FOREIGN EXCHANGE MANAGEMENT

UNIT – 1

Introduction - Foreign trade and Foreign Exchange - Balance of payments

Meaning of Foreign Trade:

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 in recent centuries.

Definition:

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".

Meaning of Foreign Exchange:

It determines the value of foreign investment. A Volatile Exchange Rate discourages Foreign Investment as does a high stable one.

A Low Stable Exchange Rate however encourages foreign investment but at the price of the low valid currency economy.

Definition:

Foreign Exchange Market is market where the buyer and seller are involved in the buying and selling of the foreign currency. The transfer function is performing through a use of credit instruction such as Bank draft, Bills of Foreign Exchange and Telephone Transfer.

Features of international Trade:

1) **Regional differences:**

There is uneven distribution of natural resources. Cost of production varies from country to country. A country with abundance of manpower may sell labour intensive item at a lower price.

2) **International Issue:**

International trade involves a study of two fields:

- The study of International Trade in product.
- The study of International Monetary Fund.

The **International Trade** analyses his focus on those real transaction which involve in a physical movement.

The **Study of International Monetary** set up involves financial transaction of a country.

3) **The Economic integration of Nation:**

It is increasing the scope of international trade. The inter dependent of economics makes them sensitive to the international happening. The international happenings influence the domestic economy of a country in different ways.

4) **Changing international business environment:**

No economy can be design its monetary policy without taking outside economic environment into consideration.

5) **Debatable field of international trade:** The field of international trade has become more debatable in recent years, with new views emerging on trade policy, exchange rate determination and the international co-ordination.

6) **Loss of Sovereignty of nation:**

The increasing interdependent among various countries demand every country to watch the imprecations of other policy on its market.

7) **Impact of international trade on country's domestic economy:**

The impact of interdependent of nations on a country's domestic economy also falls within the preview of international trade.

Different Between Domestic Trade and International Trade:

S.NO	DOMESTIC TRADE	INTERNATIONAL TRADE
1	It is exchange of goods and services within national border.	It is exchange of goods and services across national border.
2	Only one country is involved.	Two or more countries are involved.
3	All firms have the some pattern of interest, inflation and tax system.	Firms have different interest rate, inflation and tax rate in different country.
4	It increases employment and improve specialization with the country.	It helps to improve international specialization and cause raise in global, employment.
5	Transactions are settled in domestic currency.	Payments have to be made in the currency of the exporter or some acceptable foreign currency.
6	There are no restrictions in case of domestic Trade.	Countries can impose restriction in case of this trade.
7	There are no trade barriers.	Many countries impose tariff and non-tariff barriers in case of both import and export.
8	There is better mobility of factors of production.	Mobility of factors of production comparatively loss.
9	The market size is smaller and therefore growth opportunities are limited.	The market size is very large and growth potential is very high.
10	Since the buyer and seller are located in the some country. They need to follow rules and regulation of that country alone.	Since the importer and exporter are located in different country they have to follow rules and regulation both the country.
11	Risks involved are comparatively less.	Risks involved are comparatively more.
12	Transportation costs are lesser, because goods are transported over short distance.	Transportation costs are more, because goods are transported over long distance.
13	The time involved in transportation and the possibility of spoilage is less.	The time involved in transportation and the possibility of spoilage is more
14	The major modes of transportation are by road and rail.	Transportation generally happens through sea or air.

15	It improves the social and economic welfare of the country.	It improves the social and economic welfare of the trading country.
16	Procedures and documentation involved are lesser.	Procedures and documentation involved are more and complex.

Advantages of international trade:

- It improves economic development. It helps them to increase production, employment, income and achieve higher growth.
- It makes available increase variety of goods and services. They can obtain product which are not produce in their home country.
- Countries produce and export those goods and services in which they have comparative advantages.
- It enables countries to fully use their natural resources.
- It can gain the benefit of economics of scale and achieve lower production cost.
- Countries might produce more goods than they require this excess production may result in fall in prices in their domestic market.
- Countries can specialize in the production of goods due to availability of raw material, skilled labour technology etc.
- Competition in international trade is more instance than in domestic product. The firm would improve their efficiencies and quality to win in foreign trade.
- Increased production result in higher employment benefitting the masses.
- It is helpful in attracting foreign investment. It results in inflow of fund technology and talent.
- It enables higher production, better productivity, increase in exports and employment. All these result in higher national income.
- There is better relationship between countries and increase co-operation between them.
- They focus on improving their technology to innovate new products and services in order to meet competitions.

Disadvantages of international Trade:

- The developing countries export this raw material to developed countries at cheap price to increase export they exploit their natural resources.
- Agricultural products are generally loser in international trade even if prices fall, demand does not increase.
- In case of international trade countries produce only those products in which they have comparative advantage. This causes the problem of in balance development.
- Countries compute with each other to capture a greater share of the world market. This leads to rivalry among countries.
- Though specialization provides many benefits and also affects industrial growth and employment.

- Countries with the desire to increase export keep increasing their production capacity. If the demand high they benefit. If the demand falls they incurve losses on their investment.
- Many economists state that the developing countries are negatively affected by international trade.
- Countries become dependent on other because of international trade. They do not aim to achieve self sufficiency.
- Due to international trade harmful product chemical may be imported. This may affect the health and welfare of the domestic population.
- It creates interdependent and interconnected between countries. Therefore economic problem faced by one country may spread to other countries affecting the entire world.
- Developed countries export product to developing countries at very low prices. Their objective is to without the domestic industries and controls the market. This is called dumping.
- Developing countries increasing import goods from the developed countries but their export are less. This lead to deficit in balance of payment.
- Some countries export most of their domestic production without considering domestic demand. This leads to price increases.

Difficulties involved in Foreign Trade:

Competition in international trade is very intent. Firms have to compete with large number of competitors from foreign countries. Language barriers pose a huge challenge. There are cultural differences among countries. Currency values keep fluctuating and may upset calculations of income, expenses and profit. Marketing practices and facilities differ among countries. The political and government environment poses serious challenge in international marketing.

Legal rules differ among countries and companies have to understand the change in rules. Since markets are separated by long distance transportation cost are high. Global warming and climate change poses serious challenge to international trade. Rise in terrorism poses serious economic risk and affect international marketing. Certain countries impose tariff and non-tariff barriers to protect their domestic producers.

Balance of Payment:

<u>Meaning:</u>

It is a record of all economic transaction between the residences of the country and the rest of the world during a specific period. It indicates the amount spent by a country in importing goods and services and money earned through exporting goods and services.

Definition:

According to **kindle Berger,** "the balance of payment of a country is a systematic record of all economic transactions concerning good; capital and services flows between its resident and resident of foreign countries".

Balance of Trade:

Meaning:

It refers to the difference between the value of goods exported and goods imported.

Balance of Trade = Export of Visible Item – Import of Visible Item

Definition:

According to **Bentham, "**Balance of trade of a country is the relation over a period between the value of her export and the value of her imports.

Difference between Balance of Trade and Balance of payment:

S.NO	BALANCE OF TRADE	BALANCE OF PAYMENT
1	It shows a country's export and import of the goods with the remaining world.	It is a statement that shows economic transaction by a country with the remaining world.
2	It is a narrow concept. It is a part of Balance of Payment.	It is a broad term. It includes Balance of Trade.
3	It includes only imports and export of goods.	It includes import and import of goods, services and capital.
4	It consider only visible item.	It consider both visible and invisible item.
5	Deficit in Balance of Trade can be met by balance of trade.	Deficit in Balance of Payment cannot be met by balance of trade.
6	It can be balance surplus or deficit.	Both the receipt and payment side also balances.
7	It is a component of current account of balance of payment.	It comprises of current and capital account.
8	It is only partial indicator of economic performance of a country.	It is a true and complete indicator of economic performance of a country.

Importance:

i. **Indicator of economic situation:**

Countries having long term favorable balance of payment position are considered to be economically strong. Countries having adverse balance of payment are considered to be economically weak.

ii. **Reflect economic change:**

Balance of payment position reselects the changes happening in the economic sector and the economic position of a country.

iii. **Indicates of foreign trade:**

It will help to understand the foreign trade of a country. Foreign trade policies of a country are based on knowledge of Balance of Payment.

iv. **Aids economic planning:**

It helps to know the extent of under spending or over spending of an economy.

v. **Information of foreign receipts and payments:**

The foreign receipts received by a country and foreign payment made can be known from the balance of payment.

vi. **Extent of dependency:**

In which it is dependent on foreign countries and international financial institution.

vii. **Knowledge of foreign investment:**

It shows the income earned by the foreigners on their investment. It also informs the income earned by the country and its nationals on their investment abroad.

viii. **Indicates nature and composition of international trade:**

It indicates the nature size, composition and direction of its foreign trade.

ix. **It aids in preparation of government policies:**

It helps to decide on foreign trade policies.

x. **Helps to understand and exchange rate movement:**

It helps to know the movement in exchange rate by studying the demand and supply of foreign currency.

xi. **Aids to explain change in money supply:**

It helps to understand a country's capacity to with stand external shocks due to financial flows between countries.

<u>Balance of Payments Equilibrium:</u>

The balance of payment of a country is in equilibrium if the demand for foreign exchange is exactly equal to its supply. There is neither surplus nor deficits. The sum of debit and credit from the current account and the capital account and the financial account is equal to zero.

