

PONDICHERRY UNIVERSITY

(A Central University)

DIRECTORATE OF DISTANCE EDUCATION

International Trade and Finance

Paper Code: MBFM 4003



MBA - FINANCE

IV - Semester

Author

Prof. P. Natarajan

Director (i/c) - Directorate of Distance Education,

Head - Dept. of Commerce,

Pondicherry University,

Puducherry

©All Rights Reserved

For Private Circulation Only

ISBN 978-93-81932-15-5

TABLE OF CONTENTS

UNIT	LESSON	TITLE	PAGE NO.
I	1.1	International Trade	3
	1.2	Balance of Payment and Balance of Trade	25
	1.3	Indian EXIM Policy	45
II	2.1	Export and Import Finance	73
	2.2	Export – Import (EXIM) Bank of India	94
	2.3	Export Credit Guarantee Corporation	125
	2.4	Import Licensing	140
III	3.1	Foreign Exchange Market	157
	3.2	Hedging Techniques	179
	3.3	Foreign Exchange Management (FEMA) Act	189
	3.4	Exchange Rate Determinations And Forecasting	203
IV	4.1	Export Trade Documentation: Financial and Commercial	251
	4.2	Transport and Office Documents	261
V	5.1	Export Promotion Schemes	275

Paper - XVIII

International Trade and Finance

Objectives

- To make the students well aware about the formalities associated with International trade
- To make the students aware of the documentation of International Trade and
- To make the students aware of the FOREX Management and Export Promotion Schemes.

Unit - I

International Trade –Benefits – Basis of International Trade – Foreign Trade and Economic Growth – Balance of Trade – Balance of Payment – Current Trends in India – Barriers to International Trade – Indian EXIM Policy.

Unit - II

Export and Import Finance: Special need for Finance in International Trade – INCO Terms (FOB, CIF, etc.,) – Payment Terms – Letters of Credit – Pre Shipment and Post Shipment Finance – Forfaiting – Deferred Payment Terms – EXIM Bank – ECGC and its schemes – Import Licensing – Financing methods for import of Capital goods.

Unit - III

Foreign Exchange Markets – Spot Prices and Forward Prices – Factors influencing Exchange rates – The effects of Exchange rates in Foreign Trade – Tools for hedging against Exchange rate variations – Forward, Futures and Currency options – FEMA – Determination of Foreign Exchange rate and Forecasting – Law of one price – PPP theory – Interest Rate Parity – Exchange rate Forecasting.

Unit - IV

Export Trade Documents: Financial Documents – Bill of Exchange – Type – Commercial Documents – Proforma, Commercial, Consular, Customs, Legalized Invoice, Certificate of Origin Certificate Value, Packing List, Weight Certificate, Certificate of Analysis and Quality, Certificate of Inspection, Health certificate. Transport Documents - Bill of Lading, Airway Bill, Postal Receipt, Multimodal Transport Document. Risk Covering Document: Insurance Policy, Insurance Cover Note. Official Document: Export Declaration Forms, GR Form, PP Form, COD Form, Softer Forms, Export Certification, GSPS – UPCDC Norms.

Unit - V

Export Promotion Schemes – Government Organizations Promoting Exports – Export Incentives: Duty Exemption – IT Concession – Marketing Assistance – EPCG, DEPB – Advance License – Other efforts I Export Promotion – EPZ – EQU – SEZ and Export House.

References

1. **Jeevanandam. C**, INTERNATIONAL BUSINESS, M/s Sultan & Chand, Delhi, 2008
2. **Sumathi Varma**, INTERNATIONAL BUSINESS, *Ane, Delhi, 2010*

UNIT – I

Unit Structure

Lesson 1.1 - International Trade

Lesson 1.2 - Balance of Payment and Balance of Trade

Lesson 1.3 - Indian EXIM Policy

Lesson 1.1 - International Trade

Learning Objectives

After studying this lesson you are able to

- Comprehend the nature of International Trade
- Understand the need for and method of trade credit
- Know the impact of the export in the development process

Introduction

The world economics are changing rapidly and most countries of the world including developing countries are gearing up to the challenges of competing in a highly integrated global market place. In such a situation, the issue of “international Trade” is attaining much attention of the government authorities, traders and policy makers in recent years.

For the developing countries, specifically a country like India, growth requires a steady in flow of imported capital and intermediate goods, and this, in turn necessitates foreign exchange to pay for them. To this end, this lesson explains in detail the framework of International Trade, its characteristics, limitations and international corporations in trade finance, practices and the international situations that assist the international trade operations.

Basis of International or Foreign Trade

Foreign trade is based on the **theory of comparative cost advantage**. It states that every nation exercises certain kinds of benefits from the production of a particular type of commodity whose resources are exclusively available in that nation or available in other nations in very less amounts. For example, Iraq and the similar nations have comparative advantage over the production of crude oil. Hence, it can export it to other nations and earn huge profits. Similarly, India specializes in the production of sugarcane and tobacco. No country is self-sufficient and it has to depend on other nations to obtain the required inputs be it machines, labor, raw materials or even finished products.

Thus, the **need for foreign trade** arises due to the following factors:

1. All nations of the world have to depend on the other nations as it cannot produce every thing by itself in a lower cost.
2. A country may get the resources and manpower to produce all types of commodities but it may be able to get that commodity at a cheaper rate from the other nation who specializes in the production of that commodity.
3. Similarly, a country may produce some goods at a cheaper rate than the other nation and may try to export it to other nations at a higher rate if there is a surplus.

Difficulties in International Trade

- Distance: Due to long geographical distances between the nations, goods are either sent through rail, road or sea or air. All these modes of transport are expensive and may face the dangers of sea or air perils such as explosions or accidents etc. There may be a delay in the delivery of goods that may lead to the spoilage of certain perishable goods. Distance creates higher transport costs as well as more risks.
- Different languages; Different languages are spoken in different nations. Hence, the buyers and the sellers may not be able to communicate with each other effectively. They may have to depend on the translators that are not always reliable.
- Risk in transit: Foreign trade involves high risks than the home trade. Many of the risks can be covered by insurance but still, the danger persists.
- Lack of information about foreign businessman: A seller is always worried about the credit-worthiness and the financial standing of the prospective buyer as there is no strong proof of the buyers' ability to pay. Thus, there is the risk of bad debt for the seller.

- Import and export restrictions: Every country charges a high rate of custom taxes and duties on the import of the goods. Also, businessman are required to fill various documents and formalities to complete the transactions. Foreign trade policies and procedures vary from nation to nation and also from time to time.
- Study of foreign markets: Every foreign market has its own features. There are different price interactions, demand supply interactions, government policies, marketing methods, customs laws, weights etc. It is very difficult to collect all the information accurately about the foreign markets.
- Problems in payments: Every country has its own currency and exchange rates with which the transactions can be completed. These exchange rates keep on changing. Remittance of money in foreign trade involves much time and expense. There are also huge risks of bad debt.
- Intense competition: There is a huge competition between the sellers of the different nations involved in exporting the same commodity. The one who succeeds in influencing the buyers from the advertisements and other incentives stands out as the winner of the market. Thus, heavy and useless expenses are incurred in these activities.

Characteristics of International Trade

Territorial Specialization

International trade among the countries is possible only because each country has certain resources that can be well utilized for the production of certain type of commodity that is not available in other countries or available in very less quantities. Hence, each country has some sort of comparative cost advantage that means each country can produce a good at a lower price than the other country and hence, can export that.

International Competition

Producers from different nations are always in a race with one another to sell their products in as much quantity as possible. Thus, advertisements, sales promotion activities are very helpful in these types of selling techniques.

Separation of Sellers from Buyers

Each country is separated by a large geographical distance and hence, the buyers and the sellers are unable to meet each other physically. They contact each other through mass communication devices such as telephones, internet, video conferencing etc.

Long Chain of Middleman

Since the buyers and the sellers are unable to meet each other, they have to rely on long chain of middleman to complete their international transactions. It does increase the cost of the goods of the buyers and hence, the imported goods are much expensive.

