counter purchase:** Agreement of an exporter to purchase a quantity of unrelated goods or services from a country in exchange for and approximate in value to the goods exported.
- **Countertrade:** Sale of goods or services that are paid for in whole or in part by the transfer of goods or services rather than money. See *Barter*.
- **Countervailing duty (CVD):** Duty levied on an imported good to offset subsidies to producers or exporters of that good in the exporting country. GATT Article VI permits the use of such duties if material injury to the importing country's producers occurs.
- **Country of export destination:** Country where the goods are to be consumed, further processed or manufactured, as known to the shipper at time of export. If the country of ultimate destination is unknown, the shipment is credited to the last country in which the shipper knows that the merchandise will be shipped in the same form as when exported.
- **Country of origin:** U.S. Customs & Border Protection defines country of origin as the country where an article was wholly grown, manufactured or produced, or, if not wholly grown, cultivated or produced in one country, the last country in which the article underwent a substantial transformation. Duty rates vary according to the country of origin.
- **Country of transshipment:** Name of the country, where goods will be discharged, from a vessel or aircraft, and transit through that country to reach their final country of destination.
- **Court of international trade:** Has jurisdiction over any civil action against the United States arising from Federal laws governing import transactions. The court hears antidumping, product classification, and countervailing duty matters as well as appeals of unfair trade practice cases from the International Trade Commission. The court was originally established in 1890; principal offices are located in New York City, but the court is empowered to hear and determine cases arising at any port or place within the jurisdiction of the United States. The judges are appointed for life by the President, subject to Senate confirmation.
- **Courtage:** (Fr.) Brokerage; brokerage fee.
- **Cover note:** Insurance document indicating coverage of a particular shipment under an open cover policy. Also known as broker's cover note; to be distinguished, particularly as regards presentation under a documentary credit, from an insurance policy or insurance certificate.

- **CPT:** See *Carriage paid to.*
- **Credit risk insurance:** Insurance designed to cover risks of nonpayment. Compare *Marine insurance*.
- **Credit Agreement:** Agreement between carrier and shipper for release of cargo with promise to pay ocean freight within specified time.
- **c/s:** Case(s).
- **CSC:** Container service charge. See *Terminal handling charge.*
- **CST:** Commodity Specialist Team.
- **Cumulative Revolving Letter of Credit:** Revolving L/C under which unused amounts can be carried forward and become available under the next draft.
- **Currency Adjustment Factor (CAF):** Additional charge in carrier's tariff when the currency used for payment is valued low in relation to other currencies.
- **Currency future:** Contract for the future delivery of a commodity, currency or security on a specific date.
- **Currency option:** Contractually-agreed right to buy (call option) or to sell (put option) a specific amount of a foreign currency at a predetermined price on a specific date (European option) or up to a future date (American option).
- **Customs broker:** Individual or firm licensed to enter and clear goods through customs.
- **Customs duty:** Tax levied by the government on goods crossing the customs border, usually a tax imposed on imports.
- **Customs:** Authorities designated to collect duties levied by a country on imports and exports. The term also applies to the procedures involved in such collection.
- **Customs entries:** Custom entries are classified in several ways:
- **Consumption Entry:** Form required by U.S. Customs for entering goods into the U.S. The form contains information as to the origin of the cargo, a description of the merchandise, and estimated duties applicable to the particular commodity. Estimated duties must be paid when the entry is filed.
- **Immediate Delivery Entry (I.D. Entry):** Procedure used to expedite the clearance of cargo. It allows up to ten days for the payment of estimated duty and processing of the consumption entry. In addition, it permits delivery of the cargo prior to payment of the estimated duty and then allows subsequent filing of the consumption entry and duty.
- **Immediate Transportation Entry (I.T. Entry):** Allows the cargo to be moved from the pier to an inland destination via a bonded carrier without the payment of duties or finalization of the entry at the port of arrival. Cargo must clear Customs at the inland destination point.
- **Transportation and Exportation Entry (T&E Entry):** Allows goods coming from or going to a third country (such as Canada or Mexico) to enter the U.S. for the purpose of Trans-shipments.

- **Customhouse broker:** Individual or firm licensed to enter and clear goods through customs.
- **Customs bonded warehouse:** Authorized by Customs to store or manufacture goods while deferring payment of duties until goods are moved into Customs territory. These goods are not subject to duties if reshipped to foreign ports.
- **Customs import value:** U.S. Customs' appraisal value of merchandise.
- **Customs tariff:** Charges imposed by governments on imported and/or exported goods.
- **Customs union:** Association between two or more countries whereby they eliminate tariffs and other import restrictions on each other's goods and establish a common tariff on the goods from all other countries.
- **Customs Valuation Code:** Formally known as the "Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade," this MTN agreement provides detailed rules for the determination of value for customs purposes. These rules are designed to provide a fair, uniform and neutral system of valuation based on transaction value and preclude the use of arbitrary or fictitious values.
- **Cut-off:** Last possible date cargo may be delivered to vessel or designated point.
- **CW:** Commercial weight.
- **CWO:** Cash with order.
- **Cwt:** Hundredweight; unit of measurement.
- **CY:** See *Container Yard.*
- **CY/CFS:** Cargo loaded in a full container by a shipper at origin, delivered to pier facility at destination, and then devanned by carrier for loose pick up.
- **CY/CY:** Cargo loaded by shipper in a full container at origin and delivered to carrier's terminal at destination for pick up intact by consignee.
- **Cylinder:** Pressure vessel designed for pressures higher than 40 psi and having a circular cross section. It does not include a portable tank, multi-unit tank car tank, cargo tank, or tank car.

D

- **D/A:** See *Documents against acceptance.*
- **DAF:** See *Delivered at frontier.*
- **Date draft:** Draft that matures in a specified number of days after the date it is issued, without regard to the date of acceptance. See *Draft, Sight draft,* and *Time draft.*
- **D/C:** Documentary credit. See *Letter of credit.*
- **D/D:** Delivered.
- **ddc (also DDC):** Sometimes said to be "delivered destination charges"; referring to various miscellaneous charges in the port of destination; alternatively, said to refer to dispatch money at discharge.

- **DDP:** See *Delivered Duty Paid.*
- **DDU:** See *Delivered Duty Unpaid.*
- **Dead freight:** Freight charge to be paid even when shipment was not made, owing to failure by shipper or charterer to actually ship goods in the shipping space for which a reservation was made.
- **Deadweight (DWT):** Total carrying capacity of a vessel.
- **Deck cargo:** Goods shipped on the deck of a ship rather than in its holds
- **Defense trade controls:** Directorate of Defense Trade Controls at the Dept. of State administers licenses for the export of defense articles and services including arms, ammunition, and implements of war. These items are listed in the International Traffic in Arms Regulations (ITAR) and the U.S. Munitions List. DTC is involved in the commodity jurisdiction (CJ) process. The CJ process is used to determine whether a particular item should be transferred to another control list (primarily, whether an item may be subject to the ITAR or considered either dual-use and subject to the Commodity Control List). See *International Traffic in Arms Regulations.*
- **Deferred air freight:** Air freight offered at cheaper rates for non-urgent shipments.
- **Deferred payment credit:** Type of letter of credit providing for payment sometime after presentation of shipping documents by exporter.
- **del.:** Delivery.
- **del credere:** As relates to international commercial agency relationships: a del credere agent is one who guarantees the ability to pay of prospective clients he has brought to the principal; in exchange, the del credere agent is usually accorded a higher percentage commission than is a regular agent.
- **Delivery instructions:** These instructions provide specific information to the inland carrier about the merchandise to the particular pier or steamship line. This term is not to be confused with "Delivery Order" which is used for import cargo.
- **Delivery order (D/O):** Order, commonly addressed to a terminal superintendant or warehouse manager, directing the release of specified cargo to a particular receiver.
- **Delivered at frontier (DAF):** Incoterm that means the seller's obligations are fulfilled when the goods have arrived at the frontier — but before "the customs border" of the country named in the sales contract. The term is primarily intended to apply to goods by rail or road but is also used irrespective of the mode of transport. In the U.S. this term of sale is relevant only to U.S. persons selling goods to a Mexican buyer.
- **Delivered duty paid (DDP):** Incoterm® for when the seller bears all obligations, risk and costs to delivers the goods, cleared for export and import, at the named point in the country of destination.
- **Delivered duty unpaid (DDU):** Incoterm® for when the seller bears all obligations, risk and costs to delivers the goods, cleared for export, at the named point in the country of destination. The buyer arranges and pays for customs formalities upon import into the destination country In Incoterms ® 2010, this has been replaced by DAP.

- **Delivered ex ship (DES):** Incoterm® for when the seller bears all obligations, risk and costs to delivers the goods, cleared for export, on board the named vessel in the port of destination, not offloaded. In Incoterms® 2010, this has been replaced by DAP.
- **Delivered ex quay (DEQ):** Incoterm® for when the seller bears all obligations, risk and costs to delivers the goods, cleared for export, on the quay in the port of destination; offloaded from the delivering vessel In Incoterms® 2010, this has been replaced by DAT.
- **Delivery verification certificate:** U.S. CBP defines a DVC as a form used to track imported merchandise from the custody of the importer to the custody of a manufacturer and is used to substantiate a manufacturing drawback claim. The DVC is also known as a Certificate of Delivery (Customs Form 331). An export license may be issued with a requirement for delivery verification by a governmental authority in the receiving country. When delivery verification is required by a foreign government for goods imported into the U.S., the U.S. CBP will certify a delivery verification certificate (Form ITA-647). A U.S. export license may require submission of a similar form from an importing country.
- **Demand draft:** See *Sight draft.*
- **Demand guarantee:** Guarantee usually issued by a bank, under which the beneficiary is only required to make a demand in order to receive payment.
- **Demurrage:** Penalty for exceeding free time (generally 48 hours) allowed for loading/unloading under terms of railroad/ocean tariffs; detention is used to mean the same thing for motor carriers. Excess time taken for loading or unloading of a vessel not caused by the vessel operator, but due to the acts of a charterer or shipper. Also refers to imported cargo not picked up within prescribed time.
- **DEQ:** See *Delivered ex quay*.
- **DES:** See *Delivered ex ship.*
- **Destination control statement:** U.S. exporters are required to place destination control statements on commercial invoices and bills of lading for most export sales. These statements alert foreign recipients of goods and documents that diversion contrary to U.S. law is prohibited. Destination control statements are discussed in the Code of Federal Regulations (15 CFR §786.5 and §786.6).
- **Destination Delivery Charges (DDC):** Unloading charges at destination port of a steamship line of NVOCC.
- **Destuffing:** Unloading goods from a container.
- **Devanning:** Unloading goods from a container.
- **Devaluation:** Official lowering of the value of one country's currency in terms of one or more foreign currencies. For example, if the U.S. dollar is devalued in relation to the euro, one dollar will "buy" fewer euros than before.
- **Direct exporting:** Sale by an exporter directly to a buyer located in another country.
- **DISC:** Domestic international sales corporation.
- **Discount**: Purchase by a bank or finance house of a bill of exchange at face value less interest.

- **Discrepancy:** Situations where documents do not conform to an L/C's terms and conditions.
- **Dispatch Money:** Incentive payment paid by a vessel's operator to a charterer if loading or unloading is completed in less time than stipulated in the charter party. (Also despatch)
- **Distributor:** Foreign company or person who purchases directly from a supplier and maintains an inventory of the supplier's products.
- **Diversion:** Change made in the route of a shipment.
- **Dk.:** Dock.
- **D/O:** See *Delivery Order*.
- **Dock receipt:** Receipt issued by an ocean carrier to acknowledge receipt of a shipment at the carrier's dock or warehouse facilities. Also see *Warehouse receipt.*
- **Document of title:** Evidence of entitlement or ownership, such as a carrier's negotiable bill of lading, which allows a party to claim title to the goods in question.
- **Documentary collection:** Method of payment under which the shipping documents relating to a particular cargo are released to the importer on payment (documents against payment D/P) or acceptance (documents against acceptance D/A) of a documentary draft drawn on him by the exporter.
- **Documentary draft:** Draft to which documents are attached.
- **Documents against acceptance (D/A):** Instructions given by a shipper to a bank indicating that documents transferring possession rights and/or title to goods should be delivered to the buyer (or drawee) only upon the buyer's acceptance of the attached draft.
- **Documents against payment (D/P):** In the case of a sight draft, the documents transferring title to goods are released to the buyer/importer only against cash payment.
- **Documentary credit (D/C):** See *Letter of credit.*
- **Domestic Consignee:** Normally, the U.S. consignee on a domestic Bill of Lading. For instance, you may prepare a short form Straight Bill of Lading to send your goods to your Freight Forwarder's warehouse. In this case, your Freight Forwarder would be your domestic consignee.
- **Domestic transportation:** Transportation between places within the United States other than through a foreign country.
- **Door-to-door:** Transport service covering carriage from the seller's premises to the buyer's premises. Note that this term refers to a freight charge in a carriage contract between a carrier and a shipper and thus is distinct from the issue of the Incoterm chosen in the contract of sale (an agreement between seller and buyer).
- **DOT:** Department of Transportation.
- **Double Stack Train (DST):** Rail car train capable of carrying two forty-foot equivalent containers, one on top of each other.
- **D/P:** See Documents against payment.