If total receipt of a country or export is equal to its total payment (import), then it is Balance of Payment is in balance

B=R-P=O

B= Balance of Payments R= Receipts (Exports) P= Payment (Import)

<u>Balance of payments Disequilibrium:</u>

It occurs when receipt of a country is not equal to its total payment (import). The two types of disequilibrium:

- **Favorable Balance of Payment**
- **Unfavorable Balance of Payment**

Favorable Balance of Payment:

Total receipt is greater than total payment.

B=R-P>O

Unfavorable Balance of Payment:

Total receipts are lesser than total payment.

B=R-P<O

Types of Disequilibrium:

- **Structural Disequilibrium:**

It occurs when structural change in certain sector of the economy. Change in technology, taste, income, crop failure, bumper crop strikes.

- **Secular Disequilibrium:**

  It refers to long term disequilibrium in the balance of payment of a country due to secular economic trend. The developed countries have high income level which cost high demand.

- **Short term Disequilibrium:**

  They are caused by short term or temporary factors. For Example during brought period in a country import of food grains would increase. It would cause trade deficit and deficit in balance of payment.

- **Cyclical Disequilibrium:**

  It refers to disequilibrium cost by business cycle. During boom its imports would grow faster than export while recessions export growth more than import.

- **Fundamental Disequilibrium:**

  When there is persistent and chronic disequilibrium in the balance of payment of a country. The IMF (International Monetary Fund's) terms it as fundamental equilibrium.

<u>Causes of Disequilibrium in Balance of Payment:</u>

- **Economic Causes**
- **Political Causes**
- **Natural Causes**

Economic Causes:

- Stages of Economic Development
- Population Explosion
- Business Cycle
- Foreign Exchange Rate
- Inflation
- Change in consumer taste
- Influence of foreign culture
- Inability to compete
- Foreign Investment Outflows
- Resources scarcity

Political Causes:

- Political instability
- International relation

Natural Causes:

In case of natural calamities a country's production wood gets affected. It would not be able to export its goods to foreign market. This would cause adverse impact on its balance of payment.

Features of Balance of Trade:

The elements of balance of trade are exports and imports.

It shows the total value of goods exported and total value of goods imported by a country for a specific time period.

It considers only the value of visible goods exported and imported. It does not include services.

It is a narrow concept as compared to Balance of Payment.

Balance of trade can be favorable or unfavorable. Favorable balance indicates the surplus enjoyed by a country. Unfavorable shows a deficit balance.

Features of Balance of Payment:

It is a systematic record of receipts and payments of a country with other country.

Its relate to fixed period of time which is generally a year.

It includes all three items that is visible, invisible and capital transfer.

Receipts and payments are recorded on the basis of double entry system.

The double entry systems ensure that debit and credit sides of the accounts are in balance.

Whenever the total receipts and total payments do not balance there is need for necessary adjustment.

Balance of Payment includes receipts and payments of all government items and non government items.

Types of Balance of Trade:

- **Favorable Balance of Trade**
- **Unfavorable Balance of Trade**
- **Equilibrium Balance of Trade**

Favorable Balance of Trade:

It is a favorable of the value of goods exported by the country is higher than the value of goods imported.

For example, the value of goods exported is Rs.100 crores and value of goods imported is 90 crores the balance of trade is favorable. It is also known as trade surplus.

Exports > Imports = Favorable Balance of Trade

Unfavorable Balance of Trade:

It is unfavorable if the value of goods exported by the country is lesser than the value of goods imported.

For example the value of goods exported is 90 crores and the value of goods imported is 100 crores then the balance of trade is unfavorable. It is also known as trade deficit

Exports < Import = Unfavorable Balance of Trade

Equilibrium Balance of Trade:

It is in equilibrium if the value of goods exported is equal to the value of goods imported. It is also known as equilibrium.

Export = Import = Equilibrium Balance of Trade

Components of Balance of Payment:

Balance of Payments (BOP) = Current Account + capital Account + Official Reserve Transaction + Errors and Commission.

1) **Current Account:**

It consists of transaction in goods and services, income and current transfer.

It covers items of both visible and invisible trade and includes all transaction between resident and non-resident. It excludes capital or financial items current account includes.

Merchandise export and import:

It refers to imports of goods to India and Export of goods from India.

Invisibles:

It includes services like banking insurance, Education, Transportation etc.

It includes investment like remittances, receipts and payments on profit and dividend and interest on foreign loan and dividend.

It includes transfer like aid received or extended to foreign countries, donations to religions, transfer from migrant.

2) **Capital Account:**

It consists of inflow and out flow of money for investment and international grant and loan.

It includes foreign investment loans, banking capital and other capital.

Foreign Investment:

It refers investment made by non-residence in starting a new company, acquiring a company or investing in securities of companies in foreign market.

It can be foreign Direct Investment (FDI) and Foreign Port Folio Investment (FPI).

Loans:

It refers to borrowing from global financial institution or other countries.

It includes external assistant such as IMF, World Bank etc

It includes external commercial borrowing such as bond market, credit from export credit agencies.

It includes short term debt which is repayable within one year.

Banking Capital:

It includes assets and liabilities of commercial Bank, Non-Resident Deposit accounts and other financial institution.

Other Capital:

It includes any capital transaction which was not included in the above.

UNIT – 2

Exchange System – Exchange Rate System Prior to IMF and under IMF – External Value of Rupee – Convertibility of Rupee.

Meaning of Exchange rate system:

The Exchange rate system followed by a country can fall under either of the extreme. Fixed exchange rate and floating exchange rate.

Meaning of Fixed Exchange rate:

It refers to the system under the gold standard where the rate of exchange tends to stabilize around the mint par value.

Meaning of Floating Exchange Rate:

It refers to the system where the exchange rates are determined by the condition of demand for and supply of foreign exchange in the market.

Exchange Rate system prior to IMF:

IMF (International Monetary Fund)

Prior to the institution of IMF the international monetary system was following the fixed exchange rate system based on international gold Standard.

Over the years the gold Standard took three forms:

- **Gold Currency Standard**
- **Gold Bullion Standard**
- **Gold Exchange Standard**

Gold Currency Standard:

Gold Currency Standard or gold coin standard was the monetary system where gold coins of a definite weight and fineness circulated are the standard unit of currency. To a small paper currencies and coins of other metals like nickel and silver also circulated but they were freely convertible into Gold. Gold coins can be melted and used for industrial or other purposes.

The exchange rate system between two currencies was determined on mint parity that is the relative value of gold content of each country. The gold currency standard could survive up to 1914 because of many facilitating factors that prevailed up to the period. European government ceased to allow their currencies to be convertible either into gold causing the collapse of the gold standard.

Gold Bullion Standard:

During the First World War brought out the weakness of the gold standard. If the imports into it were met by export of gold, the entire gold reserve of any country would have been duplicated. After the war and international conference at Brussels in 1922 decided to reintroduce gold standard in a modified form. The result was the gold bullion standard. Under the gold bullion standard, paper currency re4placed gold coin.

Paper currency and other form of money were redeemable into gold at the fixed rate but only for large quantities. With the introduction of paper money. The purchasing power of money was discovered from the value of gold. Countries indulged in open market operation of offset gold movement thereby not allowing the gold money relationship to function. High tariff were imposed on imports. Many countries faced difficulty in repayment of war debt.

Gold Exchange Standard:

The great depression of 1930 showed the weakness of the gold standard. The British return to the gold standard from 1925 to 1931 was widely held responsible for the contraction of the British economy over this period. The general conference suggested gold exchange standard to conserve gold reserves. They were not expressed in terms of gold but in terms of foreign currency which was on gold standard.

Exchange Rate System under IMF:

The fixed exchange rate system with central place for US Dollar was the exchange rate system officially adopted when the international monetary fund was founded. Since 1970 IMF has much diluted role to play in the exchange rate arrangement of its member countries.

Original Scheme under IMF:

The original scheme of IMF therefore provided that,

a) Each member country should declare the external value of its currency in terms of gold and a currency pledged to gold most countries declared value of their currency in terms of gold and US Dollar. This was known as the par value of the currency.

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

c) Following the above the monetary reserve of member countries came to consist of gold and US Dollars. Thus US Dollar got the posion of reserve assets.

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

e) Members were force 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 advice a lower rate. However it had no power to reject the proposal.

f) The IMF granted short term financial assistance to its member to ride out their temporary balance of payment problems. For chronic problems the members were expected to use permanent solution like devaluation.

Working of the system:

- For the smooth running of the system the major industrialized countries other than the USA endeavourer to keep exchange rate changes to the minimum and maintain a common price level for tradable goods.

- On the other hand it had to follow a monetary policy that could provide a stable price level for tradable goods.
- It means that USA could obtain goods and services from abroad by mearly 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 reserve could be used for settlement of their international debts or that they could convert their reserves into gold.

Collapse of the system:

- For above 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 settlements of international debts.
- The reason can be attributed to the fact that increase in international liquidity depend upon the availability of gold.
- The other reason was the under importance given to a single country via, the US Dollar.