Mutually Acceptable Currency

All the nations, except countries of Europe, have their own currencies and other modes of payment. Hence, it is not possible to have a common currency for exchange between nations. Thus, dollars, pounds are selected for this purpose and hence, they are called “hard currencies”. These currencies are acceptable all over the world.

International Rules and Regulations

Each buyer and seller involved in the international trade have to complete the guidelines and norms set up the custom authorities of the other country. They have to follow the restrictions of that nation.

Government Control

The government of every nation exercises effective control over the **export and import trade** of the nation. Hence, various types of formalities and documents have to be submitted to the government.

International Trade Theories

A number of theories have been developed by economists as basis of International Trade, some of these are as follows:

1. **Theory of Comparative Cost Advantage:** According to this theory, a country tends to specialize in the production of those goods for which it has got a comparative cost advantage, or where its costs are lower than in other countries.
2. **Factor Proportions Theory:** This theory is also known as Factor Endowment Theory; which was developed by Heckcher and Ohlin. This theory suggests that a country will specialize and export that product which is more intensive in that factor (a two-country, two commodity and two-factor model) which is more abundant. It will import those goods which, on the other hand, are more intensive in that factor of production which is scarce in that country.

3. **Human Capital Approach Theory:** This theory also known as Skills Theory of International Trade, advocated by Becker, Kennen and Kessing. According to this theory, labour can be classified into skilled and unskilled labour. A developing country which has more abundant supply of unskilled labour will specialize and export labour intensive products. Imports, on the other hand, will consist of goods which are more skill intensive.
4. **Natural Resource Theory:** This theory was proposed by Vanek, J. The basic hypothesis of this theory is that a county will export those products which are more intensive in that natural resource with which it is more relatively endowed.
5. **Research and Development, and Product Life-Cycle Theories:** A number of economists, especially Vernon have contributed the development of this theory. It suggests that industrial countries allocate more resources to R and D programme, to develop new products. These countries will enjoy monopoly benefits in the initial stages of production, and will access to foreign markets, leading to trade between the developed and developing countries as well as trade among the industrialized countries themselves.
6. **Economies of Large-scale Theory:** A company operating in a country where the domestic market is large; will be able to reach a high out-put level, by reaping the benefits of large-scale production. The lower cost of production will increase the competitiveness of the company enabling it to make an easy entry into the export markets.

International Cooperation in Trade Finance

The global financial crisis, which has resulted in slowdown in economic growth, has also impaired the access to trade finance. As a result cost of finance had increased by over 3-4% in international markets, last year, even for exporters considered to be good. Many Governments have quickly sought to mitigate the potential impact of the crisis on their domestic economy and export sector, through various measures, albeit in varying degrees and forms. The main actions taken by Governments can be grouped in two categories:

- (i) To increase banks' liquidity to alleviate liquidity pressure including for trade finance;
- (ii) To enhance the long-term competitiveness of the country's exports by developing and expanding export promotion programs.

The commitment of G-20 leaders calling for collective fight against protectionism, and the action by Multilateral Agencies to counter the shortage in trade finance indicates the need for international cooperation in trade finance.

Export Credit Agencies (ECAs), particularly in developing countries, have assumed greater role to channel trade finance to firms. In some countries, Government has channeled the trade credit enhancement measures through the ECAs. Exchange of information and institutional cooperation are the two important strategies for enhancing trade finance and trade amongst the trading partners. During the recently concluded BRIC Summit, Exim Bank of India entered into a Memorandum of Cooperation with three major development banks of Brazil, Russia and China. One of the objectives of the Memorandum is to develop comprehensive long-term cooperation among the signatories to facilitate and support cross-border transactions and projects of common interest. Such institutional cooperation is pertinent in enhancing trade finance. Earlier, EXIM Bank of India mooted the idea of forming the Asian Exim Banks Forum, in 1996, in order to forge a stronger link among the member institutions. The forum facilitated signing of bilateral L/C confirmation facility among the members. The forum is also exploring the possibility of setting up a regional ECA with the support of multilateral funding institution like ADB. Extending the similar concept at global level, Bank took the initiative of setting up a Global Network of Exim Banks and Development Finance Institutions (G-NEXID), under the auspices of UNCTAD, with the objective of supporting rapidly increasing trade between developing countries with expanded financial services that can spur and stabilize economic growth. Such cooperation is expected to reduce the costs of trade for the developing countries, spurring investment across borders and making financing more readily available to new and innovative businesses and enabling the growth of “niche markets.”

Multilateral / regional development finance institutions should play a pivotal role in rebuilding confidence amongst member governments, banks and financial institutions in the region, through provision of well targeted credit enhancements, policy support, and capacity building initiatives. These may include technical assistance / advice on trade finance policy, loans for creation of finance-related infrastructure, and support in creation and strengthening of institutions that support trade finance transactions. The institutions from developed countries should also extend credit lines to Governments / institutions in developing countries with the objective of enhancing trade financing. Rules-setting organizations, like WTO, may have to provide necessary comfort to banks and financing institutions (that are providing finance and guarantees), especially from developing countries, and set flexible policies for developing countries that encourages concessional trade financing; it may be appreciated that the priority task would be to enhance the capacity in developing countries to mitigate the effects of increased perception of risks

and to provide the market with earmarked liquidity for trade finance. It is also necessary to persuade the Bank for International Settlements (BIS) to build suitable models and treat trade finance differently under Basel - II. Greater level of institutional cooperation among the developing countries is required for closely monitoring payment delays and sharing of information on credit risks.

Such international cooperation would be collectively beneficial to enhance trade finance and thereby contribute to the growth in trade and economic development.

Trade Composition

Export Composition

There were substantial changes in the composition of exports in 2008-09 and 2009-10(April-September) with the fall in share of petroleum, crude and products and primary products resulting in corresponding rise in share of manufactured goods. The share of petroleum, crude and products fell from 17.8 per cent in 2007-08 to 14.9 per cent in 2008-09 and 14.2 per cent in the first half of 2009-10, while the share of primary products fell from 15.5 per cent in 2007-08 to 13.3 per cent in 2008-09 and further to 12.7 per cent in the first half of 2009-10. The share of manufactured exports increased by 2.3 percentage points to 66.4 per cent in 2008-09 and further to 69.2 per cent in the first half of 2009-10.

India's moderate growth of 13.6 per cent in 2008-09 which was due to the high growth in the first half of the year prior to the setting in of global recession, was only due to manufactured exports as both primary products and petroleum, crude and products registered negative growths of (-)2.4 per cent and (-)4.6 per cent respectively. Among manufactured products, the major drivers were gems and jewellery, engineering goods and chemicals and related products with export growths of 42.1 per cent, 18.7 per cent and 7.2 per cent respectively.

The first half of 2009-10 when the global recession was in full swing, also saw an accentuation in the fall of India's export growth resulting in negative growth of (-) 29.7 per cent compared to the positive 48.1 per cent in the corresponding period of the previous year. All the three sectors were badly affected during this period with petroleum, crude and products being the worst affected at (-)44 per cent export growth due to the low crude oil prices in the first half of 2009-10, which started declining from the high reached in the first half of 2008-09. Primary product exports also registered a decline of 32.4 per cent with fall in growth of both ores and minerals and agriculture and allied products. Manufactured goods registered negative export growth of (-) 24.9 per cent, with the worst affected sectors

being engineering goods at (-)34.6 per cent, followed by handicrafts including carpets at (-) 33.7 per cent and leather and leather manufactures at (-) 24.2 per cent.

In the first half of 2009-10, India's export growth of all items to almost all three destinations was negative with global recession in full swing. Among manufactured goods, textiles export growth was comparatively less negative mainly to 'Others', whose share also rose. India's gems & jewellery exports and chemicals & related products exports were more affected in the EU market, while the worst affected sector was engineering goods, especially in the US and EU markets with negative export growths of (-)49.7 per cent and (-)42.5 per cent, respectively. The performance of handicrafts (including carpets) exports which were badly affected even in 2008-09, worsened in all the three markets with a negative growth above 30 per cent in all of them.