- **Draft (or Bill of Exchange):** Unconditional order in writing from one person (the drawer) to another (the drawee), directing the drawee to pay a specified amount to a named drawer at a fixed or determinable date. See *Date draft, Sight draft, Time draft.*
- **Drawback:** Articles manufactured or produced in the United States with the use of imported components or raw materials and later exported are entitled to a refund of up to 99 percent of the duty charged on the imported components. The refund of duty is known as a drawback.
- **Drawee:** Individual or firm on whom a draft is drawn and who owes the stated amount. Compare *Drawer.* Also see *Draft.*
- **Drawer:** Individual or firm that issues or signs a draft and thus stands to receive payment of the stated amount from the drawee. Compare *Drawee.* Also see *Draft.*
- **Drum:** Flat-ended or convex-ended cylindrical packaging made of metal, fiberboard, plastic, plywood, or other suitable materials. This definition also includes packaging of other shapes made of metal or plastic but does not include cylinders, jerricans, wooden barrels or bulk packaging.
- **D/S:** Days after sight.
- **DST:** See *Double Stack Train.*
- **Dumping:** Generally seen as an unfair trading practice. It occurs when a good is sold for less than its "fair value", generally meaning it is exported for less than it is sold in the domestic market or third country markets, or it is sold for less than production cost. Article VI of the GATT permits the imposition of special anti-dumping duties against dumped goods, equal to the difference between their export price and their "fair value" in the export market, if dumping causes injury in the importing country.
- **Dumping Margin:** Amount by which the imported merchandise is sold in the United States below the home market or third country price or the constructed value (that is, at less than its "fair value"). For example, if the U.S. "purchase price" is $200 and the fair value is $220, the dumping margin is $20. This margin is expressed as a percentage of the United States price. In this example, the margin is 10 percent.
- **Duty:** Tax imposed on imports by the customs authority of a country. Duties are generally based on the value of the goods (ad valorem duties), some other factor such as weight or quantity (specific duties), or a combination of value and other factors (compound duties).
- **Duty Rates:** Tax imposed by U.S. Customs on imported merchandise. There are three basic types: (1) ad valorem – based on the entered value, (2) specific – an amount per unit of quantity, (3) compound – combination of ad valorem and specific rates.
- **DWT:** See *Deadweight.*

E

- **EAR:** See *Export Administration Regulations.*
- **EAR99:** Provision within the Commerce Control List (CCL) for any item subject to the EAR but not specifically provide for within a particular ECCN. In essence, a 'basket' provision for all items not otherwise defined in the CCL.
- **ECCN:** See *Export Control Classification Number.*
- **ECE:** See *UNECE.*
- **Export Identification Code (EIC):** Code used by the AES to qualify the nature of the export of the particular product. For UnzHazmat® software: a drop down menu from which you must select the qualified nature of the exported product.
- **EDI:** Electronic data interchange.
- **EDIFACT:** Electronic Data Interchange for Administration, Commerce, and Transportation EDIFACT is an international syntax used in the interchange of electronic data. Customs uses EDIFACT to interchange data with the importing trade community.
- **EIC:** See *Export Identification Code.*
- **EIN:** See *Exporter's Identification Number (often known as Employer's Identification Number*)
- **EIN Type:** When export data is submitted electronically via AES, this field of data identifies the nature or type of the identification number being submitted.
- **Electronic data exchange:** (EDI) Computer-to-computer transmission of business messages (such as purchase orders, invoices, booking instructions, etc.) according to an agreed standard (such as EDIFACT).
- **Elevated temperature material:** Material which, when offered for transportation or transported in a bulk packaging: (1) Is in a liquid phase and at a temperature at or above 100 °C (212 °F); (2) Is in a liquid phase with a flash point at or above 38 °C (100 °F) that is intentionally heated and offered for transportation or transported at or above its flash point; or (3) Is in a solid phase and at a temperature at or above 240 °C (464 °F).
- **EMC:** See *Export management company.*
- **Emergency Response Guidebook (ERG):** The industry standard for emergency response information Developed jointly by the US Department of Transportation, Transport Canada and the Secretariat of Transportation and Communications of Mexico, the ERG provides critical health and safety information to emergency responders, shippers and transporters of dangerous goods/hazardous materials. A shipper of dangerous goods that require shipping papers is required to provide emergency response information with each shipment. UnzHazmat® Software includes an integrated electronic version of the 2008 ERG (the most current version).
- **Enhanced Proliferation Control Initiative (EPCI):** In December 1990, the United States announced a series of measures – collectively referred to as the Enhanced Proliferation Control Initiative (EPCI) – to reduce certain proliferation risks. Under the initiative, the U.S.

requires licenses for exports of: (a) precursor chemicals that can be used in making chemical weapons and whole chemical plants to make such precursors; (b) potential chemical and biological weapon-related industrial facilities, related designs, technologies, and equipment; and (c) any items to destinations that raise proliferation concerns when the exporter knows, or is informed by the Commerce Department, of such concerns. The initiative also calls for: (d) penalties on U.S. firms and individuals that promote the spread of chemical weapons and missile technology; (e) control lists of (i) dual-use equipment and technologies related to chemical and biological weapons and missiles, and (ii) countries to which exports of such items should be controlled; and (f) multilateral adoption of the initiative's measures.

- **Entry:** Document or set of documents required to be filed with U.S. Customs to secure the release of imported merchandise. The entry is the appropriate Customs document accompanying required supporting documentation. The final disposition of the imported cargo will determine the type of entry to be filed.
- **EPCI:** See *Enhanced Proliferation Control Initiative.*
- **ERG:** See *Emergency Response Guidebook.*
- **Est.:** Estimated.
- **ETA:** Estimated time of arrival.
- **ETD:** Estimated time of departure.
- **Ethnocentrism:** Belief that the way things are done in a particular person's culture is automatically the correct way for everyone. Anyone who deviates is wrong.
- **ETS:** Estimated time of sailing.
- **ETC:** See *Export trading company.*
- **EU:** European Union.
- **EURO:** European Currency Unit, previously called ECU.
- **Eurodollars:** U.S. dollars placed on deposit in banks outside the United States; usually refers to deposits in Europe.
- **European Commission:** One of the five major institutions of the European Community, the Commission is responsible for ensuring the implementation of the Treaty of Rome and Community rules and obligations; submission of proposals to the Council of Ministers; execution of the Council's decisions; reconciliation of disagreements among Council members; administration of EC policies, such as the Common Agricultural Policy and coal and steel policies; taking necessary legal action against firms or member governments; and representing the Community in trade negotiations with non-member countries.
- **European Community (EC):** One of the three pillars of the European Union (EU) created under the Maastricht Treaty (1992), the customs union of countries in Europe, organizing freedom of movement for goods, services, capital and people.
- **Ex:** From. When used in terms of sale such as "ex works" it signifies that the price quoted applies only at the point of origin (at the seller's factory). In practice, this kind of quotation

indicates that the seller agrees to place the goods at the disposal of the buyer at the specified place within a fixed period of time.

- **Ex-factory:** Non-standard term, a variation of the preferred formulation: EXW Incoterms 1990.
- **EX number:** Number preceded by the prefix "EX", assigned by the DOT, to an item that has been evaluated and classified as an explosive material.
- **Exchange permit:** Permit sometimes required by the importer's government to enable the import firm to convert its own country's currency into foreign currency with which to pay a seller in another country.
- **Exchange rate:** Price of one currency in terms of another, that is, the number of units of one currency that may be exchanged for one unit of another currency.
- **Eximbank:** Export-Import Bank of the United States http://www.exim.gov/
- **Export:** To send or transport goods out of a country for sale in another country. In international sales, the exporter is usually the seller or the seller's agent. Compare Import.
- **Export Administration Regulations (EAR):** The U.S. regulations governing the export of all goods not specifically subject to the control of some other federal agency. *(Example: military goods fall under exclusive jurisdiction of the State Department's Traffic in Arms regulations).* Export Administration Regulations provide specific instructions on the use and types of licenses required and the types of commodities and technical data under control. These regulations are found in Title 15, Code of Federal Regulations, Parts 730 through 774.
- **Export broker:** Individual or firm that brings together buyers and sellers for a fee but does not take part in actual sales transactions.
- **Export commission house:** Organization which, for a commission, acts as a purchasing agent for a foreign buyer.
- **Export Control Classification Number (ECCN):** All commodities, technologies and software have an export control classification number (formerly: Export Control Commodity Number) within the Commerce Control List (CCL); 15 CFR Part 774, Supplement 1.
- **Export credit insurance:** Exporter's insurance provided either by a private supplier or government agency against non-payment by importer and certain other risks depending on the type of policy.
- **Export declaration:** Required by the U.S. Department of Commerce to control exports and to act as a source document for export statistics. It includes complete particulars on the shipment. Common abbreviation is Ex Dec.
- **Export identification code (EIC):** Code used by the AES to qualify the nature of the export of the particular product. For UnzHazmat® and UnzExport® software: a drop down menu from which you must select the qualified nature of the exported product.
- **Exporter's identification number (often known as Employer's Identification Number) (EIN):** For most corporate exporters, this number will be their Internal Revenue Service

(IRS) Number. If the exporter is a business entity but does not have an IRS assigned number, then it may be the company's DUNS number, if the company is a D&B subscriber. However, there must be some kind of identification number. A person's social security account number (SSAN) can no longer be used as a means of exporter identification.

- **Export-Import Bank of the United States:** Eximbank was chartered in 1934 as an independent agency to finance the export of U.S. goods and services. Eximbank offers four major export finance support programs: loans, guarantees, working capital guarantees, and insurance. Eximbank undertakes some of the risk associated with financing the production and sale of American-made goods; provides financing to overseas customers for American goods when lenders are not prepared to finance the transactions; and enhances a U.S. exporter's ability to match foreign government subsidies by helping lenders meet lower rates, or by giving financing incentives directly to foreign buyers. Eximbank's information hotline number is 1-800-424-5201. See *Commercial Risk Political Risk Private Export Funding Corporation.*
- **Export license:** Required document issued by the U.S. Government authorizing the export of specific commodities. This license is for a specific transaction or time period in which the export is to take place.
- **Export management company:** Private firm that serves as the export department for several producers of goods or services, either by taking title or by soliciting and transacting export business on behalf of its clients in return for a commission, salary, or retainer plus commission.
- **Export merchant:** Company that buys products directly from manufacturers, then packages and marks the merchandise for resale under its own name.
- **Export trading company:** Firm similar or identical to an export management company.
- **Export quota:** Restriction or set objective on the export of specified goods imposed by the exporting country's government. May be intended to protect domestic producers and consumers from temporary shortages of certain materials or as a means to moderate world prices of specified commodities. Commodity agreements sometimes contain explicit provisions to indicate when export quotas should go into effect among producers.
- **Export rate:** Freight rate to be applied to export traffic which is generally lower than the domestic rate.
- **Exporter:** For purposes of completing the Automated Export System (AES), the U.S. principal party in interest that receives the primary benefit – monetary or otherwise – of the transaction. Generally, the U.S. seller, manufacturer, order party, or foreign entity if in the U.S. when completing the AES.
- **EXW:** See *Ex works.*
- **Ex-factory:** Non-standard trade term, a variation of the preferred formation: EXW Incoterms® 2010.
- **E&OE (Errors and Omissions Excepted):** When appended to a signature on a shipping document, indicates a disclaimer of responsibility for spelling, typographical, or clerical errors.

- **Ex works (EXW):** EXW (named place); Incoterms ®rule for when the seller is required to make the goods available at seller's premises, which commonly is at his factory or warehouse, but may be any place on the seller's side of the transaction. All other obligations, risk and costs are borne by the buyer including export formalities from the origin country.

F

- **F:** Degree Fahrenheit.
- **F&D:** Freight and demurrage.
- **FAS:** See *Free alongside ship.*
- **Factor:** Agent appointed to sell goods on commission, also known as a commission merchant.
- **Factoring:** Factoring is the discounting of a foreign account receivable that does not involve a draft. The exporter transfers title to its foreign accounts receivable to a factoring house for cash at a discount from the face value. Factoring is often done without recourse to the exporter. Export factoring allows an exporter to ship on "open account," by which goods are shipped without guarantee of payment (that is, a letter of credit). The factor assumes financial ability of the customer to pay and handles collections on the receivables.
- **FAK:** See *Freight of all kinds.*
- **Fair market value:** Reference against which U.S. purchase prices of imported merchandise are compared during an antidumping investigation. Generally expressed as the weighted average of the exporter's domestic market price, or prices of exports to third countries during the period of investigation. In some cases fair value is the constructed value. Constructed value is used if there are no or virtually no home market or third country sales or if the number of such sales made at prices below the cost of production is so great that remaining sales above the cost of production provide an inadequate basis for comparison.
- **FB:** Freight bill.
- **FCA:** See *Free carrier.*
- Foreign Credit Insurance Association.
- **FCL:** Full container load.
- **Federal Maritime Commission (FMC):** U.S. Government Agency responsible for overseeing regulatory aspects of all maritime activities.
- **Federal Register:** Government publication that prints rules/regulations of federal agencies on a daily basis; rules and regulations must be published to become legal in most cases.
- **Feeder Service:** See *Connecting Carrier.*
- **FEU (Forty Foot Equivalent Unit):** 40′ container equals 2 TEUS.
- **FF (Freight Forwarder):** Federally licensed company that handles documentation details for shipper of export cargo.