Smithsonian Agreement (snake in the tunnel)

The state of instability and confusion let other countries to devote immediate attention to the issue. Ten major industrialized countries of the world (**The USA, Canada, Britain, West Germany, France, Italy, Holland, Belgium, Sweden, and Japan**) which came to be known as the '**Group of Ten**' met at the Smithsonian building in Washington during December 1971 to solve the dollar crisis and to decide about the realignment of the currencies.

Under the agreement, known as the 'Smithsonian Agreement' which came into effect from December 20, 1971, the US dollar was devalued by 7.87% and the new dollar gold parity was fixed at USD 38per ounce instead of USD 35 fixed earlier.

The Smithsonian agreement also provided for a wider band of fluctuation in exchange rate.

The USA faced unprecedented balance of payment deficit for the year 1971 characterized by increased imports due to domestic boom.

Dollar continued to fall in the exchange market.

A number of countries tried to save the situation by purchasing dollar in large quantities. The situation was beyond repair by these methods and hence the USA devalued dollar for the second time on February 13, 1973.

Abolition of gold and emergence of SDR (SPECIAL DRAWING RIGHTS**):**

The turmoil in the exchange market continued.

The Dollar continued to fall the japans' yen and Deutsche mark emerged Strong.

Major currencies of the world continued to float. The committee of 20 which had 20 principal members both from developed and developing countries made a number of for-reaching recommendations on reforming the IMF system.

The major recommendations relate to the place of gold in the IMF system and the use of SDR.

The official price of gold war abolished in November 1975 putting an end to the gold era. The countries were free to purchase or sell for monetary reserve gold at the prevailing market price. SDR emerged as the international currency.

The USA advocated floating rates, while France was for fixed rates and return to par value.

Second Amendment of IMF Articles:

A major change in the IMF system was noticed with the second amendment to its Articles of agreement which came into effect from April 1, 1978.

Under the present arrangement every member is free to choose its own exchange rate system.

But every member should endeavor along with IMF and other member to ensure general stability of exchange rate system and orderly conditions in exchange markets.

The IMF has surveillance over the exchange rate policies of the members and it's free to put forward its frank opinion on such policies.

IMF Surveillance:

The IMF's articles of agreement call for it to overseas the international monetary system, including by excusing firm surveillance over its member countries exchange rate policies.

Under the articles each member country undertakes to collaborate with the IMF in it's to ensure orderly exchange arrangements and to promote a stable system of exchange rates.

More specifically member countries agree to direct policies toward the goals of orderly economic growth with reasonable price stability together with orderly underlying economic and financial conditions and to avoid manipulating exchange rates for unfair competitive advantages.

The regular monitoring of economic and associated provision of policy advice, that IMF surveillance involves can help signal dangers a head and enable members to act in a timely way to avoid trouble.

The IMF conducts its Surveillance in three ways:

- **Country Surveillance**
- **Global Surveillance**
- **Regional Surveillance**

Country Surveillance:

Which takes the form of regular (usually yearly) compretensive consultation with individual member countries about their economic policies with interim discussion as needed.

Global Surveillance:

This entails reviews by the IMF's Executive Bank of Global economic trends and development.

Regional Surveillance:

Under which the IMF examines policies pursued under regional arrangement the group of seven major industrial countries and **APEC (**The Asia Pacific Economic Co-Operation forum**).**

Plaza – Louvre Intervention Awards:

Even though floating rate has become the order of the day the events in 1980's have cent legitimacy to official intervention in the exchange rates. Between 1981 and 1985 the US dollar appreciated by over 50% supported by expensive fiscal policy and right monetary controls followed by US government. The situation brought out the importance of exchange rate on the economics and the need for active management of the exchange rate system on September 22, 1985 officials from group of five countries (G-5 Britain, France, West Germany, Japan and USA) met at plaza hotel in New York. After meeting the official from G-5 countries announced that they would intervenes jointly to reserve the dollar appreciation.

The continued depreciation of dollar needed some corrective measure as the competitiveness of others countries was getting affected. This resulted in another effort at exchange rate co-operation by G-5 countries. At the meeting held at Louvre in Paris February 22, 1987. G-5 co7untries along with Canada agreed to faster stability of exchange rates around then existing levels. The central Banks agreed for a set of larger Zones or exchange rate ranges, that they would defend using active foreign exchange intervention.

Current Exchange Rate Regimes:

Meaning:

IMF classifies the exchange rate policies of its member into ten categories on the basis of their flexibility and the existence of formal or informal commitment to maintenance of exchange rate path.

As on April 30, 2010 the exchange rate arrangements of its member countries were as under.

I. **Exchange arrangement with no separate Legal Tender (**12 countries**)**

Under this arrangement the currency of another country circulate as the sole legal tender. For adopting such regions implies the complete surrender of the monetary authorities' independent control over domestic monetary policy. A common currency shared by the member of a monetary or currency union is not included here. Instead the classification is made based on the behavior of the common currency.

II. **Currency Board Arrangement (**13 countries**)**

This is a monetary regime based on explicit legislative commitment to exchange rate. The domestic currency thus remains fully backed by foreign assets. The traditional central banking functions of monetary central and lender of last resort are eliminate leaving little scope for discretionary monetary policy.

III. Conventional peg (44 countries**)**

Pegging of a currency means fixing its value in terms of another currency or currencies. The external value of a pegged currency is not dependent upon any independent factor.

Pegging can be done in any of the following ways:

- Pegging to a major currency **e.g. Babrain dinar** is pegged to US Dollar.
- Pegging to a basket of currencies. The basket is formed from the currencies of major trading or financial partners and the weights reflect the geographical distribution of trade services or capital flows.
- Pegging to a standardized currency composite such as SDR.

Where no central rate is fixed the maximum and minimum of the exchange rate may be fixed within a narrow band of less than 2%.

The monetary authority strand ready to maintain the fixed parity through direct or indirect interventions.

- **Direct Intervention** takes the form of sale or purchase of foreign currency in the market.
- **Indirect Intervention** is done through aggressive use of interest rate policy imposition of foreign exchange regulations and intervention through other public institution.

IV. Stabilized Arrangement (24 countries**)**

This is similar to the conventional peg but without a policy commitment on the part of the countries authorities. The classification is made when it observed by using statistical tools that the spot exchange rate remains within a margin of 2% for 6 months are more as a result of official action and the exchange rate is not floating.

V. Pegged exchange rate within horizontal band:

This arrangement is similar to the conventional peg with the difference that the fluctuation permitted. The value of the currency is maintained within certain margin of fluctuation of atleast +-% around a fixed central rate.

VI. Crawling peg:

Under crawling peg the currency is adjusted periodically in small amount at a fixed rate maintain a crawling at a fixed rate maintain a crawling pay imposs constrain on monetary policy in a manner similar to a fixed peg system. This system is followed by Nicaragua, Uzbekistan and Bots wane.

VII. Crawl like arrangement:

This system companies the features of horizontal band with crawling peg. The central rates are adjusted periodically at a fixed rate. The commitment to maintain the exchange rate within the bank imposes certain constraints on monetary policy with the degree of policy independence being a function of the band width. Ethiopia and Kazakhstan are the countries following this system.

VIII. Floating:

It refers to manage float or dirty float in which the currency is normally floating by the monetary authority intervenes when the market fluctuation or violent to bring some order in the market.

IX. Free floating:

When the currency is under free floating its exchange rate is market determine. It aims to address this orderly market conditions. The EU, USA, UK AND SWITZERLAND are some of the countries who currencies are classified under their category.

X. Other manage arrangement:

This is a residual category used when the exchange rate arrangement does not meet the criteria for any of other categories.

External value of Rupee:

When India joined the IMF value of the rupee was declared as the equivalent of 0.268601 grams of fine gold.

In terms of pound-sterling the parity was fixed at Rs.1=1 sb.6p

Rupee was declared in June 1966 by and the purity rate of rupee was fixed at USD 0.133333 equivalents to a gold purity of 0.118489 grams of fine gold per rupee.

In December 1971 the Smithsonian Agreement brought some order in the turmoil and new system of central rates with a wider margin of 2.25% on either side of the fluctuation was introduced.

With effect from mach 1992 US Dollar was adopted as the intervention currency in place of sterling and rupee was partially floated.

40% of the inward remittance other than of capital account including remittance on account of export was converted at the official rate which was the rate based an reserve bank rate which foreign currency concerned.

The external value of rupee was made fully dependent on market forces with effect from March 1993. The official rate has now been abolished.

The exchange rate for rupee is calculated based on the market rate. Even the reserve bank rates are based on market rate.

Convertibility of Rupee:

In the present 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:

a) 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
b) There should not be any quantitative restriction on the repatriation of the currency.

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.

A currency is converted to effect remittance either from the country or into the country from abroad.

Remittances are broadly classified into two categories:

a) Those an current Account and
b) Those an capital Account

This classification is based on the current and capital account in the balance of payment.

Current Account Convertibility:

Rupee is now fully convertible on account fulfilling also the second condition for convertibility via no quantitative ceiling on remittance abroad through subject to certain regulation.

As a part of liberalization of foreign exchange transaction the reserve bank has entranced the discretionary powers for authorized dealers for making various remittances abroad.

As an affirmation of the convertibility of rupee on current account with effect from August 20, 1994. India moved over to Article VII status in the IMF.