Import Composition

The composition of imports also underwent changes. Reflecting growing domestic concerns like inflation, the share of food and allied products imports which fell from 2.3 per cent in 2007-08 to 2.1 per cent in 2008-09 increased to 3.5 per cent in the first half of 2009-10 with the increase in imports of edible oils and pulses (Table). The share of fuel imports fell from 34.2 per cent in 2007-08 to 33.4 per cent in 2008-09 and 33.2 per cent in the first half of 2009-10. Among fuel items, the share of POL, the major item, fell to 30.1 per cent in the first half of 2009-10 from 34.2 per cent in the corresponding period of 2008-09 reflecting the relatively lower oil prices. The share of fertilizers increased suddenly from 2 per cent in 2007-08 to 4.3 per cent in 2008-09 with growth in imports of nearly 250 per cent, but fell to 2.5 per cent in the first half of 2009-10. The most notable change is the fall in share of capital goods imports from 18.7 per cent to 15.5 per cent in 2008-09 and to 14.3 per cent in the first half of 2009-10. The commodity group 'Others' saw increase in share from 38.9 per cent in 2007-08 to 40.0 per cent in 2008-09 and 43.4 per cent in the first half of 2009-10. Even gold and silver and electronic goods increased their import shares in the first half of 2009-10 over the corresponding period in the previous year, despite high negative growths, as other items in the import basket had still higher negative growths.

In 2008-09 there was high import growth of fertilizers reflecting the rise in fertilizer prices mirroring skyrocketing POL prices in the first half of the year, besides chemicals, pearls, precious and semi-precious stones and gold and silver. The high import growth of the last two items also contributed to the high export growth of gems and jewellery including diamond trading. In the first half of 2009-10, the only category showing positive and high import growth is food and allied products to meet the domestic needs.

Impact of the crisis on Trade Credit

The global economic crisis also impacted trade credit. A number of banks, global buyers and firms surveyed independently by the World Bank, International Monetary Fund (IMF) and Bankers Association for Finance and Trade (BAFT), have felt that lack of trade credit and other forms of finance, such as working capital and pre-export financing, has affected growth in world trade. In addition, the costs of trade credit have substantially gone up and are higher than they were in the pre-crisis period, raising the challenge of affordability of credit for exporters.

Higher funding costs and increased risk continue to put upward pressure on the price of trade credit. In 2008, as the financial crisis intensified, the spreads on trade finance increased by a factor of three to five in major emerging markets, like China, Brazil, India, Indonesia, Mexico, and Turkey. For example, the spread (over the six-month LIBOR) for Turkey jumped to 200 basis points in November 2008 from 70 basis points in the third quarter(Q3), while Brazil's spread almost trebled in 2008 (from 60 bps to 175 bps); India's spread increased from 50 bps to 150 bps during the same year. Similarly, spreads for several Sub-Saharan countries jumped from 100 basis points to 400 basis points.

Small and Medium Enterprises (SMEs) and exporters in emerging markets appear to have faced the greatest difficulties in accessing affordable credit. Increased uncertainty initially led exporters and importers to switch from less secure forms of trade finance to more formal arrangements. Exporters increasingly asked their banks for export credit insurance (ECI) or asked importers to provide Letters of Credit (LCs).

Importers were asked to pay for goods before shipment and exporters sought more liquidity to smooth their cash flow. Further, the realization of export proceeds was not taking place on the due date. This led firms to trim down inventories, and direct the funds so generated to meet their working capital requirements.

Trade Credit: Indian Scenario

As a result of difficult financing conditions prevailing in the international credit markets and increased risk aversion by the lending counterparties, gross inflows of short-term trade credit to India declined by 12.2 per cent to US\$ 41.8 billion during 2008-09. Export credit as a percentage of net banking credit also fell from 5.5 per cent as on March 28, 2008 to 4.6 per cent as on March 27, 2009 and further to 4.1 per cent as on January 15, 2010 (Table).

Export Credit

Outstanding as on	Export Credit (₹ Crores)	Variations (in %)	Export credit % of NBC
24-Mar-00	39118	9	9.8
23-Mar-01	43321	10.7	9.3
22-Mar-02	42978	-0.8	8
21-Mar-03	49202	14.5	7.4
19-Mar-04	57687	17.2	7.6
18-Mar-05	69059	19.7	6.3
31-Mar-06	86207	24.8	5.7
30-Mar-07	104926	21.7	5.4
28-Mar-08	129983	23.9	5.5
27-Mar-09	128940	-0.8	4.6
Jan. 15, 2010*	124360	-3.6	4.1

Note: * : Variation over the March 27, 2009 figure.

- 1: Data upto March 2004 relate to select banks accounting for 90 percent of bank credit.
- 2: March 18, 2005 onwards, data pertain to all scheduled banks excluding RRBs availing export credit refinance from the RBI.

On the other hand, short-term trade credit repayments registered an increase of 37.9 per cent during 2008-09 to touch US\$ 43.7 billion. Since the gap between the inflows and outflows of short-term trade credit to India were limited to a net outflow of US\$ 1.9 billion during 2008-09, financing of short-term trade credit did not pose much of a problem.

This trend also continued in 2009-10. During the first half of 2009-10, the gross inflow of short-term trade credit stood at US\$ 21.7 billion, lower by 9.2 per cent than that in the corresponding period in 2008-09, while the outflows at US\$ 22.3 billion were higher by 17.5 per cent, thereby resulting in a net outflow of US\$ 0.6 billion (inclusive of suppliers' credit up to 180 days) compared to a net inflow of US\$ 4.9 billion during the corresponding period of the previous year. Although the higher net outflows during the second half of 2008-09 and in the first half (H1) of 2009-10 suggest some challenges in rolling over maturing trade credits, the continuing trend in inflows indicates no significant problem in servicing short-term debt. This is also indicative of the confidence enjoyed by Indian importers in the international financial markets. The various policy initiatives taken by the Government and RBI have also helped ease the pressure on trade financing. This is further corroborated by the increase in share of short-term trade credit (both inflows and outflows) in the overall gross capital flows with share in inflows increasing from

10.9 per cent in 2007-08 to 13.4 per cent in 2008-09 and share in outflows increasing from 9.6 per cent to 14.3 per cent, thereby indicating that the impact of global financial crisis on trade credit was less when compared to other forms of capital flows such as portfolio investment and external commercial borrowings (ECBs).

Export as an Engine of Growth

Countries have achieved rapid economic development through export led growth strategy. Export growth not only contributes directly to economic growth but, also permits more imports, and a rapid modernization of production. The result is efficient domestic industry that meets the market test of international competition. According to World Development Report, 1989:

“Global development experience of the past few decades shows that a policy regime with fewer barriers to trade, both tariff and non-tariff and which provides equal incentives for exports as well as production for the domestic market enable countries to achieve not only impressive export growth but also rapid and sustainable economic growth”.

The fact that high growth rates can be achieved via export route has been brought out by the experiences of great many countries across the world. The experiences of Japan and South Korea provide interesting examples. Historically speaking, Japan could not have been described as a developing country prior to World War II. After the World War II, however, its economy was in shambles and the development process had to commence afresh. The national goal, which reflected the aspirations of most Japanese, was to become an economic superpower. Japan proceeded to do this not on the strength of domestic consumption, which was low on account of paucity of incomes but on these

Impact of Exports in the Development Process

Export led growth is an appealing strategy for developing nations. In the early stages of development, a country needs to import real capital (machines), which often entails borrowing in a foreign currency. Export allows barrowing of nation to earn the foreign currency required to service its external debt. This strategy is often successful – the U.S.A is perhaps the best example that followed such a strategy in its early stages of development—at least over the short run.