- **Flat Car:** Platform rail car on which trailers, containers, etc. are loaded.
- **FI:** See *Free in.*
- **FIO:** See *Free In and Out.*
- **Floating policy:** See *Open insurance policy.*
- **FMC:** See *Federal Maritime Commission.*
- **FO:** See *Free out.*
- **FOB:** See *Free on board.*
- **Fob airport:** No longer a valid Incoterm, see *FCA, Inctoterms® 2010.*
- **f.o.c.:** Free of charge.
- **f.o.d.:** Free of damage.
- **FOR:** Free on rail. No longer a valid Incoterm. Suitable term from Incoterms® 2010 is FCA.
- **Force majeure:** Title of a standard clause in marine contracts exempting the parties for nonfulfillment of their obligations as a result of conditions beyond their control, such as earthquakes, floods, or war.
- **Foreign assets control:** Also known as OFAC, the Treasury Department's Office of Foreign Assets Control administers sanctions programs involving specific countries and restricts the involvement of U.S. persons in third country strategic exports.
- **Foreign Corrupt Practices Act (FCPA):** Act prohibiting U.S. individuals, companies and direct foreign subsidiaries of U.S. companies from offering, promising, or paying anything of value to any foreign government official in order to obtain or retain business.
- **Foreign exchange:** Currency or credit instruments of a foreign country. Also, transactions involving purchase or sale of currencies.
- **Foreign freight forwarder:** Corporation carrying on the business of forwarding who is not a shipper or consignee. The foreign freight forwarder receives compensation from the shipper for preparing documents and arranging various transactions related to the international distribution of goods. Also, a brokerage fee may be paid to the "forwarder" from steamship lines if the forwarder performs at least two of the following services: (1) coordination of the movement of the cargo to shipside; (2) preparation and processing of the Ocean Bill of Lading; (3) preparation and processing of dock receipts or delivery orders; (4) preparation and processing of consular documents or export declarations; (5) payment of the ocean freight charges on shipments.
- **Foreign sales agent:** Individual or firm that serves as the foreign representative of a domestic supplier and seeks sales abroad for the supplier.
- **Foreign Trade Agreement:** Agreement between countries to reduce and eventually eliminate tariff and non-tariff barriers between them.
- **Foreign trade zone (FTZ):** U.S. form of free trade zones. These zones are restricted-access sites in or near ports of entry that operate under public utility principles to create and maintain employment by encouraging operations in the U.S. which might otherwise have

been carried on abroad. Goods brought into a zone for a bona fide Customs reason are exempt from state and local ad valorem tax. The zones are licensed by the Commerce Department's Foreign-Trade Zones Board and operate under the supervision of the Customs Service. Quota restrictions do not normally apply to foreign goods stored in zones, but the Board can limit or deny zone use in specific cases on public interest grounds. Domestic goods moved into a zone for export may be considered exported upon entering the zone for purposes of excise tax rebates and drawback. A foreign trade "subzone" is a non-contiguous zone site located at a manufacturing plant.

- **Forfaiting:** Form of supplier credit in which an exporter surrenders possession of export receivables, which are usually guaranteed by a bank in the importer's country, by selling them at a discount to a "forfaiter" in exchange for cash. These instruments may also carry the guarantee of the foreign government. In a typical forfaiting transaction, an exporter approaches a forfaiter before completing a transaction's structure. Once the forfaiter commits to the deal and sets the discount rate, the exporter can incorporate the discount into the selling price. Forfaiter usually works with bills of exchange or promissory notes, which are unconditional and easily transferable debt instruments that can be sold on the secondary market. Three primary differences between export factoring and forfaiting are:- Factors usually want access to a large percentage of an exporter's business, while most forfaiters will work on a one-shot basis; -Forfaiters generally work with medium and long-term receivables (180 days to seven years), while factors work with short-term receivables (up to 180 days). Payment terms usually reflect the type of product involved: forfaiters usually work with capital goods, commodities, and large projects; factors work mostly with consumer goods. – Most factors do not have strong capabilities in developing regions of the world where legal and financial frameworks are inadequate and credit information is not readily available through affiliate factors. However, since forfaiters usually require a bank guarantee, most are willing to work with receivables from these countries.
- **FOT:** Free on truck. No longer a valid Incoterm. The suitable term from Incoterms® 2010 is FCA.
- **Forward rate:** Price of a foreign currency which is bought or sold for delivery and payment at a fixed future time, usually 30, 60, or 90 days.
- **Foul bill of lading:** Receipt for goods issued by a carrier with an indication that goods were damaged or missing when received. Compare *Clean bill of lading.*
- **FPA:** See *Free of Particular Average.*
- **Franchising:** System based on the licensing of the right to duplicate a successful business format or industrial process.
- **Franco (French; European shipping):** Non-standard term meaning "free delivered": shipper pays all charges to a particular point.
- **Free Alongside Ship:** FAS (named port of export); Under Incoterms® FAS, the seller bears obligations, risk and costs for delivery of the goods alongside a vessel at the port of departure. The costs and risk of loading, unloading, ocean transportation, and insurance are

borne by the buyer. This Incoterm rule may be used only for ocean and inland waterway transport.

- **Free Carrier:** FCA (named place); Under Incoterm FCA, the seller is responsible to make the goods available to the buyer at a named place within the seller's country. Once delivery by the seller to the named place has been completed, the buyer bears all further obligations, risks, and costs in taking the goods to whatever final destination of the buyer's choosing. FCA is applied to all modes of transport.
- **Free In (FI):** Pricing term indicating that the charterer of a vessel is responsible for the cost of loading goods onto the vessel.
- **Free In and Out (FIO):** Pricing term indicating that the charterer of a vessel is responsible for the cost of loading and unloading goods from the vessel.
- **Free of Particular Average (FPA):** Title of a clause used in marine insurance, indicating that partial loss or damage to a foreign shipment is not covered. (Note: Loss resulting from certain conditions, such as the sinking or burning of the ship, may be specifically exempted from the effect of the clause. Compare *WPA.*
- **Free On Board:** FOB (named port); Under Incoterm® FOB, the seller bears obligations, risk and cost to deliver the goods to a named port of export in the seller's country. Once the goods have been loaded aboard a vessel arranged for by the buyer, all further obligations, risk and cost are for the account of the buyer. FOB is applicable only to ocean or inland waterway modes of transport.
- **Free out (FO):** Pricing term indicating that the quoted prices include the cost of unloading the goods from the vessel.
- **Free port**: Area into which merchandise may legally be moved without payment of duties.
- **Free time:** Storage time allowed at carriers' facility without penalties being assessed.
- **Free trade agreement (FTA):** Arrangement which establishes unimpeded exchange and flow of goods and services between trading partners regardless of national borders. An FTA does not (as opposed to a common market) address labor mobility across borders, common currencies or uniform standards or other common policies such as taxes. Member countries of a free trade area apply their individual tariff rates to countries outside the free trade area.
- **Free trade area:** A free trade area is a cooperative arrangement among two or more nations, pursuant to the General Agreement on Tariffs and Trade, whereby trade barriers are removed among the members. The arrangement generally includes a customs union with a common external tariff, although there are exceptions in which members maintain individually separate tariff schedules for external countries.
- **Free-trade zone:** Area designated by the government of a country for duty-free entry of any non- prohibited goods. Merchandise may be stored, displayed, used for manufacturing, etc., within the zone and reexported without duties being paid. Duties are imposed on the merchandise (or items manufactured from the merchandise) only when the goods pass from the zone into an area of the country subject to the customs authority. (These are called foreign trade zones in the United States).

- **Freight all kinds (FAK):** Freight rate applicable to all types of goods.
- **Freight bill receipt:** See *Freight release.*
- **Freight brokerage:** Commission paid to a licensed Freight Forwarder or Custom House Broker by the steamship line concerning export transactions. Commission is paid either as a percentage or the freight charges or as a lump sum amount per container, depending on the carrier and/or trade lane.
- **Freight forwarder:** Independent business that handles export shipments for compensation. (A freight forwarder is among the best sources of information and assistance on U.S. export regulations and documentation, shipping methods, freight costs, and foreign import regulations.)
- **Freight release:** Evidence that the freight charges for the cargo have been paid. If in writing, it may be presented at the pier to obtain release of the cargo. (Normally, once the freight is paid, releases are usually arranged without additional documentation).
- **FSC:** See *Fuel surcharge.*
- **FTA:** See *Free Trade Agreement.*
- **Fuel surcharge (FSC):** Additional charge in a carrier's tariffs when the price of fuel increases.

G

- **GA:** See *General Average.*
- **Gas:** Material which has a vapor pressure greater than 300 kPa (43.5 psia) at 50°C (122°F) or is completely gaseous at 20°C (68°F) at a standard pressure of 101.3 kPa (14.7 psia).
- **Gateway:** Principal airport, domestic or international, with many flights, offering maximum service and connections. Sometimes used to refer to a truck or trail border crossing to Canada or Mexico.
- **GATT:** General Agreement on Tariffs and Trade now called the World Trade Organization (WTO). A multilateral treaty intended to help reduce trade barriers between signatory countries and to promote trade through tariff concessions. http://www.wto.org
- **General Average (GA):** Coverage for loss resulting from voluntary sacrifice, e.g., jettison, or the act of expending cargo to prevent loss of vessel, crew, passengers, or total cargo. The value of such a loss is averaged among all interested parties.
- **General Export License:** Any of various export licenses covering export commodities for which *Validated Export Licenses* are not requires. No formal application or written authorization is need to ship exports under a General Export License.
- **General Order (GO):** Cargo seized by customs due to failure on part of consignee to make customs entry within allotted free time.

H

- **Hard currency:** Currency of a nation which may be exchanged for that of another nation without restriction. Sometimes referred to as convertible currency. Hard currency countries typically have sizeable exchange reserves and surpluses in their balance of payments.
- **House bill of lading (house B/L):** Bill of lading issued by a freight forwarder. Often covers a consignment of parcels from various shippers that has been grouped or consolidated by the forwarder.
- **House to house:** Terms generally refers to a container yard to container yard (CY/CY) shipment (in which case, it may be used merely to quote the rental rate for the container itself), but is also used in some cases, synonymously with "door to door" a term which more generally refers to overall transport services from seller's premises to buyer's premises.
- **HTS:** See *HTSUSA.*
- **HTSUSA:** Harmonized Tariff Schedule of the U.S. Annotated. The U.S. application of the Harmonized System for the classification of imported merchandise. The U.S. adheres to the international classification system to the six digit level and then adds four addition digits for rate of duty assignment and statistical purposes.

I

- **IA:** *See Independent Action.*
- **IATA:** See International Air Transport Association.
- **IATA Non-Restricted Declaration:** Form provided to freight forwarders and air carriers that declare goods described on the form non-dangerous for transport via air. Often used by shippers when a product has an ominous sounding description that could lead someone to believe it is dangerous but it is actually not.
- **IBCC:** International Bureau of Chambers of Commerce.
- **IBCC:** Net – International data bank for the posting of commercial offers, including the purchase and sale of consumer goods and commodities; operates through networks of chambers of commerce.
- **ICAO:** See *International Civil Aviation Organization.*
- **ICC:** See *International Chamber of Commerce.*
- **ICC Arbitration:** Loose term to refer either to ICC Rules for Conciliation and Arbitration or the process of submitting an arbitral complaint to the ICC Court of International Arbitration.
- **ICPO:** See *Irrevocable Corporate Purchase Order.*
- **ICTF:** Immediate Container Transfer Facility.
- **IFM:** Inward Foreign Manifest
- **IMDG:** See *International Maritime Dangerous Goods Code.*

- **Immediate Delivery Entry:** See *Customs Entries.*
- **Immediate Transportation Entry (IT):** See *Customs Entries.*
- **IMO:** See *International Maritime Organization.*
- **Import:** To bring foreign goods into a country. In international sales, the importer is usually the buyer or an intermediary who accepts and transmits goods to the buyer. Compare *Export.*
- **Import Letter of Credit:** Used to finance importation of goods.
- **Importer:** U.S. CBP defines "importer" as a person primarily liable for the payment of duties on the merchandise, or an authorized agent acting on the importer's behalf. The importer may be: (a) a consignee, (b) the importer of record, or (c) the actual owner of the merchandise if the actual owner has filed with Customs a declaration acknowledging ownership along with a superseding bond. See *19 CFR 141.20.*
- **Importer of Record:** See *Importer*.
- **Import license:** Document required and issued by some national governments authorizing the importation of goods into their individual countries.
- **Import Quota:** Means of restricting imports by the issuance of licenses to importers, assigning each a quota, after determination of the total amount of any commodity which is to be imported during a period. Import licenses may also specify the country from which the importer must purchase the goods.
- **In Bond:** Procedure under which goods are transported or warehoused under customs supervision until they are either formally entered into the customs territory of the United States and applicable duties are paid, or until they are exported from the United States.
- **Incoterms ® 2010:** Set of eleven internationally standard trade rules (also known as delivery terms or terms of sale) which define the obligations, risks and costs of buyer and seller for the delivery of goods subject to their contract Incoterms are issued by the International Chamber of Commerce. Terms of Sale *do not specify where the title or ownership* of the goods pass from seller to buyer. We strongly recommend that you limit your input to the accepted eleven rules and always designate a point or place where obligations, risks, and costs will transfer from Seller to Buyer. *(Example: FCA Newark Liberty Intl Airport. Or FOB Port of Boston-Maersk/Sea-Land Terminal.)*
- **Independent Action (IA):** Carrier can take an independent action within a conference resulting in a unique rate for that carrier, ability to file a rate independently of other carrier's action.
- **Indirect Export:** Sale to the buyer through an intermediary in the domestic market.
- **Inherent Vice:** Insurance term referring to any defect or other characteristics of a product which could result in damage to the product without external cause. Insurance policies may specifically exclude losses caused by inherent vice.
- **Inland bill of lading:** Bill of lading used in transporting goods overland. Although a Through bill of lading can sometimes be used, it is usually necessary to prepare both an

inland bill of lading and an ocean bill of lading for export shipments. Compare *Air waybill, Ocean bill of lading,* and *Through bill of lading.* (Also see *Pre-carriage* and *On-carriage*).