IMF members accepting the obligation of Article VII undertake to reframe from imposing restriction on the making of payments and transfer for current international transactions or from engaging in discriminatory currency arrangement or multiple currency practices without IMF approval.

Advantages of currency convertibility:

1. **Encouragement to exports:**

An important advantage of currency convertibility is that it encourages exports by increasing their profitability. With convertibility profitability of exports increases because market foreign exchange rate is higher than the previous officially fixed exchange rate.

2. **Encouragement to import substitution:**

Since free or market determined exchange rate is higher than the previous officially fixed exchange rate, imports become more expensive after convertibility of a currency. This discourages imports and gives boost to import substitution.

3. **Incentive to send remittances from abroad:**

Thirdly, rupee convertibility provided greater incentives to send remittances of foreign exchange by Indian Workers living abroad and by NRI. Further, it makes illegal remittance such ‘hawala money’ and smuggling of gold less attractive.

4. **A self-balancing mechanism:**

Another important merit of currency convertibility lies in its self-balancing mechanism. When balance of payments is in deficit due to over-valued exchange rate, under currency of the country depreciates which gives boost to exports by lowering their prices on the one hand and discourages imports by raising their prices on the other.

5. **Specialization in accordance with comparative advantage:**

Another merit of currency convertibility ensures production pattern of different trading countries in accordance with their comparative advantage and resource endowment. It is only when there is currency convertibility that market exchange rate truly reflects the purchasing powers of their currencies which is based on the prices and costs of goods found in different countries.

6. **Integration of World Economy:**

Finally, currency convertibility gives boost to the inte-gration of the world economy. As under currency convertibility there is easy access to foreign exchange, it greatly helps the growth of trade and capital flows between the countries. The expan-sion in trade and capital flows between countries will ensure rapid economic growth in the econo-mies of the world. In fact, currency convertibility is said to be a prerequisite for the success of globalization.

Capital Account Convertibility:

In this budget speech for 1997-98 the union finance minister described capital account convertibility as the cherished goal of the government.

The reserve bank of India appointed in February 1997 the committee on capital account convertibility with **Mr. S.S Tarapore,** former Deputy Governor of RBI as its chairman. Tarapore committee defined capital account convertibility as the freedom to convert local financial assets with foreign financial assets and vice-versa at market determined rates of exchange.

Benefits of Capital Account Convertibility:

The Tarapore Committee mentioned the following benefits of capital account convertibility to India:

1. Availability of large funds to supplement domestic resources and thereby promote economic growth.
2. Improved access to international financial markets and reduction in cost of capital.
3. Incentive for Indians to acquire and hold international securities and assets, and
4. Improvement of the financial system in the context of global competition.

Accordingly, the Tarapore Committee recommended the adoption of capital account convertibility.

Preconditions for Capital Account Convertibility:

The Tarapore Committee recommended that, before adopting capital account convertibility (CAC), India should fulfill three crucial pre-conditions:

(i) Fiscal deficit should be reduced to 3.5 per cent. The Government should also set up a Consolidated Sinking Fund (CSF) to reduce Government debt.

(ii) The Governments should fix the annual inflation target between 3 to 5 percent. This was called mandated inflation target — and give foil freedom to RBI to use monetary weapons to achieve the inflation target.

(iii) The Indian financial sector should be strengthened. For this, interest rates should be folly deregulated, gross non-paying assets (NPAs) should be reduced to 5 per cent, the average effective CRR should be reduced to 3 per cent and weak banks should either be liquidated or be merged with other strong banks.

Apart from this thee essential pre-conditions, the Tarapore Committee also recommended that:

(a) RBI should have a monitoring exchange rate band of 5 per cent around Real Effective Exchange Rate (REER) and should intervene only when the RER is outside the band:

(b) The size of the current account deficit should be within manageable limits and the debt service ratio should be gradually reduced from the present 25 per cent to 20 per cent of the export earnings.

(c) To meet import and debt service payments, forex reserves should be adequate and range between $ 22 billion and $ 32 billion; and

(d) The Government should remove all restrictions on the movement of gold.

It was generally agreed that foil convertibility of the rupee, both on current account and capital account was a welcome measure and is necessary for closer integration of the Indian economy with the global economy.

Conclusion:

In a speech at RBI on March 18,2006, Prime Minister Dr. Manmohan Singh stated: “Given the changes that have taken place during the last two decades, there is merit in moving towards fuller capital account convertibility with a transparent framework… I will, therefore, request the Finance Minister and RBI to revisit the subject and come out with a roadmap based on current realities.” Promptly, within two days RBI constituted the “Committee on Fuller Capital Account Convertibility” with S.S. Tarapore again as chairman. This Tarapore Committee submitted its report in September 2006 (more commonly called the Second Tarapore Report or II).

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 place of instituting CAC without undertaking large and dramatic shift in a stone of macroeconomic policies

The following are considered important pre-condition for CAC.

- **A strong balance of payment position.**
- **The strengthening of financial system.**
- **Fiscal consolidation.**
- **Conduct of an appropriate exchange rate policy.**

Pre-conditions for CAC in India:

The committee stipulated pre-conditions in three important areas for Implementation CAC. They are

1. **Fiscal consolidation.**
2. **Mandated inflation rate.**
3. **Exchange rate policy.**

1. Fiscal consolidation:

The ratio central gross fiscal deficit to gross domestic production to be reduced from budgeted 4.5% in 1997-98 and further to 3.5% in 1999-2000 accompanied by a reduction in the status deficit.

2. a) Mandated Inflation Rate:

The inflation for the three year period (1997-2000) should be an average of 3-5 percent.

b) Strengthening of financial system:

Interest rates should be fully deregulated in 1997-98.

Implementation CAC should be implemented in three phase:

Phase I 1997-98, Phase II 1998-99 and Phase 1999-2000.

3. 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.

Adequacy of Reserves:

The following four indicators should be for evaluating the adequacy of Reserve:

- **i.** Reserve should not be less than Six Month of imports
- **ii.** Reserve should not be less than three months of imports plus 50% of debt service payment plus one month exports and imports.
- **iii.** The short term debt and portfolio stock should be lowered to 60%
- **iv.** The net foreign exchange asset to currency ratio should be prescribed by law at not less than 40 percent.

Narrow Bank:

The weak banks should be converted into Narrow Bank and the incremental resources of these narrow banks should be deployed only in government securities.

Risk of Convertibility:

Credit rating institutions will play a vital role in decision making by the investors. It exposes banks liabilities and assets to more price and exchange risks. Bank may supplement their domestic deposit base with borrowings from off share markets.

Fluctuation in interest rate may affect the cost of borrowings for emerging markets and alter the relative attractiveness of investing in these4 markets. Due to increased competition the margin for the banks may be reduced.

Implementation in India:

India is already moving towards capital convertibility through not at the speed envisaged by the committee.

The Reserve Bank and the government are progressively relaxing the conditions attracted to such areas as investment abroad. Investment into India and maintenance of foreign currency account by banks.

Thus, India is continuously moving towards convertibility of its currency on capital account.

Provision under FEMA:

The foreign exchange management Act 1999 which come into force with effect from June 2000 continues restriction on capital account transaction.

Section 6(2) provides that the Reserve Bank, in consolidation with the central Government specify the permissible classes of capital account transactions and the limit up to which foreign exchange share admissible for such transaction.

Committee and fuller Capital Account Convertibility:

The Reserve Bank of India appointed March 2006 a committee to set out the Roadmap towards fuller capital account convertibility under the chairmanship of **Mr. S.S Tarapore.**

It favors the move towards full capital convertibility to be achieved by 2011 to be implemented in three phrases.

Among other the committee has recommended further liberalization on remittances freeing of capital markets for non-resident 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 or borrowing from external markets and increasing external commercial borrowing units.

Unit – III

Exchange Control – Objectives – Methods – Foreign Exchange Management Act – Administration of foreign Exchange – Functions of Foreign Exchange Department.

EXCHANGE CONTROL

Meaning:

It is a process by which the government centralizes all foreign exchange operations within its preview through the central bank of the country and administers. Regulation pertaining to it so that the foreign exchange resources will be utilized carefully on the basis of priorities.

The Entire Foreign Exchange earned by the country's exporters has to be deposited with the Central Bank of the Country.

Under exchange control the private traders are not free to buy or sell foreign exchange in the desired quantities.

Objective:

There are several objectives in adopting exchange control by a country. Some of the important to objectives or the reasons for adopting exchange control are as follows:

1) When the government feels that the normal mechanism of free foreign exchange market may not be desirable or effective.
2) When there is a heavy run on the country's foreign exchange reserve due to heavy adverse balance of payments or due to outflow of capital on a large scale.
3) When the government wants to and thereby brings about economic development of the country.
4) When the government wants to secure adequate foreign exchange in order to buy essential goods from abroad.
5) When the government of a country wants to avoid fluctuation and maintain stable exchange rate exchange control will be adopted.
6) Exchange control is essential in a planned economy in which all economic activities of the country are controlled by the government.
7) Finally when the government wants to freeze the assets of the foreigner's particularly in times of war and prevent them from helping their own countries, exchange control in full measures will be adopted.