An important consideration is an important for policy-makers when promoting development is to improve “Export Competitiveness”. While export competitiveness starts with increasing international market shares, it goes far beyond that it involves diversifying

the export basket, sustaining higher rates of export growth over time, up grading the technological and skill content of export activity, and expanding the base of domestic firms able to compete internationally so that competitiveness becomes sustainable and is accompanied by rising incomes. Competitive exports allow countries to earn more foreign exchange and so to import the products, services and technologies they need to raise productivity and living standards. Greater competitiveness also allows countries to diversify away from dependence on a few primary commodity exports and move up the skills and technology ladder, which is essential for increasing local value added and sustaining rising wages. It permits a greater realization of economies of scale and scope by offering larger and more diverse markets. Exporting feed – back into the capacities; it exposes enterprises to higher standards, provides them to greater competitive pressures, thereby encouraging domestic enterprises to make more vigorous efforts to acquire new skills and capabilities.

However, these developmental impacts from improved export competitiveness cannot be taken for granted. For same product at the same time, most of them may well become worse off. Similarly, in the absence of adequate national capabilities and increase local value added and expansion in market shares may not produce the expected benefits. Export competitiveness is important and challenging, but it needs to be seen as a means to an end—namely development.

The above discussion focuses on the broader outlook of the overall impact of exports in development process. To have specific outlook, it would be note worthy to mention the benefits and risk associated with exporting.

Export Benefits

The Export benefits may vary by company and product\service. They are:

- There is potential for greatly increased company turnover.
- Economies of scale are achieved
- Potential levels of profitability are much increased.
- The product or service offered is more competitive it reflects overseas market needs and conforms to a wider legal environment.
- Companies became much more integrated with market they serve and this encourages higher standards and the use of more high technology.
- Diversification of risk. Company risk and business risk is not confined to one market.
- The company becomes more competitive in all areas of the business.

Export Risk

- Repatriation of profits from the target country may be constrained or forbidden
- Fluctuation in exchange rate may decrease or eliminate profits, or even in losses.
- The export market evolves a longer time scale of payment. This may be 90 or 180 days or even some years.
- Product launch in an overseas market is more costly and complex in comparison with a domestic launch.
- Trade barriers are politically and economically manipulated.
- Economic and political risk is much more.
- Instability in the target market/country can lead to losses from war or civil strife or nationalization by the foreign government.
- In case of non-payment other contractual problems, there may be questions of jurisdiction, i.e. Indian courts may not be able to enforce contracts between parties in different countries.

Export Promotion Measures

1. Advanced Licence Scheme

An advance licence is now granted for the duty free import of raw material, components, intermediaries, consumables, and parts, spares, including mandatory spares and packing materials. Such licences are subject to the fulfillment of a time bound export obligation and value addition as may be specified.

Advance licences may be based on either value or quantity. an exporter may apply for a value based or quantity based advanced licence.

2. International Price Disbursement Scheme (IPRS)

This was introduced to make available to exporters raw materials at international prices. In the case of raw materials, notified by the Government as coming under the IPRS, the difference between the international prices as notified by the government and the domestic price, is reimbursed to the exporters.

3. Cash Compensatory Support (CCS)

In existence till 1 July, 1991 this scheme provided cash payment to exporters at a predetermined percentage on the FOB value of exports. This incentive was removed when the rupee was devalued in the 15th week of July 1991.

4. Drawback of Duties

There is a substantial element of customs duty paid on imported components, as well as excise duty on the indigenous purchase. In the manufacture of many export products, these are evaluated on a yearly basis, and the exact quantum of this drawback duties is published by the Ministry of Finance. Accordingly, they are refunded to the exporter after the completion of the export.

5. Marketing Development Fund (MDF)

Founded in 1963-64, its nomenclature was changed to Marketing Development of Assistance (MDA) in 1975. It is administered bodies, also for special for providing grants/ assistance to Export Promotion Councils promotion efforts. As other export schemes approved for specific set export in recent years the fund sufficient amount has not been apart is on the decline.

6. Fiscal Benefit

The government has exempted export profits from tax under 80H1-1C provisions of the I.T. Act to promote exports and enable the exporters to plough back into the export trade, their profits for higher exports. For an exporter who is engaged in the sale of goods, both in the export and domestic market, the proportion of profits is now taken in the same ratio of the export turnover to total turnover items like petroleum products, fertilizers, news print, sulphur, nonferrous metal, etc., on the rupee payment basis. It has helped to diversify Indian exports to these countries and balance the trade by substantial exports from India on a rupee basis.

Legal Dimensions of Exports

The exports have to deal with different legal systems. an exporter selling his products to an overseas buyer of the USA, for example, may well have some influence either on the terms and conditions of the contract entered into between him and the importer. The conflicting laws can be settled in advance by incorporating specific provisions in the contract for the supply of goods and services.

The major laws or regulatory provisions which would be kept in mind while entering to export contracts are:

(1) Foreign Trade Development and Regulation Act 1992

This act replaces the export-import (control) Act; 1947 under the provisions of this act, the central government is empowered to suspend or cancel a code no granted to an exporter if a person has made exports/imports in grave negligence of the trade relations of India with any foreign country.

Under the authority of this act the director general of foreign trade brings out the export-import policy and lays down the procedures thereof

(2) Foreign Exchange Regulation Act, 1973

Sec.18 of FERA provides that for all cash exports, the foreign exchange proceeds must be brought back to India within a period of 180 days. The exporter, therefore, cannot enter into an export contract with an importer under which he extends credits for more than 180 days except where exports are made on deferred payment terms or on consignment basis. Under the provisions of FERA, an exporter normally cannot pay more than 12.5 percent to his agent abroad for the services rendered by him, unless he has obtained prior permission of the RBI to that effect.

(3) Pre-Shipment Inspection and Quality Control Act 1963

Subject to the provisions of this act, the government of India has provided that items cannot be exported unless a designated agency certifies quality of the product as per the standard prescribed. This is to protect the country's image among the importing countries. Even if the importer does not ask for quality certificate, it is obligatory on the part of the exporter to obtain such a certificate from the concerned policy.

(4) Customs Act, 1962

The customs department is entrusted with the task of carrying out physical and documentary check of all the articles crossing Indian Territory. All export consignments are checked by the customs authorities at sea port or airport to ascertain whether the goods being shipped are those declared in the documents and that no over or under invoicing is involved. this authority is given to custom authority under customs Act, 1962.

(5) International Commercial Practices

In addition to the Indian, laws, there are certain international commercial practices which have to be taken care of in export contract. Two documents: (i) Uniform customs practice for documentary. Credit (UCP), 1993 and (ii) INCO terms 1990; prepared by the international chamber of commerce, Paris are widely used. The UCP is the document used by the banks in the negotiation of export-import documents. INXO terms presents the various trade terms like F.O.B. & F.O.R. International Trade if etc., and codify the respective rights and obligations of the two parties under terms of contract.

Type of Legal Issues in International Trade

The basic legal issues can be classified as:

- a) those relating to export-import contract:
- b) those relating to relationships between: the exporter and his agent
- c) those relating to products (trade mark, patents etc.)
- d) those relating to letter of credit

a. Issues Relating to Export Import Contract

These issues are almost universal in their application: viz. parties, description of products, quality price, currency, packaging, schedule of delivery, inspection, documents, passing of risk, settlement of dispute, etc.

b. Issue Relating To Relationships Between: The Exporter & His Agent

Agency contract is a legal documents establishing commercial relationship between the principal and the agent. Agency contract incorporate the conditions mutually agreed upon. While negotiating an agency agreement, the exporter should be careful on the following matters:

- i. Parties to contract
- ii. Contractual products for which the agency is concluded.
- iii. The territory for which the sole agency is being granted. customers to be contracted
- iv. Acceptance of rejection of orders secured by the agent.
- v. Payment of agents' commissions (rate of commission, time when the commission becomes payable, etc)

- vi. Settlement of disputes- venue of the dispute and possibility of compromise etc.
- vii. Renewal and termination of agency and procedure

c. Issue Relating to Products

This is related to law dealing with trademarks, product liability, packaging and promotion requirements. Trademarks are used to differentiate a product and symbolize the quality, and stimulate the desire to buy.

Product liability of the world have laid down rules regarding the packaging of items, especially toiletries and pharmaceuticals, which generally include chemical composition of the product, net weight, date of manufacturing and the date of expiry. if any special precautions are to be taken while using the product, that also must be indicated on the package.