- **Inland B/L:** See *Inland Bill of Lading.*
- **Inland carrier:** Transportation line that hauls export or import freight between ports of entry and inland destinations.
- **Inland clearance depot (inland dry port):** Combination transport terminal and customs clearance centre.
- **Injury:** In U.S. law, a finding by the International Trade Commission that imports are causing, or are likely to cause, harm to a U.S. industry. An injury determination is the basis for a Section 201 case. It is also a requirement in all antidumping and most countervailing duty cases, in conjunction with Commerce Department determinations on dumping and subsidization.
- **Inner packaging:** Packaging for which an outer packaging is required for transport. It does not include the inner receptacle of a composite packaging.
- **Inner receptacle:** Receptacle that requires an outer packaging in order to perform its containment function. The inner receptacle may be an inner packaging of a combination packaging or the inner receptacle of a composite packaging.
- **Inspection certificate:** Some purchasers and countries may require a certificate of inspection attesting to the specifications of the goods shipped, usually performed by a third party. Inspection certificates are often obtained from independent testing organizations.
- **Institute clauses:** Standard international transport insurance clauses, published by the Institute of London Underwriters. The Institute Cargo Clauses are three sets of clauses providing different levels of protection: The "A" Clauses correspond to the general notion which is referred to in the trade as "all risks" coverage; while clauses "B" and "C" indicate a lower level of coverage and a greater number of exclusions.
- **Instruments of international traffic:** Lift vans, cargo vans, shipping tanks, skids, pallets, caul boards, and cores for textile fabrics, arriving (whether loaded or empty) in use or to be used in the shipment of merchandise in international traffic are designated as "instruments of international traffic" (IIT) within the meaning of section 322(a), Tariff Act of 1930, as amended. Upon Customs acceptance of a type 3 bond, covering these IIT types, such instruments may be released without entry or the payment of duty, subject to the provisions of 19 CFR 10.41a.
- **Insurance certificate:** Assures the consignee that insurance is provided to cover loss or damage to the cargo while in transit.
- **Integrated carrier:** Carriers that have both air and ground fleets; or other combinations, such as sea, rail, and truck. Since they usually handle thousands of small parcels an hour, they are less expensive and offer more diverse services than regular carriers.
- **Intellectual property rights:** Generic phrase encompassing intangible property rights, including, among others, patents, trade and service marks, copyrights, industrial designs, rights in semiconductor chip layout designs, and rights in trade secrets.

- **Interchange:** Transfer of a container from one party to another.
- **Interchange Agreement:** Contract between carrier and trucker that legally permits interchange of equipment.
- **Interline service:** Routing from origin to destination involving more than one carrier.
- **Intermediate Consignee:** Intermediate consignee is the bank, forwarding agent, or other intermediary (if any) that acts in a foreign country as an agent for the exporter, the purchaser, or the ultimate consignee, for the purpose of effecting delivery of the export to the ultimate consignee. For exports to foreign countries, the intermediate consignee shall be the person named as such on an export license. If there is no intermediate consignee, the word "none" shall be entered.
- **Intermodal:** More than one mode of transportation is used, e.g. truck and steamship, in one shipment, and one bill of lading is issued for the entire shipment.
- **International Air Transport Association (IATA):** Established in 1945, is a trade association serving airlines, passengers, shippers, travel agents, and governments. The association promotes safety, standardization in forms (baggage checks, tickets, weigh bills), and aids in establishing international airfares. IATA headquarters are in Geneva, Switzerland. IATA publishes its Dangerous Goods Regulations which are based on the ICAO Technical Instructions and which governs the movement of dangerous goods in domestic and international transport by air.
- **International Atomic Energy Agency (IAEA):** Specialized agency of the UN, is the primary international organization that enforces a system of safeguards to ensure that non-nuclear weapons states do not divert shipments of sensitive nuclear-related equipment from peaceful applications to the production of nuclear weapons. Before a supplier state of nuclear materials or equipment may approve an export to a non-nuclear weapons NPT (Nuclear non-Proliferation Treaty) signatory state, it must receive assurances that the recipient will place the material under IAEA safeguards. Subsequent to shipment, the recipient state must allow IAEA officials to verify the legitimate end use of the exported materials or equipment. IAEA, established in July 1957, gives advice and technical assistance to developing countries on nuclear power development, nuclear safety, radioactive waste management, and related efforts. Safeguards are the technical means applied by the IAEA to verify that nuclear equipment or materials are used exclusively for peaceful purposes. IAEA headquarters are in Vienna, Austria.
- **International Chamber of Commerce (ICC):** World business organization headquartered in Paris. See *Incoterms® 2010.*
- **International Civil Aviation Organization (ICAO):** United Nations specialized agency which promotes international cooperation in civil aviation. The ICAO Council adopts standards and recommended practices concerning air navigation, prevention of unlawful interference, and facilitation of border-crossing procedures for international civil aviation. Operating since 1947, ICAO includes almost all U.N. members. Headquarters are in Montreal, Canada.

- **International Emergency Economic Powers Act (IEEPA):** Enacted in 1977 to extend emergency powers previously granted to the President by the Trading with the Enemy Act of 1917 (which still authorized the President to exercise extraordinary powers when the United States is at war). IEEPA enables the President, after declaring that a national emergency exists because of a threat from a source outside the United States, to investigate, regulate, compel or prohibit virtually any economic transaction involving property in which a foreign country or national has an interest.
- **International freight forwarder:** See *Freight forwarder.*
- **International Maritime Organization (IMO):** Established as a specialized agency of the United Nations in 1948. The IMO facilitates cooperation on technical matters affecting merchant shipping and traffic, including improved maritime safety and prevention of marine pollution. Headquarters are in London, England.
- **International Maritime Dangerous Goods Code (IMDG):** The regulatory standard for the shipment of dangerous goods internationally by vessel.
- **International Trade Commission:** Independent U.S. Government agency concerned with imports, import duties, and the effect of imports on U.S. industry. The Commission has six commissioners who review and make recommendations concerning countervailing duty and antidumping petitions submitted by U.S. industries seeking relief from imports that benefit unfair trade practices. Known as the U.S. Tariff Commission before its mandate was broadened by the Trade Act of 1974.
- **International Traffic in Arms Regulations (ITAR):** Administered by the State Department to control the export of U.S. defense articles and services. The provisions implemented in the ITAR are governed by the Arms Export Control Act. Direct commercial sales of U.S. origin defense products, components, technologies, and services are controlled under the ITAR by the State Department's Directorate of Defense Trade Controls.
- **International transportation:** Transportation (1) Between any place in the United States and any place in a foreign country; (2) Between places in the United States through a foreign country; or (3) Between places in one or more foreign countries through the United States.
- **Intransit (IT) entry:** Customs entry permitting goods to move between ports under bond.
- **Inv.:** Invoice.
- **Immediate Transportation Entry (IT):** Type of customs entry declaring goods for transportation by a bonded carrier from a port of entry to a bonded warehouse at an inland port, or another customs port where entry will be filed.
- **Inland Point Intermodal (IPI):** Inland carriage by another mode of transportation after port discharge, cargo moving to/from an inland point.
- **IPI:** See Inland Point Intermodal.
- **Irrevocable:** Most common designation of an instrument of credit in international trade. It carries an irrevocable obligation of the issuing bank to pay the beneficiary when drafts and

documents are presented in accordance with the terms of the letter of credit. An irrevocable letter of credit, once issued, cannot be amended or canceled without the agreement of all named parties. As such, it must have a fixed expiration date.

- **Irrevocable Corporate Purchase Order:** Offer to buy stated goods under specified terms and conditions.
- **Irrevocable letter of credit:** Irrevocable letter of credit, once issued, cannot be amended or canceled without the agreement of all named parties. As such, it must have a fixed expiration date.
- **ISO 9000:** International production quality standards established by ISO (International Standards Organization).
- **Issuing Bank:** Bank which opens, issues, a straight or a negotiable letter of credit. This bank assumes the obligation to pay the beneficiary or a correspondent bank if the documents presented are in accordance with the terms of the terms and conditions of the documentary credit instrument.
- **ITAR:** See *International Traffic in Arms Regulations.*

J

- **Japan External Trade Organization (JETRO):** Administers the export programs of the Japanese Government independently. MITI subsidizes about 60 percent of JETRO's total annual expenditures and, technically, has final decision-making authority over JETRO management and programs. Originally established to help Japanese firms export, JETRO also assists American companies seeking to export to Japan and promotes Japanese direct investment in the United States and U.S. direct investment in Japan.
- **Joint Venture:** Business undertaking in which more than one firm share ownership and control of production and/or marketing.

L

- **Landbridge:** Microbridge or a minibridge.
- **Laydays/laytime:** Time allowed by the ship-owner to the charterer or shipper in which to load or discharge the cargo. May be expressed in days or hours, or tons per day. Set in running days (every calendar day), working days (excludes Sundays and holidays observed by the port), or weather working days (in addition, excludes days where operations are prevented by bad weather).
- **L/C:** Letter of Credit.
- **LCL:** Less than container load. Refers to shipments of goods which will have to be packed together with other consignments in order to fill up a container.
- **LCL/FCL:** Way of quoting container freight rates in which the carrier agrees to pack the container at the outset (LCL), but the unpacking at destination must be carried our by the receiver or consignee.

- **LCL/LCL:** Way of quoting container freight rates in which the carrier agrees to pack the container on departure as well as unpack the container at destination.
- **ldg.:** Loading.
- **Legal weight:** Weight of the goods plus any immediate wrappings which are sold along with the goods; e.g. the weight of a tin can as well as its contents. See Net weight.
- **Legalization:** Approval of export documents by a foreign consulate or other entity in the United States.
- **Letter of credit (L/C):** Financial document issued by a bank at the request of a buyer guaranteeing payment to the seller if certain terms and conditions are fulfilled. Normally it contains a brief description of the goods, documents required, a shipping date, and an expiration date after which payment will no longer be made. An Irrevocable Letter of Credit is one which obligates the issuing bank to pay the exporter when all terms and conditions of the letter of credit have been met. None of the terms and conditions may be changed without the consent of all parties to the letter of credit. A Revocable Letter of Credit is subject to possible recall or amendment at the option of the applicant, without the approval of the beneficiary.- A Confirmed Letter of Credit is issued by a foreign bank with its validity confirmed by a U.S. bank. An exporter who requires a confirmed letter of credit from the buyer is assured payment from the U.S. bank in case the foreign buyer or bank defaults.- A Documentary Letter of Credit is one for which the issuing bank stipulates that certain documents must accompany a draft. The documents assure the applicant (importer) that the merchandise has been shipped and that title to the goods has been transferred to the importer.
- **Letter of Credit Advice:** Communication by the advising bank that a letter of credit has been issued. The primary responsibility of the advising bank is to take care in establishing the authenticity of the credit.
- **Letter of Credit-Revolving:** Credit which includes a provision for reinstating its face value after being drawn under within a stated period of time. This kind of credit facilitates the financing of on going regular purchases.
- **Letter of Credit-Standby:** Issued for the express purpose of effecting payment in the event of default. The issuing bank is prepared to pay but does not expect to as long as the underlying transaction is properly fulfilled.
- **Letter of Indemnity (LOI):** Document commonly used in international trade to allow a carrier to release goods to a receiver who is not yet in possession of the bill of lading.
- **Lex mercatoria:** Internationally accepted general trade practices; the international, informal law of merchants.
- **License Exception:** Export Administration Regulations (EAR) provide that commodities which may be otherwise subject to an export license may not require one under certain circumstances. If the export meets the criteria of a particular license exception, then an export license will not be required. The exporter must make this decision having consulted the EAR.