Methods of Exchange Control:

According to **Prof. Paul Eli zing** there are as many as 41 methods of exchange control. Generally the methods adopted can be classified under:

- **Direct Method**
- **Indirect Method**

Direct methods:

1) **Intervention:**

Intervention refers to the control in which all foreign exchange transaction is centralized with the government either through the Central Bank of the country or any government agency authorized for this purpose.

All those who have to make payments to foreigners will have to buy 'foreign exchange' from the central authority.

This method will enable the governments to centralize the entire demand and supply of foreign exchange resources. So, that it may prudently adjust the one with the other and utilize the scarce foreign exchange in a judicious manner.

The foreign exchange is rationed among the licensed importers for the import of very essential and indispensable goods needed for the country for sustenance and development.

2) **Exchange pegging:**

Intervention may also take from of exchange pegging which means the government intervened the foreign exchange market either to hold the value of the currency up or to hold it down.

When the government fixes the rate of exchange above the normal rate it is known as pegging up.

On the other hand if the government fixes the exchange rate below the normal market rate it is known pegging down.

Pegging up and pegging down are typical example of intervention by the government in order to exercise exchange control.

The policy of intervention aims at neutralizing the forces of demand and supply of foreign exchange resources.

When this method is adopted it has to be continued indefinitely and if it fails due to some reason or other, it has to be augmented by other direct method.

3) **Restriction:**

Restriction is more powerful and effective method of exchange control than intervention.

- The restriction may take three forms:

a) Al foreign exchange dealings are centralized with the central bank of the country.
b) The national currency may not be offered without the previous permission of the government.
c) All foreign exchange transaction should be made only through the agency of the government and any private dealings in foreign exchange will become illegal.

4) **Clearing Agreement:**

A country instead of adopting exchange control on 'unilateral' basis may be so on 'bilateral' basis with an agreement along with another foreign country. This is called clearing agreement.

5) **Standstill Agreement:**

Under this method the movement of capital between two countries is checked through a moratorium on outstanding short term foreign debts especially inter-bank debts.

6) **Transfer Moratoria:**

Under this method, the payment for imported goods or the interest on foreign capital is not made immediately, but after the lapse of certain period which will be predetermined by means of agreement between the two countries.

7) **Blocked Accounts:**

This is the logical outcome of the previous two devices mentioned via, standstill agreement and transfer moratoria. Blocked accounts are said to a rise when foreign debts paid by importers in domestic currency to their central bank cannot be remitted abroad.

The government imposes restriction on the banking accounts of foreigners who will not be allowed to withdraw money from them.

Indirect Methods:

There are certain indirect methods of exchange control.

The most important indirect method is quantitative restriction of the volume of imports through import quotas and imposition of tariff.

The imposition of tariff duties on imports leads to a rise in the prices of imports and therefore a decline in the demand for imports.

This will naturally give rise to lesser demand for foreign currencies and the rate of exchange will go up in favors of importing country which maintain the export at the same level.

Regulation of Bank rate is also one of the methods of influencing exchange rate in an indirect way.

When the bank rate is rate is raised by the government or central bank all other interest rates automatically follow the bank rate.

The indirect methods of exchange control have their limitation.

For instance, if the country imposes restriction on imports through tariff, other countries may also adopt similar method and prevent import into their countries and the desired results may not be achieved.

Merits of Exchange Control:

Exchange control is very indispensable for the country, particularly during the period of war.

During the war period, the country may have to import arms and ammunitions and other war materials on a very large scale.

This may turn the rate of exchange of the currency of the country very adverse.

Exchange control is also essential for a country on the way of economic development.

Countries on the course of economic development require large scale import of machines, raw materials, finished and semi-finished goods and also technicians.

This will result in the decline of the value of the currency.

Exchange control is useful in controlling the large scale movement of not money amongst the countries of the world.

Exchange control is enables for maintaining stability and smooth functioning of economy.

This enables the country to correct adverse balance of payments, adopt independent economic policy and arrest violent fluctuation in the foreign exchange rate and also avoid depressionary trend.

Disadvantages of Exchange Control:

Exchange control will result in the contraction of foreign trade, since the imports are deliberately curtailed through exchange control.

Exports too will also decline in the long run due to exchange control adopted by foreign countries.

Exchange control scarifies the principle of comparative cost only in free trade this is possible.

Administration of exchange control will become very expensive.

Finally the system of exchange control will become the source of corruption and it will encourage political and administrative favoritism nepotism and bribery etc.

Foreign Exchange Management Act – 1999(FEMA)

The Foreign Exchange Management Act (FEMA) 1999 had come into effect from June 1, 2000 replacing the Foreign Exchange Regulation Act (FERA).

The object of the new Act FEMA is facilitate external trade and payments and to promote orderly maintenance of the foreign exchange market in India.

Features of FEMA:

As against FERA, FEMA has substantially liberalized several things to facilitate external trade and payment.

The resident now going abroad for business purposes or for participating in conference / seminar need not seek the RBI's permission to avail themselves of foreign exchange up to 25,000Dollars per trip irrespective of the period of stay, the basic quota has been increased to 5000 Dollars from 3000 Dollar per calendar year.

The Exchange Earner's Foreign Currency (EEFC) account holders and Residents Foreign Exchange (RFE) account holders are permitted to freely use the fund held in EEFC/RFE Account for payment of all permissible current account.

The rules for foreign investment in India and Indian investment abroad are also made comprehensive and transparent.

The new Act repeats the old FERAQ but any offence committed under the old Act which is taken cognizance of by a court within two years from the repeal of FERA would be debt with under the provisions of the old Act as indicated earlier.

Further FEMA is a civil law unlike FERA.

Contravention under FEMA will be dealt with through civil procedures.

Application of FEMA may be seen broadly from two angles namely, capital account transactions and current account transaction, the former relates to capital movements, i.e. transaction in property and investment as well as lending and borrowings.

Meaning of FEMA:

The aims of this act is to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payment for promoting the orderly development and maintenance of foreign exchange market in India.

Definition:

1. **Adjudicating Authority:**

It means an officer authorized under sub-section 16, and "Appellate Tribunal" means the Appellate Tribunal for Foreign Exchange established under section 18.

2. **Authorized person:**

It means an authorized dealer, money changer, off-share banking unit or any other person for the time being authorized under sub-section (1) of section 10 to deal in foreign exchange or foreign securities.

3. **Bench:**

It means a bench of the Appellate Tribunal.

4. **Capital Account Transaction:**

It means a transaction which alters the assets or liabilities, including contingent liabilities. Outside India of personal resident in India or assets and liabilities in India of persons resident outside India and includes transaction referred to in sub-section (3) of section (6).

5. Chairperson:

It means the chairperson of the Appellate Tribunal.

6. Currency:

It includes all currency notes, postal notes, postal orders, money orders, cheques, drafts, travelers' cheque, letter of credit, bills of exchange and promissory notes, credit cards or such other similar instruments as may be notified by the Reserve Bank.

7. Current Account Transaction:

It means a transaction other than a capital account transaction and without prejudice to the generality of the foregoing.

8. Foreign Currency:

It means any currency other than Indian Currency.

9. Export:

It means

i. The taking out of India to a place outside India any goods
ii. Provision of services from India to any person outside India.

10. Foreign Exchange:

It means foreign currency and includes:

i. Deposits credit and balance payable in any foreign currency
ii. Drafts, travelers cheque, letter of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency,
iii. Drafts, traveler cheque, letter of credit or bills of exchange drawn by banks, institutions or person outside India but payable in India curry.

11. Foreign Security:

Foreign security means any security in the form of shares, stock, bonds, debentures or any other instrument6 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 Indian currency.

12. Indian Currency:

It means currency which is expressed or drawn in Indian rupees but does not includes special one rupee notes issued under section 28A of the Reserve Bank of India Act 1934.

13. Notify:

It means to notify in the official Gazette and the expression "Notification" shall be constructed accordingly.

14. Person:

It includes:

i. An individual
ii. A Hindu Undivided Family
iii. A company
iv. A firm
v. An association of persons or a body of individuals, whether incorporated or not
vi. Every artificial juridical person not falling within any of the preceding sub-clauses and

vii. Any agency office or branch owned or controlled by such person.

15. Person Resident in India:

It means a person residing in India for more than one hundred and eighty two days (182) during the course of the preceding financial year but does not include.

1) **A Person who has gone out of India or who stays outside India in either case:**
    a) For or on taking up employment outside India (or)
    b) For carrying on outside India a business or vocation outside India (or)
    c) For any other purpose in such circumstances as would indicate his intention to stay outside India for an uncertain period.
2) **A Person who has come to or stay in India in either case, otherwise than:**
    a) For or taking up employment in India (or)
    b) For carrying on in India a business or vocation in India (or)
    c) For any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period.

16. Security:

Security means shares, stocks, bonds and debentures.

17. Services:

It means services of any description which is made available to potential users and includes the provision of facilities in connection with banking, financing, insurance medical assistance, legal assistance, chit fund, real estate, transport, processing, supply of electrical or other energy, boarding or loading or both, entertainment amusement or the purveying of news or other information but does not include the rendering of any services free of charge or under a contract of personal services.

18. Specify:

Specify means to specify by regulation made under this Act and the expression "specified" shall be constructed accordingly.

19. Transfer:

It includes sale, purchase, exchange, mortage, pledge, gift, loan or any other form of transfer of right title, possession or lien.