Most countries of the world have laid down rules regarding the packaging of items, especially toiletries and pharmaceuticals, which generally include chemical composition of the product, net weight, date of manufacturing and the date of expiry. If any special precautions are to be taken while using the product, that also must be indicated on the package.

Similarly, many countries have laid down laws regarding advertising of the products. the advertising industry associations have prescribed code of conduct for the industry members and an exporters who wants to promote his products must see the codes.

d. Issue Relating to Letter of Credit

If the export wants that he is paid for the goods exported before the title to the goods passes on the importer is sought to open a letter of credit on behalf of the exporter through the intermediary of the bank. a letter of credit creates a contractual relationship between the opening bank and the exporter. the bank would make payment of the sum indicated in the letter of credit subject to the bank and are found in order. Opening and negotiation of the letter of credit are governed by the international chamber of commerce brochure no 500 entitled uniform customs & practice for documentary credits commonly known as UCP

Methods of Settlement of Trade Dispute in International Trade

There are two well recognized method of disputes settlements in international trade; viz litigation and arbitration. Litigation is usually not followed for settlement of trade defaults as in involves undue delays and high costs; and uncertainty about the final decisions.

Moreover, the court proceedings are open to the public, and therefore, they have adverse impact on the image of the parties of the disputes. On the other hand, arbitration is the best suitable method of settlement of trade disputes. It has advantage of quicker and sound decisions, less expensive, and the arbitration proceedings are not open to the public and privacy can be maintained.

In the case of foreign trade transactions, arbitration becomes widely accepted procedure and the law applicable to arbitration proceeding may be based on Indian law or of foreign law, depending on the terms of the contract. In the case of foreign trade transactions, arbitration can take place in the exporter's or importer's country.

India, which is a party to the 1927 Geneva and the 1958 New York convention, has enacted the arbitration (protocol and convention) act, 1961 respectively giving effect to these two conventions. The Arbitration And Conciliation Act, 1996 passed by India has replaced the earlier acts viz, the Arbitration Act, 1940, The Arbitration (Protocol And Convention) Act 1937 and Foreign Awards (Recognition And Enforcement) Act 1961. The new act has classified the provisions relating to arbitration in depth.

Procedure of Arbitration

Any person interested in a foreign award for enforcement in India may apply to any court in writing having jurisdiction over the subject matter; it should be registered in the court as suit between the plaintiff and defendants. The court shall follow and no appeal should be made unless the award is not in accordance with the provision of arbitration and conciliation act 1996.

Arbitration awards made in India will be similarly enforceable in foreign countries according to the provisions of respective conventions.

Barriers to International Trade

Tariffs

A tariff is a tax imposed by the local government on goods and services coming into a country. They increase the price of the goods being imported. Tariffs were created by the government to protect local businesses from low-priced competitive products.

An example would be a shirt made in China now costs a department store \$53.80. (\$40.00+\$8.80=\$48.80, plus shipping and handling which costs \$5.00 per shirt.) The shirt would now cost the Canadian consumer \$108.00 making the Canadian shirt a better deal.

Canada can encourage trade with other countries by lowering their tariffs on their exports. Eventually this can lead to free trade with participating countries. Canada has already managed free trade with such countries as: USA, Mexico, Chile and Israel.

Currency Fluctuation

Every country has its own currency and its patrons know how to use it but everything you know about your own currency changes when you are dealing with another country.

The rate given by one country for another country's currency is called the currency exchange rate. The daily exchange rate for the rest of the world is made according to the rates used when two banks trade between different countries.

Rates of currency are always fluctuating and that can be a major barrier to trade because the buyer could end up paying way more than intended.

When a country's currency is devalued in relation to another country's currency it means the country with the lower value can sell more because the other country saves money. However, it discourages the devalued country from buying the goods and services from the country with the higher currency value because they would pay more for less.

Investment Regulations

Investors are non Canadians who must comply with the provision of the investment Canada Act, which requires them to file a notification when they commence a new business activity in Canada or each time they acquire control of an existing Canadian business. The investment will be reviewed if both the investor and the vendor are from a country that is not a World Trade organization member and if the value of the business being acquired in Canada is over 5 million. If the investor's country is a WTO any direct investment in excess of 223 million is reviewable.

If the investment involves the acquisition of a company which produces uranium and owns an interest in a uranium property, or engages in financial services, transportation, or culture and is worth over 5 million, a review must take place.

Environmental Restrictions

A large portion of Canada's economy depends on its natural resources. Foreign insects and diseases could destroy entire industries and seriously harm the Canadian economy.

Restrictions are now placed on imports to protect Canadian crops from contamination. The Canadian law requires that all food, plants, fish, animals, and their products that are brought into Canada must comply with Canadian standards.

Canada is a signatory to the convention on International trade in endangered species of wild fauna and flora. This agreement is against the trade on 30 000 wild animals and plant species.

In other words products that do not meet Canadian environmental standards are not allowed to enter Canada.

Foreign Relations and Trade Sanctions

Canada uses trade sanctions to influence policies or actions of other nations. Also attempts to stop human right violations by imposing sanctions instead of using force. Canada tends to join with other nations who share the same views to implement sanctions jointly.

The United Nations Act incorporates into Canadian law the decisions are passed by the United Nations Security Council. The United Nations Security Council imposes a legal obligation on Canada to uphold the decisions enacted by the United Nations Act.

Canada has authority which it can impose sanctions in relation to a foreign state, either as implementing a decision, resolution or recommendation of a international or organization of states or association of states.

Export and Import Permits Act allows goods to be traded with regulations (area control list, export control list and the import control list) Area control list is a list of restricted countries, special permit is needed for Canada to trade to a country on this list. Export control is a list that consists of restricted goods. Import control is a list of goods that are not permitted into Canada. Import control list is not used to impose sanctions onto a foreign state. But there are some exceptional circumstances.

Safety Regulations

The government regulates and administers commerce and trade in specified goods under the following acts

*Food and drug act *Meat inspection act *Health of animals act *Hazardous Products act *Customs act

All of these acts affect both domestic and foreign imports. Each of these acts sets up many regulations. These regulations could act as barriers to trade for foreign exporters who may need to make costly changes in their manufacturing procedures to conform to Canadian standards.

Immigration Policies

Since the first settlers arrived in New France in the early 1600s, Canada has been a nation that depended on immigrants to grow the country and its economy. The Canadian economy benefits from their skills and financial investments. The immigrants maintain Canada's population as well as create a demand for imports –this encourages trade and makes Canada more culturally diverse.

Visitors

Canada welcomes visitors. People coming to Canada spend money on goods, services, or products they purchase to take home. Many international companies wish to transfer key managers and specialists to Canada for a period of time. They must apply for a work permit and if the work permit is granted these individuals may later apply for Permanent Resident Status in Canada.

Immigrants

People wishing to relocate from their home country to Canada must have a Canadian Immigrant Visa. Immigrants with a Canadian Immigrant Visa are allowed to work or live anywhere in Canada. After having the Visa for three years they can apply for Canadian citizenship and they can sponsor a family member for Canadian Permanent Resident Status.

There are two ways to qualify for Canadian Permanent Resident Status: as an Independent Immigrant or as a member of the Family Class. Independent Immigrants are divided into two categories: Skilled Worker Category and Business Category.

Refugees

Refugees are peoples who have fled their country to escape persecution or war. The persecution could be physical violence, harassment, wrongful arrest or threats to their lives. Other reasons they might be persecuted could be for reasons of race, religion, gender, nationality, political opinion, or membership in a particular social group. Refugees cannot rely on their own government to provide them with legal or physical protection. They have to try and find safety in other countries.

“Asylum” is somewhere one can go to find safety. Individuals who flee to Canada have their refugee claims heard before they are granted refugee status. In 2001, approximately 11 000 refugees were granted asylum in Canada.

When refugees are in Canada they are allowed to fully participate in Canadian society. When they come over they can seek work and go to school without hassle.

Dealing with Trade Barriers

Numerous trade missions, organized by federal, provincial, and even some municipal governments, have visited foreign countries in an attempt to develop more trade with them.