- **Licensing:** Business arrangement in which the manufacturer of a product (or a firm with proprietary rights over certain technology, trademarks, etc.) grants permission to some other group or individual to manufacture that product (or make use of that proprietary material) in return for specified royalties or other payment.
- **l.i.f.o.:** In international trade: liner in free out, referring to a freight charge which includes the cost of loading in the port or departure but does not include unloading coasts in the port of destination. In accounting practice: last in first out.
- **Lighter:** Open or covered vessel which transfers cargo between ship and shore, used mainly in harbors and inland waterways. Lighters are generally used for shorter hauls than barges.
- **Limited quantity:** Maximum amount of a hazardous material for which there is a specific labeling or packaging exception Dangerous goods in limited quantities must display either LIMITED QUANTITY or LTD. QTY. on the shipping papers.
- **Line Release:** Part of Customs' Automated Commercial System, is designed for the release and tracking of shipments through the use of personal computers and bar code technology. To qualify for line release, a commodity must have a history of invoice accuracy, and be selected by local Customs districts on the basis of high volume. To release the merchandise, Customs reads the bar code into a personal computer, verifies that the bar code matches the invoice data, and enters the quantity. The cargo release is transmitted to the Automated Commercial System, which establishes an entry and the requirement for an entry summary, and provides the Automated Broker Interface system participants with release information.
- **Liner shipping:** Services provided by a steamship company or shipping line, under which cargo vessels operate according to a fixed schedule and publicly advertised freight rates.
- **Liner terms:** Freight rates which include loading/unloading charges according to the custom of the respective ports which varies widely. "Liner terms" therefore is not a standard designation. ICC currently working on establishing a standard liner term.
- **Liquidation:** Final determination of the duties due.
- **Lkg. & Bkg.:** Leakage and breakage.
- **LOI:** See *Letter of indemnity*.
- **LT:** Long Ton (2,240 pounds).
- **LTL:** Less than truck load.

M

- **M3:** Cubic meters.
- **M & R:** Maintenance and repair.
- **Main carriage:** Freight movement and cost from the seller's side to the buyer's side. Usually considered to be the international portion of the transport movement.
- **Manifest:** See *Ship's manifest.*

- **Maquiladora:** Also known as "in-bond" industry, this program allows foreign manufacturers to ship components into Mexico duty-free for assembly and subsequent reexport. Industry established under the maquiladora program is Mexico's second largest source of foreign revenue (following oil exports). The maquiladora programs was established in 1965; in December 1989, the Mexican government liberalized the maquiladora program to make this a more attractive and dynamic sector of the economy. As a result, maquiladora operations may import, duty and import license free, products not directly involved in production, but that support production, including computers and other administrative materials and transportation equipment.
- **Marine Bill of Lading (also ocean bill of lading):** Classic document of the traditional export trade. Plays three potential roles: 1) as receipt for the cargo and evidence that the goods have been received in apparent good order, 2) evidence that the terms of the contract of carriage between the shipper and the ocean carrier, and 3) an instrument enabling transfer of control over delivery of the goods (negotiability) which allows the holder of the bill to trade the goods in transit by simple endorsement and physical transfer of the bill.
- **Marine (Cargo) Insurance:** Insurance covering loss of, or damage to, goods at sea. Marine insurance typically compensates the owner of merchandise for losses in excess of those which can be legally recovered from the carrier that are sustained from fire, shipwreck, piracy, and various other causes. Three of the most common types of marine insurance coverage are "free of particular average" (f.p.a.), "with average" (w.a.), and "All Risks Coverage."
- **Marine pollutant:** Material which is listed in appendix B to §172.101 of 49 CFR and, when in a solution or mixture of one or more marine pollutants, is packaged in a concentration which equals or exceeds: (1) Ten percent by weight of the solution or mixture for materials listed in the appendix; or (2) One percent by weight of the solution or mixture for materials that are identified as severe marine pollutants in the appendix This term also includes those materials that meet the defining criteria in chapter 2.9 of the UN Model Regulations or the IMDG Code.
- **Marking (or marks):** Letters, numbers, and other symbols placed on cargo packages to facilitate identification.
- **Master document/form:** Central document in export administrative systems under which all necessary information is entered into a single master document or computer file, which is then used to generate all shipping and export documents, also known as aligned export documentation systems.
- **Mate's receipt:** Documents issued by the carrier to the shipper, indicating receipt of the goods, but not loading on board.
- **Mercosur:** An economic and political agreement between Argentina, Brazil, Paraguay and Uruguay. Its purpose is to promote free trade and the fluid movement of goods, people, and currency. The official languages are Portuguese and Spanish It has been updated, amended, and changed many times since. It is now a full customs union Bolivia, Chile, Colombia, Ecuador and Peru currently have associate member status. Venezuela signed a membership agreement on 17 June 2006.

- **Metric Ton (M/T):** 1,000 kilograms (2,204 pounds)
- **Microbridge:** Rate from a city that is not a seaport to a foreign city, via another city that is a seaport, with the steamship line or NVOCC issuing a bill of lading from the original city and taking responsibility for the cargo all the way.
- **Military Critical Technologies List (MCTL):** Document listing technologies that the U.S. Defense Department considers to have current or future utility in military systems. The MCTL describes arrays of design and manufacturing know-how; keystone manufacturing, inspection, and test equipment; and goods accompanied by sophisticated operation, application, and maintenance know-how. Military justification for each entry is included in a classified version of the list.
- **Minibridge:** Rate from a city that is a seaport to a foreign seaport, via another city that is a seaport, with the steamship line of NVOCC issuing a bill of lading from the origin city and taking responsibility for the cargo all the way.
- **Mini landbridge (MLB):** Cargo moving port to port via land or rail; port destination served overland by rail.
- **Minimum B/L:** Minimum amount one can charge per individual bill of lading.
- **Ministry of International Trade and Industry (MITI):** Occupies a central position in Japan‘s “economic bureaucracy” and is regarded as one of the three most powerful and prestigious ministries of the central government (along with the Ministry of Finance and the Ministry of Foreign Affairs). In formulating and implementing Japan’s trade and industrial policies, MITI is responsible for funding most of Japan’s export promotion programs (although operation of these programs is left to JETRO). The Ministry also supervises the export financing programs of Japan ‘s Export-Import Bank, operates several types of export insurance programs, supports research organizations, and facilitates various types of overseas technical and cooperation training programs. Lately, MITI has assumed a role in encouraging imports of foreign products into Japan.
- **Missile Technology Control Regime:** Purpose of the MTCR is to limit the proliferation of missiles “capable of delivering nuclear weapons,” to increase regional stability, and to convey publicly the firm resolve of the partners to address this issue. In April 1987, Canada, France, Germany, Japan, the U.K., and the U.S. agreed to establish the MTCR. The regime expanded to include 23 countries, with the addition of Australia, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, and Switzerland. The MTCR does not have permanent organizations but convenes regular meetings to exchange information and coordinate member country stands. Under the MTCR, each member administers missile-related export controls independently. After the MTCR agrees that certain goods and technologies should be controlled for missile proliferation reasons, each member must implement the controls in its own domestic legislation. There is no international entity that oversees the implementation and enforcement of MTCR controls. Items and technology agreed by the MTCR partners to be controlled are listed in the MTCR Annex.
- **MTO:** See *Ministry of International Trade and Industry*.

- **MLB:** See *Mini landbridge.*
- **MO:** Money order.
- **Most Favored Nation (MFN):** Commitment that a country will extend to another country the lowest tariff rates it applies to any other country. All contracting parties undertake to apply such treatment to one another under Article I of GATT. When a country agrees to cut tariffs on a particular product imported from one country, the tariff reduction automatically applies to imports of this product from any other country eligible for most-favored nation treatment. This principle of nondiscriminatory treatment of imports appeared in numerous bilateral trade agreements prior to establishment of GATT. A country is under no obligation to extend MFN treatment to another country unless both are bilateral contracting parties of the General Agreement on Tariffs and Trade or MFN treatment is specified in a bilateral agreement.
- **M/T:** Metric Ton.
- **MTCR:** See *Missile Technology Control Regime.*
- **MTO:** See *Multimodal transport operator.*
- **Multi-Fiber Agreement:** International umbrella compact, authorized by the General Agreement on Tariffs and Trade (GATT), that allows contracting parties to negotiate bilaterally quantitative restrictions on textile imports (which normally would be considered contrary to GATT provisions) to the extent the importing country considers them necessary to prevent market disruption. The Uruguay Round Agreement on Textiles and Clothing contains an agreed schedule for the gradual phase-out of quotas established pursuant to the MFA over a ten-year transition period, after which textile and clothing trade will be fully integrated into the GATT and subject to the same disciplines as other sectors.
- **Multilateral Agreement:** International compact in which three or more parties participate.
- **Multimodal transport bill of lading:** Bill of lading used for carriage whenever there are at least two different forms of transport, such as shipping by rail and by sea.
- **Multimodal transport operator (MTO):** Carrier who concludes multimodal transport contracts; i.e. contracts involving transport by more than one mode of carriage, and for which the MTO accepts liability as a carrier.
- **Multiple exchange rate:** Several countries operate systems by which different exchange rates are used for different transactions.
- **M/V:** Motor vessel.

N

- **N/A:** Not applicable.
- **NAFTA Origin:** Enter "MX," "CA," or "US" for textile and agricultural goods exported to a NAFTA country. For all other items, enter "MX," "CA," or "US" if the goods originate in that NAFTA country (per Annex 302.2, and if subsequent processing in another NAFTA country does not increase the transaction value of the items by more than seven percent). If

the item results from a joint production between Mexico, Canada, or the U.S., enter "JNT" (for co-production).

- **NCND:** See *Non-circumvention non-disclosure agreement.*
- **NCV:** No commercial value.
- **ne:** Not exceeding.
- **Negotiable instrument:** Written document that can be used to transfer the rights embodied in it by mere delivery (in the case of instruments made out to bearer) or by endorsement and delivery (in the case of instruments made out to order). Some instruments, such as the bill of exchange and the cheque, are negotiable unless their negotiability is explicitly excluded while the bill of lading is negotiable only if made negotiable by the shipper.
- **Negotiable B/L:** Original Bill of Lading endorsed by shipper that is used for negotiating documents with bank.
- **Net Cost:** For each item that is subject to a "regional value content" requirement (RVC), enter "NC" if the RVC is calculated according to the Net Cost method; enter "NO" if the RVC is calculated by some other method.
- **Net weight:** Weight of the goods being shipped not counting packaging Compare gross and tare weight.
- **Neutral body:** Neutral party used to police the practices of members of the conference.
- **N/F:** No funds.
- **NGO:** See *Non-governmental organization.*
- **No license required (NLR):** Based on classification of item within the EAR, the exporter has determined that the export may be conducted without the need for an export license or the need for a license exception.
- **Nomenclature of the customs cooperation council:** Customs tariff used by many countries worldwide, including most trading nations. Compare *Standard industrial classification, Standard international trade classification.*
- **Non-circumvention non-disclosure agreement (NCND):** Type of contract frequently requested by international broker or middlemen in order to prevent buyers form trying to go around the broker to deal directly with suppliers. Although many of these agreements are said to be "issued pursuant to ICC Rules – such ICC rules are nonexistent.
- **Non-conference carrier:** Independent ocean carrier who does not belong to any group or conference of ocean carriers and who establishes their own pricing and policies.
- **Non-governmental organization (NGO):** Generally applied to private sector nonprofit organizations that contribute to development in developing countries through such activities as development cooperation projects, financial aid, material aid, the dispatch of personnel, the acceptance of trainees, and development education. In this context, NGOs are accredited by the United Nations or its specialized agencies and can lobby and do business with them.
- **Non-negotiable:** Document that cannot be used to claim title to the cargo. Most important: Air waybills are always non-negotiable.

- **Non-negotiable B/L:** Copy of original Bill of Lading which cannot be negotiated with bank.
- **Non-tariff barriers:** Measures other than tariffs imposed by governments which restrict imports with or without the intent to do so. Such barriers have become more prevalent since the end of World War II. Since that time, tariff rates have declined significantly while other forms of protection, such as licensing and quotas, have risen.
- **Non-vessel-operating common carrier (NVOCC):** Firm which consolidates and disperses international containers that originate at, or are bound for, inland ports. They carry the same obligations and liabilities as traditional steamship lines but do not, themselves, own or operate ships.
- **NOS:** Not otherwise specified.
- **Nostro account:** Bank account held in by a bank with its foreign correspondent bank, in the currency of that foreign country.
- **Notify party:** Name and address appear in a bill of lading, who is to be notified by the shipping company of the arrival of goods at the discharge port. There is normally a box on the bill of lading where the details of the notify party are inserted.
- **N/S/F:** Not sufficient funds.
- **NSG:** See *Nuclear suppliers group.*
- **Nuclear suppliers group (NSG):** Organization of nuclear supplier nations, which coordinates exports of nuclear materials and equipment with the International Atomic Energy Agency (IAEA) inspectorate regime. The reason for creating the NSG was to allow member states some flexibility in controlling items to non-nuclear weapons states. The NSG's independence from the NPT enables NSG to enlist the cooperation of supplier states that are not signatories to the NPT and thus not involved in the nuclear export control activities of the Zangger Committee. It requires the imposition of safeguards on exports of nuclear technology in addition to nuclear materials and equipment. The NSG developed a multilateral list for national adoption of export controls on dual-use commodities with a nuclear application.
- **NVOCC:** See *Non-vessel-operating common carrier.*

O

- **O/A:** See *Open account.*
- **OBL:** Original bill of lading.
- **Ocean bill of lading (B/L):** Receipt for the cargo and a contract for transportation between a shipper and the ocean carrier. It may also be used as an instrument of ownership which can be bought, sold, or traded while the goods are in transit. To be used in this manner, it must be a negotiable "Order" Bill-of-Lading. A *Clean Bill-of-Lading* is issued when the shipment is received in good order. If damaged or a shortage is noted, a clean bill-of-lading will not be issued. An *On Board Bill-of-Lading* certifies that the cargo has been placed aboard the named vessel and is signed by the master of the vessel or his representative. On

letter of credit transactions, an On Board Bill-of-Lading is usually necessary for the shipper to obtain payment from the bank. When all Bills-of-Lading are processed a ship's manifest is prepared by the steamship line. This summarizes all cargo aboard the vessel by port of loading and discharge. An *Inland Bill-of-Lading* (a waybill on rail or the "pro forma" bill-of-lading in trucking) is used to document the transportation of the goods between the port and the point of origin or destination. It should contain information such as marks, numbers, steamship line, and similar information to match with a dock receipt.