Foreign Exchange Department (Administrative Set-up and Functions)

A Brief History of Exchange Control in India:

- Exchange control in India was first introduction at the outbreak of Second World War in September 1939 under emergency provision of the central Government under Defense of India Rules.
- The primary objectives of Foreign Exchange Regulation Act, 1973 (FERA) were as follows:

1. Conservation of Foreign Exchange resources of the country.
2. Ensuring that all foreign exchange accruing to the country were properly accounted for.
3. Ensuring proper utilization of the foreign resources of the country for the common good and economic development.

- The object of the new Act FEMA is to facilitate external trade and payment and to promote orderly maintence of the foreign exchange market in India.

- Foreign Exchange Management Act (FEMA) 1999 has been done in a separate chapter under “Exchange control in India”.

Authorized Person:

- ❖ Chapter III of the Act, covering section 10,11,12 deals comprehensively about “Authorized person ”, his duties responsibilities in carrying out the foreign exchange operation under the direction of RBI.
- ❖ The RBI has full power to issue necessary directors to the authorized person and also inspect the activities of the authorized persons.
- ❖ Anyone to become an “Authorized person” in foreign exchange should make an application for this purpose to the Reserve Bank of India. The RBI after examining all the aspects relating to the applicant will make him an authorized dealer to deal in foreign exchange or in foreign securities or money change.

Authorized Dealers and Foreign Exchange Dealers Association of India:

In India most of the work connected with Foreign Exchange for the benefit of customer will be done by selected banks who will be authorized dealers in foreign exchange.

Any Authorized dealer (firm or bank) in foreign exchange should strictly adhere to the regulation found in FEMA and also incorporate all the directions given by the RBI.

Regarding charging of commission by the authorized dealers and also quotation of rates etc. The authorized dealer cannot do anything independently. He has to comply with the rules of Foreign Exchange Dealers Association of India **(FEDAI)**

Foreign Exchange Dealers Association of India (FEDAI)

All Authorized dealers of foreign exchange have formed themselves into an association called which was established in the year 1958 with its head quarters at Mumbai.

There are local offices also in Bangalore, Chennai, New Delhi and Kolkata.

The activities and affairs of this association are managed by a managing committee at the Head office and also local committees in the regional offices.

The committees are represented equally by banks incorporated in India and outside India.

Functions of FEDAI:

1) Framing rules for the co-ordinate conduct of foreign exchange business in India. These rules include various aspects like hours of business, charges to be made for foreign exchange transaction quotation of rates to customer besides co-ordination interbank dealings.
2) Besides effecting interbank dealing in foreign exchange operation co-ordination with the Reserve Bank of India is essential.
   FEDAI under takes the work of effective co-ordination with the RBI in proper administration of exchange controls.
3) FEDAI undertakes the work of circulating information which is of interest to its member.

FEDAI acts as a clearing house for exchange information among members.

FEDAI provides a vital link in the administrative set up of foreign exchange in India. This is the mouth piece of all authorized dealers of foreign exchange in India.

Authorized Money changers:

In addition to authorized dealer in foreign exchange. The Reserve Bank of India has provided facilities for encashment of foreign currency for the tourists.

The RBI has granted limited licenses to well established firms, hotels and other organizations permitting them to deal in foreign currency notes, coins and traveler's cheques, subject to directions issued to them from time to time. These firms and organization are called "Authorized Money changers".

There are two categories of authorized money changers. Money changers may be a 'fully-fledged money changer' or a 'restricted money changer'.

The former **i.e.,** fully fledged money changer is authorized to undertake both purchase and sale transaction with the public.

The latter **i.e.,** Restricted money changer is authorized only to purchase foreign currency notes, coins and travelers cheque subject to the condition that all such collections are surrendered by him in turn to an authorized dealer in foreign exchange.

Functions of Foreign Exchange Department of a Bank (Authorized Dealer)

Since foreign exchange is a highly specialized business combined with shouldering onerous responsibility under the very nose of the Reserve Bank of India, only some selected branches of the bank will be entrusted with the task.

The authorized Banks will have a Foreign Exchange Department headed by a very senior executive of the bank who has in depth knowledge of all regulation relating to foreign exchange business.

The decision making process of the foreign exchange department will be done at the corporate level as the operation relating to foreign exchange department of the bank are combined and co-ordinate with several other activities related to foreign exchange.

The foreign exchange department of the bank will also be called International Banking Division.

The policy decision are taken and foreign exchange resources are managed at the corporate level, the actual dealing with the customers take place at the branches authorized for this purpose.

The Foreign Exchange Department at the central, zonal and overseas branches is divided into specific 'section' each undertaking a specialized activity.

Each bank will follow its own methods of classifying and dividing the section for the execution of the work.

<u>Sections of the Department Depending on the nature of work:</u>

i. **Exports Department:**
    - ❖ Making pre-shipment advances to the customer, who intend making export of goods to any foreign country.
    - ❖ Similarly post-shipment advances may also required by the exporters on several counts. They may require credit for publicity payment of port dues. Payment of ECGC premium, payment towards marine insurance premium etc.
    - ❖ Another function performed by the bank is executing Export guarantees in favors of overseas buyers. Performance guarantees is also extended in the care of export of capital goods and construction projects.

- ❖ Advising or confirming letters of credit is another important work of the section is export department.
- ❖ After exporting in due course the exporters has to receive the sale proceeds from the importer. This will be received through the bank of the exporters. Hence, the bank has to look into the bills for collections.

ii. Imports Department:

a) Opening Letters of credit:

- ❖ Opening letters of credit will be the primary work of imports departments to facilitate imports of commodities by the customers.
- ❖ A letter of credit is a signed instruction including an understanding by the authorized dealer in foreign exchange **(i.e., bank)** of the Indian importer to pay to the overseas seller a certain sum of money on presentation of the import documents evidencing shipment of the specified commodities and subject to compliance with the stipulated terms and conditions in the letter of credit.

b) Advance Payments:

- ❖ This is yet another work to be looked into by the section of the import department. Advance remittances for imports of goods are permitted by the authorized dealers (i.e., Bank)
- ❖ Remittance will be made direct to the supplier of goods. For this, the importer has to submit documentary evidence indicating the cost of the goods and also the insistence of overseas seller on advance payment.
- ❖ If the amount of advance remittance exceeds US Dollar 15,000/- a guarantee from an international bank of repute situated outside India should be obtained.

c) Foreign Inward Bills for Collection:

- ❖ This is another important work of the department which has to exercise due care. In the case of bills involving large value, the bank should check up the benefit particularly when the importer is not their customer.

iii. Department dealing with Remittance:

- ❖ This department is entrusted with the work of actual issue of Demand drafts, mail transfers, telegraphic transfer etc., after undergoing all formalities and clearance done in the other department of foreign exchange.
- ❖ This department is entrusted with the issue of Travelers, cheque encashment of traveler cheque, besides sale and encashment of foreign currency notes.
- ❖ This department has also to deal with non-resident Deposits as this will involve transfer of fund between countries, involving foreign exchange operations.

iv. Correspondent arrangement Activities:

- ❖ Since the sphere of activities relating to foreign exchange extend throughout the globe, it will not be possible for a bank which is an authorized dealer in foreign exchange to have branches all over the world.
- ❖ The Indian Bank will utilize the service of an American Bank for its transaction in places in America, where Indian Bank will not have branches.
- ❖ On behalf of Indian Bank and the transaction will be dealt with in US Dollar.

- ❖ In order to facilitate smooth functioning of these types of correspondent arrangement, the signatures of the authorized officials of the banks who will sign the documents and letters on behalf of the respective banks are exchanged between the banks.

Services between two banks under correspondent Relationship:-

- **a)** Collection of Bills, Cheques etc.
- **b)** Issue of demand Drafts, mail transfer Telegraphic Transfer and Travelers, Cheques.
- **c)** Arrangement for reimbursement on letters of credit issued by the bank.
- **d)** Advising / Confirming and amending letters of credit.
- **e)** Granting / guaranteeing of loans and overdrafts.
- **f)** Sales and purchase of foreign currencies
- **g)** Furnishing of credit information, such as report on business houses markets report etc.

- ➢ This type of one bank of a country having an account with the foreign bank in another country is called 'Nostro Account' and 'Vastro Account'.

Nostro Account:

It is an account maintained by a bank in India with a bank in a foreign country. For Example, if Bank of India maintains an account with Grind lays Bank London, it is Nostro Account. They will be called Nostro Account which means "our Account with you".

Vastro Account:

All foreign exchange transaction is routed through Nostro accounts. When a foreign bank has opened an account with Bank of India in 'Rupee'. It is called Vastro Account. Whenever Bank of India wants to refers to the foreign bank's account say grind lay's Bank, it will call it Vastro Account which means "your Account with us".