The federal government has indicated a willingness to establish the FTAA. Canada has strong ties to the United Kingdom and is using them to forge trade deals with European Union at preferred tariff rates. The Asia-Pacific Economic Cooperation (APEC) was established in 1989 in response to the growing interdependence among Asia-Pacific economies. APEC has since become the primary regional vehicle for promoting open trade and economic cooperation with Canada and the other twenty member countries. The World Trade Organization (WTO) is influencing and ruling on international trade policies and on some existing bilateral and multilateral agreements.

As for currency fluctuations, business can deal with the fluctuation in the value of the Canadian dollar by buying foreign currency.

Canada’s immigration policies are constantly being reviewed to allow more people to come to Canada.

The Investment Canada Act replaced the more restrictive Foreign Investment Review Act and significantly loosened restrictions on foreign investment in Canada, allowing the establishment of almost any new business by foreign investors without government review.

Lesson 1.2 - Balance of Payments and Balance of Trade

Learning Objectives

Having gone through this lesson, you are able to:

- Vividly understand the concepts of BOT and BOP and economic impact
- Describe why and how imbalances arise now then and how to control them.

Balance of Trade

Cumulative current account balance 1980–2008 based on International Monetary Fund data.

Cumulative current account balance **per capita** 1980–2008 based on International Monetary Fund data.

The **commercial balance** or **net exports** (sometimes symbolized as **NX**), is the difference between the monetary value of exports and imports of output in an economy over a certain period, measured in the currency of that economy. It is the relationship between a nation's imports and exports. A positive balance is known as a **trade surplus** if it consists of exporting more than is imported; a negative balance is referred to as a **trade deficit** or, informally, a trade gap. The balance of trade is sometimes divided into a goods and a services balance.

Policies of early modern Europe are grouped under the heading mercantilism. Early understanding of the imbalances of trade emerged from the practices and abuses of mercantilism in which colonial America's natural resources and cash crops were exported in exchange for finished goods from England, a factor leading to the American Revolution. An early statement appeared in *Discourse of the Common Wealth of this Realm of England*, 1549: "We must always take heed that we buy no more from strangers than we sell them, for so should we impoverish ourselves and enrich them. Similarly a systematic and coherent explanation of balance of trade was made public through Thomas Mun's c1630 "England's treasure by foreign trade, or, The balance of our foreign trade is the rule of our treasure

Definition

The balance of trade forms part of the current account, which includes other transactions such as income from the net 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 re-spent on foreign stock, nor does it factor in the concept of importing goods to produce for the domestic market).

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 the entire world's countries are added up, exports exceed imports by almost 1%; 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.

Factors that can Affect the Balance of Trade Include

- The cost of production (land, labor, capital, taxes, incentives, etc.) in the exporting economy *vis-à-vis* those in the importing economy;
- The cost and availability of raw materials, intermediate goods and other inputs;
- Exchange rate movements;
- Multilateral, bilateral and unilateral taxes or restrictions on trade;
- Non-tariff barriers such as environmental, health or safety standards;
- The availability of adequate foreign exchange with which to pay for imports; and
- Prices of goods manufactured at home (influenced by the responsiveness of supply)

In addition, the trade balance is likely to differ across the business cycle. In export-led growth (such as oil and early industrial goods), the balance of trade will improve during an economic expansion. However, with domestic demand led growth (as in the United States and Australia) the trade balance will worsen at the same stage in the business cycle.

Monetary balance of trade is different from physical balance of trade (which is expressed in amount of raw materials, known also as Total Material Consumption). Developed countries usually import a lot of raw materials from developing countries. Typically, these imported materials are transformed into finished products, and might be exported after adding value. Financial trade balance statistics conceal material flow. Most developed countries have a large physical trade deficit, because they have a large ecological footprint. Civil society organizations point out the predatory nature of this imbalance, and campaign for ecological debt repayment.

Since the mid-1980s, the United States has had a growing deficit in tradable goods; especially with Asian nations (China and Japan) which now hold large sums of U.S debt that has funded the consumption. The U.S. has a trade surplus with nations such as Australia. The issue of trade deficits can be complex. Trade deficits generated in tradable goods such as manufactured goods or software may impact domestic employment to different degrees than trade deficits in raw materials.

Economies such as Japan and Germany which have savings surpluses, typically run trade surpluses. China, a high-growth economy, has tended to run trade surpluses. A higher savings rate generally corresponds to a trade surplus. Correspondingly, the U.S. with its lower savings rate has tended to run high trade deficits, especially with Asian nations.

Views on Economic Impact

Classical Theory

From Classical economic theory, those who ignore the effects of long run trade deficits may be confusing David Ricardo's principle of comparative advantage with Adam Smith's principle of absolute advantage, specifically ignoring the latter. The economist Paul Craig Roberts notes that the comparative advantage principles developed by David Ricardo do not hold where the factors of production are internationally mobile.^{[7][8]}

Global labor arbitrage, a phenomenon described by economist Stephen S. Roach, where one country exploits the cheap labor of another, would be a case of absolute advantage that is not mutually beneficial. In 2010, economist Ian Fletcher authored a significant work entitled, *Free Trade Doesn't Work: What Should Replace It and Why*, where he has supported a strategic approach to trade rather than an unconditional or unilateral approach

Small trade deficits are generally not considered to be harmful to either the importing or exporting economy. However, when a national trade imbalance expands beyond prudence

(generally thought to be several percent of GDP, for several years), adjustments tend to occur. While unsustainable imbalances may persist for long periods (cf, Singapore and New Zealand's surpluses and deficits, respectively), the distortions likely to be caused by large flows of wealth out of one economy and into another tend to become intolerable.

In simple terms, trade deficits are paid for out of foreign exchange reserves, and may continue until such reserves are empty, at which point, the importer can no longer purchase abroad. This is likely to have exchange rate implications: a loss of value in the deficit economy's currency relative to the surplus economy's currency will change the relative price of tradable goods, and facilitate a return to balance or (quite commonly in historical data) an over-shooting into surplus, the other direction.

When an economy is unable to export enough physical goods to pay for its physical imports, it may be able to find funds elsewhere: Service exports, for example, are more than sufficient to pay for Hong Kong's domestic goods import.

In poor countries, foreign aid may compensate, while in developed economies a capital account surplus caused by sales of assets often offsets a current-account deficit. There are some economies where transfers from nationals working abroad contribute significantly to paying for imports. The Philippines, Bangladesh and Mexico are examples of transfer-rich economies.

A country may rebalance the trade deficit by use of quantitative easing at home. This involves a central bank printing money and making it available to other domestic financial institutions at small interest rates, which increases the money supply in the home economy. Inflation usually results, which devalues in real terms the debt owed to foreign creditors if that debt was instantiated in the home currency.

Adam Smith on the Balance of Trade

"In the foregoing part of this chapter I have endeavoured to show, even upon the principles of the commercial system, how unnecessary it is to lay extraordinary restraints upon the importation of goods from those countries with which the balance of trade is supposed to be disadvantageous. Nothing, however, can be more absurd than this whole doctrine of the balance of trade, upon which, not only these restraints, but almost all the other regulations of commerce are founded. When two places trade with one another, this [absurd] doctrine supposes that, if the balance be even, neither of them either loses or gains; but if it leans in any degree to one side, that one of them loses and the other gains in proportion to its declension from the exact equilibrium." (Smith, 1776, book IV, ch. iii, part ii)

Keynesian Theory

In the last few years of his life, John Maynard Keynes was much preoccupied with the question of balance in international trade. He was the leader of the British delegation to the United Nations Monetary and Financial Conference in 1944 that established the Bretton Woods system of international currency management.

He was the principal author of a proposal – the so-called Keynes Plan — for an International Clearing Union. The two governing principles of the plan were that the problem of settling outstanding balances should be solved by ‘creating’ additional ‘international money’, and that debtor and creditor should be treated almost alike as disturbers of equilibrium. In the event, though, the plans were rejected, in part because “American opinion was naturally reluctant to accept the principle of equality of treatment so novel in debtor-creditor relationships”.