- **OCP:** See *Overland common point.*
- **Offset:** Type of countertrade transaction. In an offset contract, which may be required by importers' governments as a condition for approval of major sales agreements, the exporter makes an additional agreement to buy goods and services from the importer's country. In a "direct offset" transaction, an exporter may be required to establish manufacturing facilities in the importing company or to use a specific percentage of the components in the product sold from the importer's country. In an indirect offset, an exporter may be obliged to buy goods or services from the importing country without any link to the product sold. See *Countertrade*.
- **O/N:** Order notify.
- **O/o:** Order of.
- **OP:** Open policy.
- **On board bill of lading (B/L):** Ocean bill of lading in which a carrier certifies that goods have been placed on board a certain vessel.
- **On-carriage:** Inland freight movement and cost on the buyer's side.
- **Open account (O/A):** Trade arrangement in which goods are shipped to a foreign buyer without promise of payment. The obvious risk this method poses to the supplier makes it essential that the buyer's integrity and the buyer's country's stability be unquestionable.
- **Open account trading:** Exporter allows buyer to pay a specified time after receiving the shipment.
- **Open insurance policy:** Marine insurance policy that applies to all shipments made by an exporter over a period of time rather than to one shipment only.
- **Opening bank:** Bank that opens a letter of credit as the request of an importer.
- **OPIC:** See *Overseas private investment corporation.*
- **Order bill of lading (B/L):** Bill of lading made out to the order of the shipper (also called a negotiable bill of lading).
- **Original bill of lading (B/L):** Bill of lading that bears the original signature of the master of a ship or his agent.
- **OR:** Owner's Risk.
- **ORB:** Owner's risk of breakage.
- **ORF:** Owner's risk of fire.
- **ORL:** Owner's risk of loss (or leakage).

- **Origin receiving charges:** Loading charges at origin point. See TRC.
- **Originator (name & address):** Where the invoice is completed on behalf of a company, the name and address of the company must be indicated. The name of the person completing the invoice may also be indicated. Invoices completed on behalf of individuals must indicate the name and address of the person completing the invoice. This field may be left blank if this information is provided elsewhere on the invoice.
- **ORM:** Other Regulated Material Consumer commodities shipped within the U.S. are classified as ORM-D.
- **Overland common point (OCP):** Term stated on bill of lading offering lower shipping rates to importers east of the Rockies provided merchandise from the Far East comes in through the West Coast Ports.
- **Overpack:** Enclosure that is used by a single consignor to provide protection or convenience in handling of a package or to consolidate two or more packages. Examples of overpacks are one or more packages: (1) Placed or stacked onto a load board such as a pallet and secured by strapping, shrink wrapping, stretch wrapping, or other suitable means; or (2) Placed in a protective outer packaging such as a box or crate.
- **Overseas private investment corporation (OPIC):** Wholly-owned government corporation designed to promote private U.S. investment in developing countries by providing political risk insurance and some financing, including project financing.

P

- **Package:** Packaging plus its contents.
- **Packaging:** Receptacle and any other components or materials necessary for the receptacle to perform its containment function in conformance with the minimum packing requirements of 49 CFR or the ICAO/IMDG regulations.
- **Packing group:** Grouping according to the degree of danger presented by hazardous materials. Packing Group I indicates great danger; Packing Group II, medium danger; Packing Group III, minor danger.
- **Packing list**: List showing the number and kinds of items being shipped, as well as other information needed for transportation purposes as well as types of packaging.
- **Pallet:** Flat support of wood or steel on which goods can be stacked and which can be easily moved by forklift trucks.
- **Paramount clause:** Clause in a bill of lading or charter party invoking coverage by the Hague Rules, Hague-Visby Rules, or by the particular enactment of these rules in the country with jurisdiction over the counteract.
- **P/A:** Power of attorney.
- **PA:** Particular average.
- **Parcel post receipt:** Postal authorities' signed acknowledgment of delivery to receiver of a shipment made by parcel post.

- **Parties to transaction:** Check "related" if transaction is between a USPPI and foreign buyer when, at any time during a fiscal year, one of the parties owns 10 percent or more of the other party's voting securities if incorporated or equivalent if unincorporated. Otherwise, check "Non-related."
- **Passenger-carrying aircraft**: Aircraft that carries any person other than a crewmember, company employee, an authorized representative of the United States, or a person accompanying the shipment.
- **PD:** Port dues.
- **PEFCO:** See *Private export funding corporation.*
- **Performance bond (guarantee):** Bond or guarantee which had been issued as security for one party's performance: if that party (the principal) fails to perform, the beneficiary under the bond/guarantee may obtain payment. A performance bond may be of either the demand or conditional variety, which means that the beneficiary may or may not be required to prove default by the principal in order to obtain payment.
- **Per diem:** Costs per day. Charge on containers held by customers for an extended time; charges levied upon a trucker due to late return of equipment.
- **Perils of the sea:** Marine insurance term used to designate heavy weather, stranding, lightning, collision, and sea water damage.
- **Person:** Individual, corporation, company, association, firm, partnership, society, joint stock company; or a government, Indian tribe, or authority of a government or tribe offering a hazardous material for transportation in commerce or transporting a hazardous material to support a commercial enterprise.
- **PHMSA:** See *Pipeline and Hazardous Materials Safety Administration of the U.S. Department of Transportation*
- **Phytosanitary inspection certificate:** Certificate, issued by the U.S. Department of Agriculture to satisfy import regulations for foreign countries, indicating that a U.S. shipment has been inspected and is free from harmful pests and plant diseases.
- **P&I Club:** Protection and Indemnity Club, ship-owners' insurance association.
- **Pick up and delivery (PU&D):** Freight quote includes service of picking cargo up at shipper's premises and delivering it at consignee's premises.
- **Pier-topier (quay to quay):** Freight quote which only covers from export pier to import pier (excludes handling charges to bring cargo to and from piers).
- **Pilferage:** The act of stealing cargo.
- **Pipeline and Hazardous Materials Safety Administration of the U.S. Department of Transportation (PHMSA):** PHMSA is responsible for writing and enforcing the hazardous materials regulations in the United States.
- **P/N:** Promissory note.
- **POD:** Pay on delivery.
- **POD:** See *Port of discharge.* Also an acronym for Proof of delivery.

- **POR:** Port of origin.
- **POL:** Port of loading.
- **Political risk:** In export financing, the risk of loss due to such causes as currency inconvertibility, government action preventing entry of goods, expropriation or confiscation, and war.
- **Port of arrival:** Location where imported merchandise is off-loaded from the importing aircraft or vessel.
- **Port of departure**: In export, the final ocean port of aircraft where the shipment in the vessel or aircraft departs from the United States.
- **Port of discharge:** Port where goods are unloaded from vessel.
- **Power of attorney:** Legal authorization from a principal party given to a forwarding agent to act on their behalf to facilitate the export of merchandise out of the U.S., specifying the responsibilities to be carried out in accordance with U.S. laws and regulations.
- **Prepaid B/L:** Freight paid prior to movement; money to be paid prior to issuance of bill of lading.
- **P/H:** Pier to House (same as *CFS/CY*).
- **P/P:** Pier to Pier (same as *CFS/CFS*).
- **Ppd. (or P.P.):** Prepaid.
- **Pre-carriage:** Inland freight movement and cost on the seller's side.
- **Pre-license check:** Conducted to determine that dual-use items on an export license application are destined for a legitimate end-use by a reliable end-user. Firms or individuals representing the licensee (the applicant), the consignee, the purchaser, the intermediate consignee, or the end user may be subject to inquiries pertaining to the pre-license check. As part of the process, BIS forwards a cable to the U.S. embassy or consulate in the respective geographical location to conduct an inspection or meet with company representatives to conduct inquiries on behalf of BIS.
- **Pre-shipment inspection (PSI)**: Inspection of contract goods prior to shipment to ascertain their quality, quantity, or price.
- **Preference criteria:** For each item, enter the applicable NAFTA origin (preference) criterion. The NAFTA Rules of Origin may be found in the Agreement in Chapter 4, Annex 401, Annex 703.2 (agricultural), Annex 300-B Appendix 6A (textiles), and Annex 308.1 (data processing). At least one of the following criteria must be met for an item to receive preferential tariff treatment:

  A. The good is "wholly obtained or produced entirely" in the territory of one or more of the NAFTA countries, as referred to in Article 415.

  NOTE: The purchase of a good in the territory does not necessarily render it "wholly obtained or produced." If the good is an agricultural good, see also criterion F and Annex 703.2.

B The good is produced entirely in the territory of one or more of the NAFTA countries, and satisfies the specific rule or origin set out in Annex 401, which applies to its tariff classification. The rule may include a tariff classification change, regional value-content requirement or a combination thereof. The good must also satisfy all other applicable requirements of Chapter Four. If the good is an agricultural good, see also criterion F and Annex 703.2.

C. The good is produced entirely in the territory of one or more of the NAFTA countries exclusively from originating materials. Under this criterion, one or more of the materials may not fall within the definition of "wholly produced or obtained," as set out in Article 415. All materials used in the production of the good must qualify as "originating" by meeting the rules of Article 401 (a) through (d). If the good is an agricultural good, see also criterion F and Annex 703.2.

D. Goods are produced in the territory of one or more of the NAFTA countries but do not meet the applicable rule or origin, set out in Annex 401, because certain non-originating materials do not undergo the required change in tariff classification. The goods do, nonetheless, meet the regional value-content requirement specified in Article 401 (d). This criterion is limited to the following two circumstances:

D1. The good was imported into the territory of a NAFTA country in an unassembled or disassembled form but was classified as an assembled good, pursuant to H.S. General Rule of Interpretation 2(a); or

D2. The good incorporated one or more non-originating materials, provided for as parts under the H.S., which could not undergo a change in tariff classification because the heading provided for both the good and its parts and was not further subdivided into subheadings, or the subheading provided for both the good and its parts and was not further subdivided.

NOTE: The criterion does not apply to Chapters 61 through 63 of the H.S.

E. Certain automatic data processing goods and their parts, specified in Annex 308.1, that do not originate in the territory are considered originating upon importation into the territory of a NAFTA country from the territory of another NAFTA country when the most-favored-nation tariff rate of the good conforms to the rate established in Annex 308.1 and is common to all NAFTA countries.

F. The good is an originating agricultural good under preference criterion A, B or C above and is not subject to a quantitative restriction in the importing NAFTA country because it is a "qualifying good" as defined in Annex 703.2, Section A or B (please specify). A good listed in Appendix 703.2.B.7 is also exempt from quantitative restrictions and is eligible for NAFTA preferential tariff treatment if it meets the definition of "qualifying good" in Section A of Annex 703.2.

NOTE: This criterion does not apply to goods that wholly originate in Canada or the United States and are imported into either country.

NOTE: A tariff rate quota is not a quantitative restriction.

✦ **Primary hazard:** Hazard class of a material as assigned in the §172.101 table of 49 CFR.

- **Private export funding corporation (PEFCO):** A corporation that lends to foreign buyers to finance exports from the United States.
- **Producer:** Enter the full legal name, address, country, and tax identification number (if known) of the producer of the goods. If more than one producers' goods are included on this Certificate, attach a list of the additional producers, including their legal name, address, country, and tax identification number (if known). If you wish to keep this information confidential, Canada & Mexico Customs will accept the notation "Available to Customs upon request." If the producer and exporter/vendor are the same, enter "Same as exporter"; if the producer is not known, enter "Unknown."
- **Producer (Column on NAFTA Certificate):** You are asked if you are the producer of the particular line item of product on the certificate. If you are, the answer is YES. If you are not the producer, then the answer should be: NO1 = I have knowledge that the goods are NAFTA originating NO2 = I have some sort of written affirmation from the producer that the goods are NAFTA originating NO3 = I have a NAFTA Certificate of Origin from the producer that the goods are NAFTA originating
- **Pro forma invoice:** Quotation in invoice form provided by a supplier prior to the shipment of merchandise, informing the buyer of the kinds and quantities of goods to be sent, their value, specifications, terms of sale and payment. Sometimes spelled Proforma invoice.
- **Promissory note:** Unconditional written promise to pay a specified sum of money on demand or at a specified date to, or to the order of, a specified person, or to bearer. Promissory notes are negotiable instruments and perform more of less the same function as an accepted bill of exchange.
- **PSI:** See *Pre-shipment inspection.*
- **PSV:** Post-shipment verification.
- **PU & D:** See *Pick up and delivery.*
- **Purchasing agent:** Agent who purchases goods in his/her own country on behalf of foreign importers such as government agencies and large private concerns.