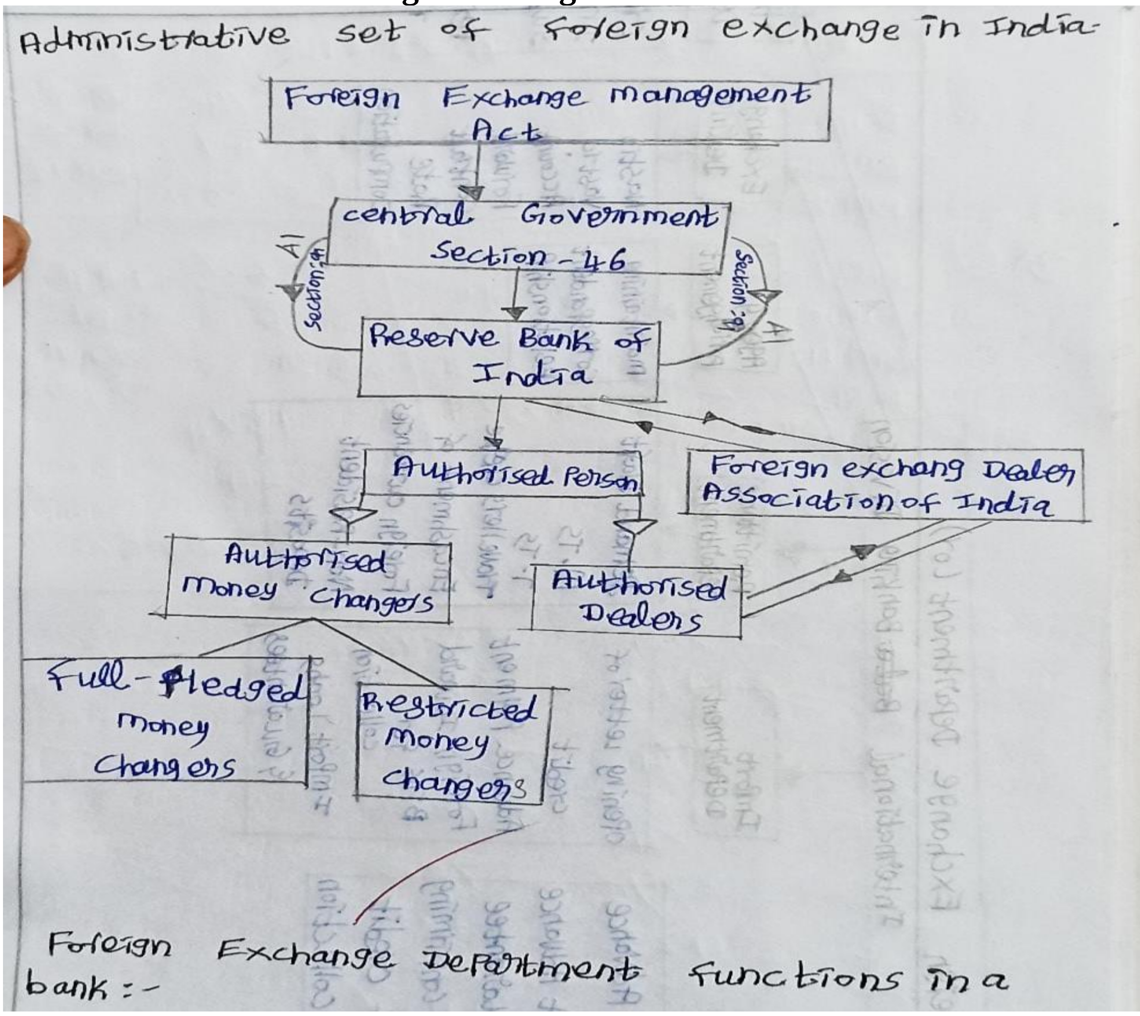
v. Department of Exchange Dealing:

- ➢ This department is entrusted with maintaining Nostro Account and Vastro Account.
- ➢ This department is also entrusted with computation of rate of exchange besides forward contracts and cover operation and ensure that all dealing in foreign exchange are done perfectly were according to the rules.

vi. Statistical information Department:

- ➢ Another important work connected with foreign exchange operation of the bank is the maintenance of statistical record of all transaction.
- ➢ This is very essential for submitting periodical returns by the Foreign Exchange Department of the Bank to the Reserve Bank of India.
- ➢ These departments have to depend on "Statistical Information Department" of the bank. Hence maintenance of statistical information by the bank is very essential.

Administrative Set of Foreign Exchange in India:



<u>**Foreign Exchange Department (or) International Banking Division**</u>**:** (chart)

i. **Export Department:**
   - **a)** Pre-Shipment Advance
   - **b)** Post-Shipment Advance
   - **c)** Export Guarantee
   - **d)** Advising & confirming
   - **e)** Letters of Credit
   - **f)** Bills for Collection

ii. **Import Department:**
   - **a)** Opening Letter of Credit
   - **b)** Advance payments
   - **c)** Foreign inward bills for collection
   - **d)** Import Loans & Guarantees

iii. **Remittance Department:**
   - **a)** Demand Draft
   - **b)** Mail Transfer
   - **c)** Telegraphic Transfer
   - **d)** Travelers cheque
   - **e)** Encashment of foreign currencies notes
   - **f)** Non-Resident Deposits

iv. **Agency arrangement:**

a) Maintaining

b) Correspondent

c) Relationship

v. **Exchange Dealing:**

a) Nostro

b) Vastro

c) Account

d) Forward

e) Contract

f) Rate

g) Computation

vi. **Statistical Department:**

a) Credit

b) Information

c) Submission of periodical return.

Unit – IV

Foreign Exchange Transaction – Exchange quotations – Spot and Forward Transaction – Forward Exchange Contracts. Introduction to currency – features and options.

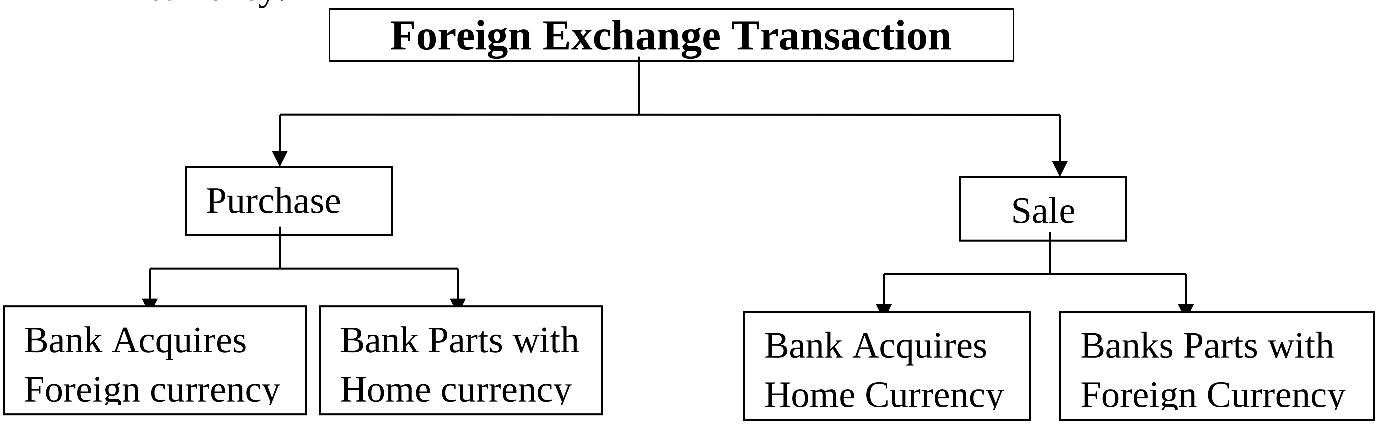
Foreign Exchange Transaction

Meaning:

A banker who is an authorized dealer in foreign exchange purchase foreign exchange and sells foreign exchange to customers who are in need of that of sources within the framework of foreign exchange regulation.

In the purchase and sale transaction of foreign currency, the following concepts should be remembered and adhered to:

- Transaction in foreign exchange is always referred to form the bank's point of view and not from customer's points of view.
- The commodity referred to is the foreign currency and not home currency.
- The bank has purchased, it means it has purchased foreign currency. When we say that the bank has sold, it means the Bank has sold foreign currency.



Foreign currency is analogous to commodity and home currency is analogous to the price for the commodity.

Exchange Quotations:

Meaning:

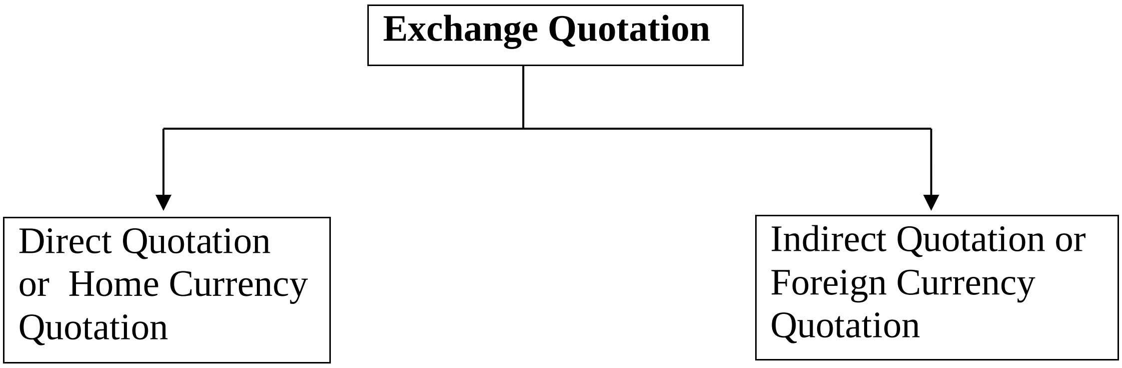
The exchange quotation may be done in two ways. They are called Direct Quotation and Indirect Quotation.