His view, supported by many economists and commentators at the time, was that creditor nations may be just as responsible as debtor nations for disequilibrium in exchanges and that both should be under an obligation to bring trade back into a state of balance. Failure for them to do so could have serious consequences. In the words of Geoffrey Crowther, then editor of *The Economist*, “If the economic relationships between nations are not, by one means or another, brought fairly close to balance, then there is no set of financial arrangements that can rescue the world from the impoverishing results of chaos.”

These ideas were informed by events prior to the Great Depression when – in the opinion of Keynes and others – international lending, primarily by the U.S., exceeded the capacity of sound investment and so got diverted into non-productive and speculative uses, which in turn invited default and a sudden stop to the process of lending.

Influenced by Keynes, economics texts in the immediate post-war period put a significant emphasis on balance in trade. For example, the second edition of the popular introductory textbook, *An Outline of Money*, devoted the last three of its ten chapters to questions of foreign exchange management and in particular the ‘problem of balance’. However, in more recent years, since the end of the Bretton Woods system in 1971, with the increasing influence of Monetarist schools of thought in the 1980s, and particularly in the face of large sustained trade imbalances, these concerns – and particularly concerns about the destabilizing effects of large trade surpluses – have largely disappeared from mainstream economics discourse and Keynes’ insights have slipped from view. They are receiving some attention again in the wake of the financial crisis of 2007–2010.^[21]

Monetarist Theory

Prior to 20th century Monetarist theory, the 19th century economist and philosopher Frédéric Bastiat expressed the idea that trade deficits actually were a manifestation of profit, rather than a loss. He proposed as an example to suppose that he, a Frenchman, exported French wine and imported British coal, turning a profit. He supposed he was in France, and sent a cask of wine which was worth 50 francs to England. The customhouse would record an export of 50 francs. If, in England, the wine sold for 70 francs (or the pound equivalent), which he then used to buy coal, which he imported into France, and was found to be worth 90 francs in France, he would have made a profit of 40 francs. But the customhouse would say that the value of imports exceeded that of exports and was trade deficit against the ledger of France.

By *reductio ad absurdum*, Bastiat argued that the national trade deficit was an indicator of a successful economy, rather than a failing one. Bastiat predicted that a successful, growing economy would result in greater trade deficits, and an unsuccessful, shrinking economy would result in lower trade deficits. This was later, in the 20th century, echoed by economist Milton Friedman.

In the 1980s, Milton Friedman, a Nobel Prize-winning economist and a proponent of Monetarism, contended that some of the concerns of trade deficits are unfair criticisms in an attempt to push macroeconomic policies favorable to exporting industries.

Friedman argued that trade deficits are not necessarily as important as high exports raise the value of the currency, reducing aforementioned exports, and vice versa for imports, thus naturally removing trade deficits **not due to investment**. Since 1971, when the Nixon administration decided to abolish fixed exchange rates, America's Current Account accumulated trade deficits have totaled \$7.75 Trillion as of 2010. This deficit exists as it is matched by investment coming into the United States- purely by the definition of the balance of payments, any current account deficit that exists is matched by an inflow of foreign investment.

In the late 1970s and early 1980s, the U.S. had experienced high inflation and Friedman's policy positions tended to defend the stronger dollar at that time. He stated his belief that these trade deficits were not necessarily harmful to the economy at the time since the currency comes back to the country (country A sells to country B, country B sells to country C who buys from country A, but the trade deficit only includes A and B). However, it may be in one form or another including the possible tradeoff of foreign control of assets. In his view, the "worst case scenario" of the currency never returning to the country of

origin was actually the best possible outcome: the country actually purchased its goods by exchanging them for pieces of cheaply made paper. As Friedman put it, this would be the same result as if the exporting country burned the dollars it earned, never returning it to market circulation.

This position is a more refined version of the theorem first discovered by David Hume. Hume argued that England could not permanently gain from exports, because hoarding gold (i.e., currency) would make gold more plentiful in England; therefore, the prices of English goods would rise, making them less attractive exports and making foreign goods more attractive imports. In this way, countries' trade balances would balance out.

Friedman believed that deficits would be corrected by free markets as floating currency rates rise or fall with time to encourage or discourage imports in favor of the exports, reversing again in favor of imports as the currency gains strength.

In the real world, a potential difficulty is that currency markets are far from a free market, with government and central banks being major players, and this is unlikely to change within the foreseeable future. Nevertheless, recent developments have shown that the global economy is undergoing a fundamental shift. For many years, the U.S. has borrowed and bought while in general, the rest of the world has lent and sold.

As of October 2007, the U.S. dollar weakened against the euro, British pound, and many other currencies. For instance, the euro hit \$1.42 in October 2007, the strongest it has been since its birth in 1999. Against this backdrop, American exporters are finding quite favorable overseas markets for their products and U.S. consumers are responding to their general housing slowdown by slowing their spending. Furthermore, China, the Middle East, central Europe and Africa are absorbing more of the world's imports which in the end may result in a world economy that is more evenly balanced. All of this could well add up to a major readjustment of the U.S. trade deficit, which as a percentage of GDP, began in 1991.

Friedman contended that the structure of the balance of payments was misleading. In an interview with Charlie Rose, he stated that "on the books" the US is a net borrower of funds, using those funds to pay for goods and services. He essentially claimed that the foreign assets were not carried on the books at their higher, truer value.¹

Friedman presented his analysis of the balance of trade in *Free to Choose*, widely considered his most significant popular work.

Trade Balances Effects Upon Their Nation's GDP

Annual trade surpluses are immediate and direct additions to their nations' GDPs.

To some extent exports' induce additional increases to the GDPs that are not reflected within the export products' prices; thus trade surpluses contributions to their GDP are generally understated.

Products' prices generally reflect their producers' production supporting expenditures. Producers often benefit from some production supporting goods and services at lesser or no cost to the producers.

For example governments may deliberately locate or increase the capacity of their infrastructure, or provide other additional considerations to retain or attract producers within their own jurisdictions.

Nations' schools' and colleges' curriculums may provide job applicants specifically suited to the producer's needs; or provide specialized research and development. Nations' entire productions contribute to their GDPs but unless those goods and services are entirely reflected within globally traded products, these other export supporting productions are not entirely identified and attributed to their nations' global trade and they do additionally contribute to their nation's economy.

Annual trade deficits are immediate and indirect reducers of their nations' GDPs.

Trade deficits make no net contribution to their nations' GDPs but the importing nations indirectly deny themselves of the benefits earned by producing nations; (refer to "Annual trade surpluses are immediate and direct additions to their nations' GDPs"). Among what's being denied is familiarity with methods, practices, the manipulation of tools, materials and fabrication processes.

The economic differences between domestic and imported goods occur prior to the goods entry within the final purchasers' nations. After domestic goods have reached their producers shipping dock or imported goods have been unloaded on to the importing nation's cargo vessel or entry port's dock, similar goods have similar economic attributes.

Although supporting products not reflected within the prices of specific items are all captured within the producing nation's GDP, those supporting but not reflected within prices of globally traded goods are not attributed to nations' global trade. Trade surpluses'

contributions and trade deficits' detriments to their nation's GDPs are understated. The entire benefits of production are earned by the exporting nations and denied to the importing nation.

Balance of Payments

Balance of payments (BoP) accounts are an accounting record of all monetary transactions between a country and the rest of the world.[1] These transactions include payments for the country's exports and imports of goods, services, financial capital, and financial transfers. The BOP accounts summarize international transactions for a specific period, usually a year, and are prepared in a single currency, typically the domestic currency for the country concerned. Sources of funds for a nation, such as exports or the receipts of loans and investments, are recorded as positive or surplus items. Uses of funds, such as for imports or to invest in foreign countries, are recorded as negative or deficit items.

When all components of the BOP accounts are included they must sum to zero with no overall surplus or deficit. For example, if a country is importing more than it exports, its trade balance will be in deficit, but the shortfall will have to be counterbalanced in other ways – such as by funds earned from its foreign investments, by running down central bank reserves or by receiving loans from other countries.