Q

- **Quantitative restrictions:** Explicit limits, usually by volume, on the amount of a specified commodity that may be imported into a country, sometimes also indicating the amounts that may be imported from each supplying country. Compared to tariffs, the protection afforded by QR's tends to be more predictable, being less affected by changes in competitive factors.
- **Quay:** Solid structure alongside a navigable waterway, used for loading and unloading of ships. Think pier or wharf.
- **Quota:** Quantity of goods of a specific kind that a country permits to be imported without restriction or imposition of additional duties.
- **Quotation:** Offer to sell goods at a stated price and under specified conditions. See *Pro forma invoice.*

R

- **r & c.c.:** Insurance clause: riots and civil commotion; also s.r.c.c. – strikes, riots, and civil commotion.
- **Railway consignment note:** Freight document indicating that goods have been received for shipment by rail. See *Bill of lading.*
- **R/T:** Revenue Ton.
- **Rates:** Ocean rates are classified in many ways, here is just a sampling:
- **Class:** Grouping of articles.
- **Commodity:** Specific articles.
- **Arbitrary:** Fixed rate according to port to port.
- **Minimum:** Lowest charge.
- **Heavy lift charge:** Extra charge for cargo which needs extra or heavy equipment to load or unload, charge assessed for cargo over a certain length.
- **Charter:** Use of an entire vessel.
- **Ad valorem:** Based on value of cargo.
- **Refrigerated:** Cargo which requires refrigeration equipment.
- **Dangerous cargo**: Needs special handling or stowage.
- **On deck cargo:** Cargo which must be shipped on the deck of the vessel.
- **Refrigerated container (Reefer):** Specialized type of container with built-in diesel power generator, engineered for the transportation of refrigerated and perishable commodities.
- **Revenue ton:** Tonnage used to calculate freight rates as in ocean cargo.
- **Reciprocity:** Reduction of a country's import duties or other trade restraints in return for comparable trade concessions from another country. Reciprocity includes the lowering of customs duties on imports in return for tariff concessions from other countries; the negotiated reduction of a country's import duties or other trade restraints in return for similar concessions from another country.
- **Red clause:** Authorization in a commercial letter of credit authorizing the advising/negotiating bank to make a limited advance to the seller before the shipment to the buyer is made. Such advances can be made up to 100% of the shipment value. These advances enable the seller to procure supplies for manufacturing or shipment. Negotiations of Red clause credits are restricted to the bank making the advances in order to assure that proceeds from the shipment are used to repay the advances.
- **Reefer box/container/ship:** Refrigerated container or ship.
- **Reexport:** *For export control purposes:* the shipment of U.S. origin products from one foreign destination to another. *For statistical reporting purposes:* exports of foreign-origin merchandise which have previously entered the United States for consumption or into Customs bonded warehouses for U.S. Foreign Trade Zones.
- **Remitting bank:** Bank that sends a draft to an overseas bank for collection.

- **Representative**: See *Foreign sales agent.*
- **Retention of title (reservation of title) clause (ROT):** Contract clause whereby a seller declares his intention to retain title or ownership over the contract goods until payment by the buyer is complete.
- **Revocable letter of credit:** Letter of credit that can be canceled or altered by the applicant (buyer) or its bank after it has been issued. Compare *Irrevocable letter of credit.*
- **Revolving letter of credit:** Credit which can be drawn against repeatedly by the beneficiary; can take a variety of different forms, depending on whether the credit is limited in terms of time, number of possible drafts, maximum quantity per draft, or maximum total quantity.
- **Roll-on/roll-off (RoRo):** Combination of road and sea transport, where loaded road vehicles are driven on to a ferry or ship (roll-on/roll-off ship) and off at the port of destination.
- **RoRo:** See *Roll-on/roll-off.*
- **ROT:** See *Retention of title.*
- **Routed export transaction:** Routed export transaction is where the foreign principal party in interest (buyer) authorizes a U.S. forwarding or other agent to facilitate export of items from the United States. In a routed export transaction, the foreign principal party in interest authorizes a U.S. forwarding or other agent to prepare and file the export documents. The exporter (USPPI) must maintain documentation to support the information provided to the forwarding or other agent for preparing the documents and provide such forwarding or other agent with the following information to assist in preparing the export documentation:

  Name and address of the USPPI;

  U.S. principal party in interest's EIN;

  Point of origin (State or FTZ);

  Schedule B description;

  Domestic (D), foreign (F), or FMS (M) code;

  Schedule B Number;

  Quantity/unit of measure;

  Value;

  Upon request from the foreign principal party in interest or its agent, the Export Control Classification Number (ECCN) or sufficient technical information to determine the ECCN;

  Any information that it knows will affect the determination of license authority.

S

- **S.A.:** Abbreviation after names of corporations in French and Spanish-speaking countries. Société Anonyme (Fr.); Sociedad Anonima (Sp.).
- **SAD:** Single Administrative Document; European administrative document for intra-European trade.

- **S&C:** See *Shipper's load and count.*
- **S&T:** Shipper's load and tally.
- **S.R. & C.C.:** Strikes, Riot, and Civil Commotion. A type of coverage that may be added as an amendment to marine cargo insurance policies.
- **SCAC code:** Standard Carrier Alpha Code. Used to identify transportation companies.
- **Schedule B:** Refers to Schedule B, Statistical Classification of Domestic and Foreign Commodities Exported from the United States. All commodities exported from the United States must be assigned a ten-digit Schedule B number. Note: the first 6 digits of the Schedule B number are harmonized.
- **SD:** Short delivery.
- **S/D:** See *Sight draft.*
- **SDN:** See *Specially Designated Nationals.*
- **Sea waybill:** Transport document for maritime shipment, which serves as evidence of the contract of carriage and as a receipt for the goods, but is not a document of title.
- **Seals on containers:** Attached to locking device on container to prevent pilferage and to certify no tampering; made of steel by customs or carrier.
- **Service contract:** As provided in the Shipping Act of 1984, a contract between a shipper (or a shipper's association) and an ocean carrier (or conference) in which the shipper makes a commitment to provide a certain minimum quantity of cargo or freight revenue over a fixed time period, and the ocean common carrier or conference commits to a certain rate or rate schedule as well as a defined service level (such as assured space, transit time, port rotation, or similar service failures). The contract may also specify provisions in the event of nonperformance on the part of either party.
- **Shipper – Export trade:** The party (as between exporter and importer) who enters into a contract of carriage for the international transport of goods. The party receiving the goods (the importer or buyer) may be called the receiver or the consignee. Depending on the Incoterm chosen, either the exporter or importer (or middleman) can be the shipper.
- **Shipper's Export Declaration:** Form formerly required for most shipments. It was prepared by the shipper and indicates the value, weight, destination, and other basic information about an export shipment.It is *no longer accepted* by the U.S. Government for the purpose of reporting export information. Use of the Automated Export System (AES) is mandatory.
- **Shipper's load and count (SL & C):** Carrier's notation disclaiming responsibility for the quantity of the cargo's contents; the quantity declared is thus purely the shipper's statement. If there is a dispute because less than contract is delivered, the carrier whishes to be free from liability and the receiver will have to claim directly against the shipper or insurer.
- **Shipping paper:** Shipping order, bill of lading, manifest or other shipping document serving a similar purpose and prepared in accordance with the transport regulations.

- **Shipping Weight:** Shipping weight represents the gross weight in kilograms of shipments, including the weight of moisture content, wrappings, crates, boxes, and containers (other than cargo vans and similar substantial outer containers).
- **Ship's manifest:** Instrument in writing, signed by the captain of a ship, which lists the individual shipments constituting the ship's cargo.
- **Short delivery (SD):** Non-delivery of cargo at the intended port. When reported, will result in ship's agent sending a cargo tracer to see if the cargo has been misdelivered in another port (also short-landed cargo).
- **Short-form bill of lading (B/L):** Simplified B/L which contain s a reference to or an abbreviation of the carrier's full B/L or carriage conditions.
- **Short Supply Controls:** Commodities in short supply may be subject to export controls to protect the domestic economy from the excessive drain of scarce materials and to reduce the serious inflationary impact of satisfying foreign demand. Items that the U.S. controls for short supply purposes include petroleum and petroleum products, unprocessed western red cedar, and shipment of horses by sea. The controls are included in the Export Administration Regulations.
- **SIC:** See *Standard Industrial Classification.*
- **Sight draft (S/D):** Draft that is payable upon presentation to the drawee. Also known as *sight bill.* Compare *Date draft* and *Time draft.*
- **Sight letter of credit:** Beneficiary is entitled to present a sight draft or sight bill of exchange which is a call for immediate payment upon acceptance of shipping documents.
- **SITC:** See *Standard International Trade Classification.*
- **SL&C (Shippers Load and Count):** Shipments loaded and sealed by shippers and not checked or verified by the carriers.
- **Special Customs Invoice:** Official form usually required by U.S. Customs if the rate of duty is based upon the value and the value of the shipment exceeds $500. This document is usually prepared by the foreign exporter or his forwarder and is used by Customs in determining the value of the shipment. The exporter or his agent must attest to the authenticity of the data furnished.
- **S/N:** Shipping note.
- **Society for Worldwide Interbank Financial Telecommunications (SWIFT):** Cooperative organized under Belgian law, with headquarters in La Hulpe, near Brussels. SWIFT provides communications services to the international banking industry, including payments and administrative messages and, more recently, securities settlements. Traffic in 1991 was about 362 million messages. SWIFT is owned by the member banks — approximately 1,600 — including the central banks of most countries. The U.S. Federal Reserve is not a member, but participates in certain types of payments. Securities brokers and dealers, clearing and depository institutions, exchanges for securities, and travelers' checks issuers also participate in SWIFT. SWIFT was organized in 1973 and started operations in 1977.

- **Soft Currency:** Currency of a nation in which exchange may be made only with difficulty. Soft currency countries typically have minimal exchange reserves and deficits in their balance of payments. See: Hard Currency.
- **Special permit:** Document issued by the Associate Administrator of PHMSA permitting a person to perform a function that is not otherwise permitted under 49 CFR.
- **Specially Designated Nationals (SDN):** Office of Foreign Assets Control (OFAC), Department of the Treasury, implements and enforces financial and trade sanctions. FAC has the authority to include within the definition of the sanctioned government those individuals and entities that FAC has determined are owned by, controlled by, or acting directly or indirectly on behalf of the target government. Parties so identified are known as Specially Designated Nationals or SDNs. In practice, an SDN is a target government body, representative, intermediary, or front (whether overt or covert) that usually is located in a third country and functions as an extension of the sanctioned government. An SDN may also be a third-party company that otherwise becomes owned or controlled by the target government or that operates on its behalf. No criminal linkage is necessary. Ownership by, control by, acting on behalf of, or profiting from trade with the target government or country would suffice to qualify a person for designation.
- **Specific duty:** Duty based on some measure or quantity, such as weight, length, or number of units.
- **Specification packaging:** Packaging conforming to one of the specifications or standards for packaging in the transport regulations.
- **Spot exchange:** Purchase or sale of foreign exchange for immediate delivery.
- **Spot rate:** Rate of exchange quoted for purchases and sales of a foreign currency for immediate delivery and payment.
- **908-753-3900:** Akin to a demand guarantee or bank guarantee, generally used to assure performance or payment by the counterparty.
- **Standard industrial classification (SIC):** Standard numerical code system used by the U.S. government to classify products and services.
- **Standard international trade classification (SITC):** Standard numerical code system developed by the United Nations to classify commodities used in international trade.
- **908-753-3900:** In a country with a state trading monopoly, a trading entity empowered by the country's government to conduct export business.
- **STC (said to contain)/STW (said to weigh):** Notations on transport documents by which carriers give notice that they do not wish to accept responsibility for the accuracy of a shipper's declarations as to the content, weight, or quantity of a particular shipped. See Shipper's load and count.
- **Steamer guarantee:** See *Letter of indemnity.*
- **Steamship conference:** Group of steamship operators that operate under mutually agreed-upon freight rates between countries but not in the U.S.