When the exchange rate is expressed as a price per unit of foreign currency in terms of home currency, it is known as direct quotation.

In the case of Dollar, direct quotation means 1 Dollar is equal to 45 Rupees. The change may be expressed in the following manner: 1Dollar = 45.2 rupees; 1Dollar = 46.2 Rupees; 1 Dollar = 44.9 rupees and So on.

In the case of indirect quotation, the unit of home currency is kept constant and the exchange rate is expressed in terms of so many units of foreign currencies.

This type the quotation will be: Rs.100 = 2.2dollars; Rs.100=2.25dollars; Rs.100=2.1dollars etc. of course we mean US Dollar.



Business Maxims in Foreign Transactions:

We have already seen that dealing in foreign exchange is actually a business to make profit.

The Bank (Authorized Dealer) makes profit by purchasing the foreign exchange at a lower price and selling it at a higher price.

In the case of direct quotations method, the concepts of buy low, sell high will be adopted as the business maxim.

Buy low means pay lesser units of home currency for a fixed unit of foreign currency. Sell high means receive more units of home currency for a fixed unit of foreign currency.

In the case of indirect quotations, the maxim is buy high, sell low. Since in the case of indirect quotation, the principles is keeping home currency fixed and foreign currency variable, the dealer has to buy more foreign currency for a fixed unit home currency; and sell lesser units of foreign currency.

Spot and Forward Transactions:

Meaning:

The Transaction in the interbank market takes for the settlement either;

a) On the same day itself or
b) It may take two days later or
c) It may take a longer time say after a month or two.

Ready Transaction:

In cases where the agreement to buy and sell the foreign exchange takes place and the actual settlement in finished i.e., delivery of foreign exchange and the receipt of the price i.e., exchange transaction proper is completed on that day, itself it is called ready transaction. It is also known as value today.

Spot Forward:

In some transaction, the deal will be struck, but the actual exchange of currencies will take place, say after two days from the date of contract. This type of transaction is known as spot transaction.

Forward Transaction:

On the other hand, the deal will be struck on the particular day where in rate will be agreed upon. But the actual transaction will take place at a specified future date. This is called forward transaction. The Forward transaction may be for one month, two month or even three months.

Forward margins / Swap points:

The forward rate of a currency will be costlier or cheaper than spot rate. The difference between the spot rate and the forward rate is known as forward margin, otherwise called swap points.

The forward margin may be either at premium or at discount.

Factors Determining Forward margin:-

Rate of Interest:

If the rate of interest at the foreign centre is higher than the home centre the forward margin would be at discount. If the rate of interest is lower in the foreign centre and higher in the home centre, the forward margin would be at premium.

$$\textbf{Forward Margin} = \frac{\textbf{spot rate x Forward period x Interest differential}}{\textbf{100 x Time}}$$

Demand and supply of Foreign Currency:

If a particular foreign currency is great demand than its supply then naturally. It will be costlier and it will be sold at a premium. If the supply exceeds the demand, the forward rate will be at a discount.

Investment Activities:

The investor may borrow from low interest centre and invest the amount in the high interest centre. For Example, the investor may borrow at London at the rate of 5% per annum and invest the amount in Chennai at 12% per annum.

The demand for forward pound sterling increases, pushing up the price. Thus, there will be widening of the gap between spot rate and forward rate of pound sterling.

Speculative activities regarding Spot Rates:

The forward rates are based on spot rates. Any speculative in the movement of spot rates would also influence forward rates. If exchange dealers anticipate spot rate to appreciate, they will quote forward rate at a premium. If they expect the spot rate to depreciate the forward rate would be quoted at a discount.

Exchange Regulation:

Exchange control regulation may also put restrictions or condition on the forward dealing, leading to changes in forward margin. The Central Bank of the country intervenes in the forward market this will influence forward margin.

Factors Determining Spot Exchange Rates:

1) **Balance of Payments:**

International trade and consequent Balance of Payment between countries will determine the value of the currencies concerned.

International trade exports from a country both visible and invisible represent the supply side of foreign exchange on the contrary imports into a country both visible and invisible create demand for foreign exchange.

The Indian exporters have to receive “Rupee” payment from USA and the importing merchants in USA would be offering lot of US Dollar in exchange for rupee for payment to Indian merchant.

Thus, there will be lot of supply of US dollar from the point of view of India and lot of demand for Indian rupees from the point of view of USA.

On the other band. If India imports more we have to pay Dollar to USA merchants. This means we will offer lot of rupees demanding Dollar. In that case the value of Dollar will go up comparative to Rupees.

When a country is continuously importing more that what it export to the other country in the long run the demand for the currency of the country importing would be lesser than its supply.

2) Inflation in the Economy:

Another important factor that would have serious effect on the value of currencies and the exchange rate is the level of inflation in country.

More inflation means increase in domestic prices of commodities, when commodities are priced at a higher level, exports would dividend as the price would not be competitive in the international market and foreigners would not demand the commodities at a higher price.

3) Interest Rates:

The difference in interest rate between countries has great influence in the short term movement of capital between countries. If the interest rate in country ‘A’ increases that country would attract short term of funds from other countries. This will create demand for the currency of the country having higher rate of interest.

If country ‘B’ also increases the interest rate like that of country ‘A’ there will be no change in the exchange rate and the effort of country ‘A’ will be null field.

4) Money supply:

Money supply is also another factor affecting the rate of exchange between countries as increased money supply will case inflationary condition in the economy and there by affect the exchange rate via increase in price of exportable commodities.

5) Increase in National Income:

Increase in national income of a country indicates an increase in the income of the resident of the country. This increase will naturally create demand for goods in the country. This will also lead to more export of goods. This result is similar to that of inflation i.e., decline in the value of the currency. Thus increase in the national income may lead to increase in investment or in consumption and accordingly it will have its effect on the exchange rate.

6) Discoveries of New Resources:

A country in its progress of economic development may also discover new resources which are very vital for the economy. These resources are called “key resources” or “basic resources”. A country may discover oil resources which are very vital for economic development.

7) Capital Movement:

The difference between the interest rate is a vital factor in the short term movement of capital from one country to another. It interest rate in a country rises due to increase in bank rate there will be flow of short term funds into the country and the exchange rate of the currency of the country will rise.

8) Speculation and Psychological Factors:

The psychological factors and speculative activities of the operators in the foreign exchange market go a long way in affecting or influencing the exchange rate between currencies.

For instance a large scale buying or selling by the major participants would induce others also to follow suit. The speculation may take the form of bull i.e., purchasing of heavily expecting a rise in price or it may take the form of bear i.e., selling heavily expecting a fall in price.

Unit – 5

International Financial Institution – International Monetary Fund – Special Drawing Rights – International Bank for Reconstruction and Development – International Finance Corporation – International Development Association.

International Monetary Fund (IMF)

Introduction

IMF is an internal monetary institution. It was established on 27th December 1945 based on the recommendations of the bretton woods conference

Meaning

It is an international financial institution which monitors the overall global financial system. Its purpose is to stabilise international exchange rates and enable development. It promotes international monetary co-operation, enables balanced growth of global trade and helps countries overcomes their balance of payments problems. As on November 2017, 189 countries were members of IMF.

Organization Structure of IMF:

The IMF is headed by the Board of governors. It consists of one governor and one alternate governor from each member country.

The governor and alternate governor are generally the finance minister and the governor of the central bank of that country.

Twenty four of the governors serve on the international monetary and financial Committee (IMFC). The IMFC provides advice to the board of governors on the management of the global financial system.

The Managing Director is the head of the IMF staff and is assisted by four Deputy Managing Directors. There are over 2700 staff members drawn from 147 countries.

Membership of IMF:

189 countries are members of IMF as on 2017. The following are the two types of members:

- **Original Members**
- **Ordinary Members**

1. **Original members:**

The 44 countries which took part in the Breton woods conferences and other countries who agreed to become members before 31.12.1945 are the original members of the fund.

2. **Ordinary members:**

All those countries which became members after 31.12.1945 are called ordinary members.

Capital of IMF:

Every member country has to contribute towards the capital of IMF. The contribution is based on the quota fixed for each member. IMF changes the quota of the member countries from time to time. Members have to contribute their share partly in gold and partly in their national currency.

Voting Share of Member Countries:

The voting share of members is based on their capital contributed to the IMF.

10 leading economics of the world (USA, Japan, Germany, UK, France, China, Italy, Saudi Arabia, Canada and Russia) enjoy more than 52% of the voting share.

India has a voting share of 2.64 percent as on November 2017. The US has the highest voting share at 17.46 per cent.

Special Drawing Rights (SDR'S)

SDR is an international reserve asset created by the IMF to increase international liquidity.

SDR's provide credit facilities to member countries in foreign currency. Countries which are facing balance of payment problems can use SDR's to finance their imports.

Earlier, countries had to purchase domestic currency in foreign exchange markets to maintain their exchange rate. Payments had to be made in gold or in widely accepted foreign currencies.

It affected the capacity of countries to trade and affected