- **Straight bill of lading:** Nonnegotiable bill of lading in which the goods are consigned directly to a named party.
- **Stevedore:** Terminal operator who facilitates the operation of loading and discharging vessels and other terminal activities.
- **Stripping:** Unloading goods from a container. See devanning, destuffing.
- **Stowage:** Placing of cargo in a ship's hold in such a fashion as to assure safe and stable transport.
- **Stuffing:** Loading goods inside a container.
- **Subsidiary hazard:** Hazard of a material other than the primary hazard.
- **Subsidy:** Two general types of subsidies: export and domestic. An export subsidy is a benefit conferred on a firm by the government that is contingent or exports. A domestic subsidy is a benefit not linked to exports, conferred by the government upon a specific industry or enterprise or group of industries or enterprises.
- **Substantial transformation:** Item is substantially transformed if it has a new name, use or character. Once an item has been substantially transformed, the country the item was transformed in becomes the new country of origin.
- **Surcharge:** Charges added to ocean freight, variously, for bunker (fuel), currency fluctuation, congestion, port detention, or extra risk insurance.
- **Surety bond:** Contract between principal and responsible third party (surety) that makes surety momentarily responsible for principals fulfillment of obligation to obligee (party who is protected).
- **Swap:** Trading of almost identical products (such as oil) from different location to save transportation coasts. See *Countertrade.*
- **SWIFT payment:** International electronic funds transfer via the system known as SWIFT (Society for World-Wide Inter-bank Financial Telecommunications) offered by most major banks.

T

- **Table of Denial Orders:** List of individuals and firms that have been disbarred from shipping or receiving U.S. goods or technology. Firms and individuals on the list may be disbarred with respect to either controlled commodities or general destination (across-the-board) exports. The list is published in the Export Administration Regulations.
- **Tare weight:** Weight of a container and packing materials without the weight of the goods it contains. Compare *Gross weight.*
- **Tariff:** Tax assessed by a government in accordance with its tariff schedule on goods as they enter (or leave) a country. May be imposed to protect domestic industries from imported goods and/or to generate revenue. Types include ad valorem, specific, variable, or some combination.

- **Tariff barrier:** Customs duties, which are one possible barrier to imports into a country by making them more expensive.
- **Tariff quotas:** Application of a higher tariff rate to imported goods after a specified quantity of the item has entered the country at a lower prevailing rate.
- **Tariff schedule:** Comprehensive list of the goods which a country may import and the import duties applicable to each product.
- **Technical name:** Recognized chemical name used in scientific and technical handbooks, journals, and texts. Examples of acceptable generic chemical descriptions are organic phosphate compounds, petroleum aliphatic hydrocarbons and tertiary amines. Unless specifically authorized, trade names may not be used as technical names.
- **Tenor (of a draft):** Designation of a payment as being due at sight, a given number of days after sight, or a given number of days after date.
- **Temporary Import Under Bond (TIB):** Procedure in which goods are imported without payment of duty, by posting a bond to guarantee that they will be exported.
- **Tender bond/guarantee:** Guarantee provided by a company responding to an international invitation to submit bids or tenders (as for a large construction project); the tender bond is submitted along with the tender; the tender bond is required with the purpose of discouraging frivolous bids and ensuring that the winning bidder will actually sign and execute the contract.
- **Terminal handling charge (THC):** Handling charges assessed for services rendered within container terminals or with respect to containers which will be processed through terminals. When delivery or pickup of the goods is expected to be at a container terminal, traders are well-advised to stipulate precisely which party will pay for all or part of the terminal handling charges.
- **Terminal Receiving Charges (TRC):** Loading charges at origin port of a steamship or NVOCC.
- **Terms of Sale ®:** Used to describe the Incoterms® 2000 terms. Now replaced with word "rules". See *Incoterms® 2010.*
- **TEU:** Twenty-foot equivalent units; a means of measuring the carrying capacity of container ships; e.g. a ship can be said to be capable of 3000 TEU's, which is roughly equivalent to saying it could carry 3000 standard containers.
- **THC:** See *Terminal handling charge.*
- **Through bill of lading:** Single bill of lading converting both the domestic and international carriage of a shipment. Compare Air waybill, Inland bill of lading, and Ocean bill of lading.
- **TIB:** See *Temporary Import Under Bond.*
- **Time draft:** Draft that matures either a certain number of days after acceptance or a certain number of days after the date of the draft. Compare Date draft and Sight draft.
- **TIR:** See *Trailer interchange receipts.*
- **TIR carnets:** Transport documents used to cover international transport shipment on road vehicles such as trucks/lorries. TIR Carnets, issued pursuant to the 1949 TIR Convention,

allow the truck or other vehicle to pass through all TIR-member countries without having to go through customs inspection until reaching the country of destination.

- **T/L:** Total loss.
- **TL:** Truckload.
- **TOFC:** See *Trailer on flat car*.
- **Trade acceptance:** Bill of exchange drawn by the seller/exporter on the purchaser/importer of goods sold, and accepted by such purchaser. See *Bill of exchange*.
- **Tramp vessel:** "Freelance" seagoing cargo vessel, available on a contract basis to carry cargoes to any given port. To be distinguished from liner ships, operating according to advertised routes, schedules, and rates.
- **Tramp steamer:** Ship not operating on regular routes or schedules.
- **Trailer Interchange Receipt (TIR):** Interchange receipt between trucker and carrier; document showing condition of container/equipment at the time of interchange.
- **Trailer on flat car (TOFC):** Containers with chassis loaded onto rail cars.
- **Transmittal letter:** Contains a list of the particulars of the shipment, a record of the documents being transmitted, and instructions for disposition of these documents. Any special instructions are also included.
- **Transportation and exportation entry:** See *Customs entries.*
- **Transshipment:** Transfer of cargo from one carrier to another.
- **Transaction statement:** Document that delineates the terms and conditions agreed upon between the importer and exporter.
- **Transaction value:** Value of the imported merchandise as determined by U.S. Customs officers for statistical purposes as well as to determine the amount of import duty This is the purchase price subject to certain additions and subtractions.
- **Transferable letter of credit:** Allows the beneficiary to make part of all of his credit payable to another supplier; used in middleman/brokerage contexts; distinguishable from back-to-back L/Cs because the transferable credit requires the knowledge and authorization of the importer (applicant/principal).
- **Transship:** To change carriers in a foreign port en route to a third port. Also used to refer to a country of transshipment as "We are shipping from Canada to Mexico, transshipping across the United States."
- **TRC:** See *Terminal Receiving Charges.*
- **Trimming:** Operation of shoveling and spreading, within the ship's hold, dry bulk cargoes such as cement, ore or grains, so as to avoid weight imbalances which might hinder the ship's handling or unloading.
- **Trust receipt:** Release of merchandise by a bank to a buyer in which the bank retains title to the merchandise. The buyer, who obtains the goods for manufacturing or sales purposes, is obligated to maintain the goods (or the proceeds from their sale) distinct from the remainder of his or her assets and to hold them ready for repossession by the bank.

U

- **UCC:** See *Uniform Commercial Code.*
- **UCP 500:** Uniform Customs and Practice for Documentary Credits, ICC Publication No. 500 the set of rules which govern international documentary credit practice. UCP 500 is generally considered contractually incorporated into the documentary credit transaction by virtue of a mention in the credit application form ; the UCP 500 may also have additional force as a trade custom, and in some countries UCP is even recognized as having legal effect generally. In other countries, the UCP 500 is complementary to national law and jurisprudence on documentary credits.
- **US Munitions List (USML):** identifies those items or categories of items considered to be defense articles and defense services subject to export control The Dept. of State, with the concurrence of Defense, designates which articles will be controlled. http://www.pmdtc.org
- **Ultimate Consignee:** Person located abroad who is the true party in interest, receiving the export for the designated end-use.
- **UNCITRAL:** United Nations Commission on International Trade Law. UN Agency based in Vienna, specializing in the development of model legal instruments and conventions in the area of international trade law. Most notable success is perhaps the so-called 1980 *Vienna Convention*, the Convention on the International Sale of Goods (CISG). Also, *UNCITRAL Rules for Arbitration*, which provides a procedural framework for international commercial arbitration but which, unlike, the ICC Rules, do not provide direct administrative supervision of the arbitral process.
- **UNCTAD:** United Nations Commission for Trade and Development UN Agency based in Geneva, which has developed numerous international instruments as regards trade with developing or transition economies. Notably, UNCTAD house the ITC (International Trade Center), a developer of useful guides and manuals for small to medium-sized exporters.
- **UNECE:** United Nations Economic Commission for Europe.
- **Unfair calling insurance:** Insurance coverage to protect principals who have issued demand guarantees or bonds against an unfair or abusive call of the bond/guarantee (i.e. one which is not truly based on non-performance by the principal).
- **Unidroit:** Institute for the Unification of Private Law. International governmental organization headquartered in Rome. Administrative organization of treaties, conventions, model instruments, and legal guides and research.
- **Uniform Commercial Code (UCC):** The codification of American commercial law, followed in more or less uniform fashion by the US states. Article 5 of the UCC deals with letters of credit.
- **United States Department of Agriculture (USDA):** Government agency which regulates functions of specific imported merchandise, e.g., plants and plant products, domestic animals, serums and by products, etc.
- **United States principal party in interest (USPPI):** Party in the United States who gains the primary benefit, monetary or otherwise, from the international transaction. Typically,

but not necessarily, this is the party who has sold the goods to a foreign buyer and will be compenstated in some manner by that foreign buyer even though the US seller may not be directing the export of the goods.

- **Unz Transaction Number:** Number assigned by the UnzHazmat® program to give you yet another point of reference to the transaction and as a database management tool for the software application.
- **Usance draft (usance bill):** Time draft; written demand for a payment which comes due as a specified future date.
- **USDA:** See *United States Department of Agriculture.*
- **USPPI:** See *United States principled party of interest.*
- **USML:** See *US Munitions List.*

V

- **Validated Export License:** Document issued by the US Government authorizing the export of commodities for which written export authorization is required by law. Compare *General Export License.*
- **Value Added Tax (VAT):** Indirect tax imposed on consumption that is reflective of the incremental increases on the value of goods throughout the chain of production, from the raw material phase to final consumption A tax which is assessed at each stage of production on the amount of value contributed at each stage to the final product.
- **VAT:** See *Valued Added Tax.*
- **Vienna Convention:** 1980 Vienna Convention on the International Sale of Goods, also known as the United Nations Convention on Contracts for the International Sale of Goods (CISG) is a treaty offering a uniform international sales law that, as of August 2010, has been ratified by 76 countries that account for a significant proportion of world trade, making it one of the most successful international uniform laws. Turkey is the most recent state to have ratified the Convention. Amounts to a virtual commercial code for international sales transactions, but excludes contracts for services, securities, electricity, and some others; parties may be able to "opt out" of coverage by the Vienna Convention by explicitly stating so in the contract of sale.
- **VIN/Product Number:** For used self-propelled vehicles, report the following items of information as defined in 19 CFR 192.1:
  - (i) Vehicle Identification Number. Report the unique Vehicle Identification Number (VIN) in the proper format;
  - (ii) Product Identification Number. Report the Product Identification Number (PIN) for those used self-propelled vehicles for which there are no VINs;
  - (iii) Vehicle title number. Report the unique title number issued by the Motor Vehicle Administration; and iv. Vehicle title state. Report the 2-character postal abbreviation for the state or territory of the vehicle title.

W

- **W:** Tonne of one thousand kilograms.
- **WA:** See *With average.*
- **War Risk:** In marine insurance, damage or loss sustained as the result of acts of war. Usually written in a separate policy against current war like acts as well as former war leftovers, such as floating mines not detected, etc. War risk is not included in an all risk policy, but can be added by endorsement. Separate premium is usually paid.
- **Warehouse entry:** Customs Entry permitting goods to enter a bonded warehouse.
- **Warehouse withdrawal:** Customs Entry permitting goods to leave a bonded warehouse.
- **Warehouse receipt (WR):** Receipt issued by a warehouse listing goods received for storage.
- **Warehouse-to-warehouse clause:** Insurance coverage of international cargo from export warehouse to import warehouse; coverage may also be substantially extended or limited according to time.
- **WFG:** See *Wharfage.*
- **Wharfage (WFG):** Charge assessed by a pier or dock owner for handling incoming or outgoing cargo.
- **Wharfinger:** Personnel in charge of receiving and registering goods in a port on behalf of the carrier. Wharfinger's signature of the shipping note assures the shipper that it can proceed to draw up bills of lading pursuant to the terms of the note. (Also known as wharf inspector, wharf superintendent, dock superintendent).
- **World Trade Organization (WTO)**: The only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The goal is to help producers of goods and services, exporters, and importers conduct their business http://www.wto.org/

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ABOUT THE AUTHOR



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Dr. R. Amuthan is the Professor in Finance area and worked as the Director of Stand-alone Management Institution for about 6 years. Currently, he is the Professor and Principal of Excel Business School, Komarapalayam. Besides, he is the practitioner in Financial Services area and he is the empaneled member of Securities Exchange Board of India and Indian Institute of Corporate Affairs, New Delhi for propagating Financial Education and registered GST Practitioner certified by Central Board of Indirect Taxes and Customs, New Delhi, Government of India. Adding fuel to the flames of his financial acumen, he has founded a start-up named ARA Corporate Services, based in Coimbatore (Regn No. TN03D0069446) in order to consult Goods and Service Tax Returns, assisting MSMEs for want of availing capital and business subsidies, consultancy on Export Credit Risk Management and Financial Planning. He is holding Ph.D. in Management, CMA (Inter), 20 research publications and his books titled “Financial Derivatives” and “International Trade Finance” have been the proof of the fact to project his leadership in Management Education particularly in Finance domain.

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