While the overall BOP accounts will always balance when all types of payments are included, imbalances are possible on individual elements of the BOP, such as the current account, the capital account excluding the central bank's reserve account, or the sum of the two. Imbalances in the latter sum can result in surplus countries accumulating wealth, while deficit nations become increasingly indebted. The term "balance of payments" often refers to this sum: a country's balance of payments is said to be in surplus (equivalently, the balance of payments is positive) by a specific amount if sources of funds (such as export goods sold and bonds sold) exceed uses of funds (such as paying for imported goods and paying for foreign bonds purchased) by that amount. There is said to be a balance of payments deficit (the balance of payments is said to be negative) if the former are less than the latter.

Under a fixed exchange rate system, the central bank accommodates those flows by buying up any net inflow of funds into the country or by providing foreign currency funds to the foreign exchange market to match any international outflow of funds, thus preventing the funds flows from affecting the exchange rate between the country's currency and other currencies. Then the net change per year in the central bank's foreign exchange reserves is sometimes called the balance of payments surplus or deficit. Alternatives to a fixed exchange rate system include a managed float where some changes of exchange

rates are allowed, or at the other extreme a purely floating exchange rate (also known as a purely flexible exchange rate). With a pure float the central bank does not intervene at all to protect or devalue its currency, allowing the rate to be set by the market, and the central bank's foreign exchange reserves do not change.

Historically there have been different approaches to the question of how or even whether to eliminate current account or trade imbalances. With record trade imbalances held up as one of the contributing factors to the financial crisis of 2007–2010, plans to address global imbalances have been high on the agenda of policy makers since 2009.

Composition of the Balance of Payments Sheet

BOP the two principal parts of the BOP accounts are the current account and the capital account.

The current account shows the net amount a country is earning if it is in surplus, or spending if it is in deficit. It is the sum of the balance of trade (net earnings on exports minus payments for imports), factor income (earnings on foreign investments minus payments made to foreign investors) and cash transfers. It is called the current account as it covers transactions in the “here and now” – those that don't give rise to future claims

The Capital Account records the net change in ownership of foreign assets. It includes the reserve account (the foreign exchange market operations of a nation's central bank), along with loans and investments between the country and the rest of world (but not the future regular repayments/dividends that the loans and investments yield; those are earnings and will be recorded in the current account). The term “capital account” is also used in the narrower sense that excludes central bank foreign exchange market operations: Sometimes the reserve account is classified as “below the line” and so not reported as part of the capital account.

Expressed with the broader meaning for the capital account, the BOP identity assumes that any current account surplus will be balanced by a capital account deficit of equal size – or alternatively a current account deficit will be balanced by a corresponding capital account surplus

The balancing item, which may be positive or negative, is simply an amount that accounts for any statistical errors and assures that the current and capital accounts sum to zero. By the principles of double entry accounting, an entry in the current account gives rise to an entry in the capital account, and in aggregate the two accounts automatically balance.

A balance isn't always reflected in reported figures for the current and capital accounts, which might, for example, report a surplus for both accounts, but when this happens it always means something has been missed – most commonly, the operations of the country's central bank – and what has been missed is recorded in the statistical discrepancy term (the balancing item).[3]

An actual balance sheet will typically have numerous sub headings under the principal divisions. For example, entries under Current account might include:

Trade – buying and selling of goods and services

Exports – a credit entry

Imports – a debit entry

Trade balance – the sum of Exports and Imports

Factor income – repayments and dividends from loans and investments

Factor earnings – a credit entry

Factor payments – a debit entry

Factor income balance – the sum of earnings and payments.

Especially in older balance sheets, a common division was between visible and invisible entries. Visible trade recorded imports and exports of physical goods (entries for trade in physical goods excluding services is now often called the merchandise balance). Invisible trade would record international buying and selling of services, and sometimes would be grouped with transfer and factor income as invisible earnings.

The term “balance of payments surplus” (or deficit – a deficit is simply a negative surplus) refers to the sum of the surpluses in the current account and the narrowly defined capital account (excluding changes in central bank reserves

Variations in the use of Term “balance of Payments”

Economics writer J. Orlin Grabbe warns the term balance of payments can be a source of misunderstanding due to divergent expectations about what the term denotes. Grabbe says the term is sometimes misused by people who aren't aware of the accepted meaning, not only in general conversation but in financial publications and the economic literature.

A common source of confusion arises from whether or not the reserve account entry, part of the capital account, is included in the BOP accounts. The reserve account records

the activity of the nation's central bank. If it is excluded, the BOP can be in surplus (which implies the central bank is building up foreign exchange reserves) or in deficit (which implies the central bank is running down its reserves or borrowing from abroad).

The term “balance of payments” is sometimes misused by non-economists to mean just relatively narrow parts of the BOP such as the trade deficit,[3] which means excluding parts of the current account and the entire capital account.

Another cause of confusion is the different naming conventions in use.[4] Before 1973 there was no standard way to break down the BOP sheet, with the separation into invisible and visible payments sometimes being the principal divisions.

The IMF has their own standards for BOP accounting which is equivalent to the standard definition but uses different nomenclature, in particular with respect to the meaning given to the term capital account.

The IMF Definition

The International Monetary Fund (IMF) use a particular set of definitions for the BOP accounts, which is also used by the Organisation for Economic Co-operation and Development (OECD), and the United Nations System of National Accounts (SNA).

The IMF uses the term current account with the same meaning as that used by other organizations, although it has its own names for its three leading sub-divisions, which are:

The goods and services account (the overall trade balance)

The primary income account (factor income such as from loans and investments)

The secondary income account (transfer payments)

Imbalances

While the BOP has to balance overall, [7] surpluses or deficits on its individual elements can lead to imbalances between countries. In general there is concern over deficits in the current account.[8] Countries with deficits in their current accounts will build up increasing debt and/or see increased foreign ownership of their assets. The types of deficits that typically raise concern are [1]

A visible trade deficit where a nation is importing more physical goods than it exports (even if this is balanced by the other components of the current account.)

An Overall Current Account Deficit

A basic deficit which is the current account plus foreign direct investment (but excluding other elements of the capital account like short terms loans and the reserve account.)

As discussed in the history section below, the Washington Consensus period saw a swing of opinion towards the view that there is no need to worry about imbalances. Opinion swung back in the opposite direction in the wake of financial crisis of 2007–2009.

Mainstream opinion expressed by the leading financial press and economists, international bodies like the IMF – as well as leaders of surplus and deficit countries – has returned to the view that large current account imbalances do matter.[9] Some economists do, however, remain relatively unconcerned about imbalances[10] and there have been assertions, such as by Michael P. Dooley, David Folkerts-Landau and Peter Garber, that nations need to avoid temptation to switch to protectionism as a means to correct imbalances.

Causes of BOP Imbalances

There are conflicting views as to the primary cause of BOP imbalances, with much attention on the US which currently has by far the biggest deficit. The conventional view is that current account factors are the primary cause– these include the exchange rate, the government's fiscal deficit, business competitiveness, and private behaviour such as the willingness of consumers to go into debt to finance extra consumption. An alternative view, argued at length in a 2005 paper by Ben Bernanke, is that the primary driver is the capital account, where a global savings glut caused by savers in surplus countries, runs ahead of the available investment opportunities, and is pushed into the US resulting in excess consumption and asset price inflation.

Reserve Asset

The US dollar has been the leading reserve asset since the end of the gold standard.

In the context of BOP and international monetary systems, the reserve asset is the currency or other store of value that is primarily used by nations for their foreign reserves. [15] BOP imbalances tend to manifest as hoards of the reserve asset being amassed by surplus countries, with deficit countries building debts denominated in the reserve asset or at least depleting their supply. Under a gold standard, the reserve asset for all members of the standard is gold. In the Bretton Woods system, either gold or the U.S. dollar could serve

as the reserve asset, though its smooth operation depended on countries apart from the US choosing to keep most of their holdings in dollars.

Following the ending of Bretton Woods, there has been no de jure reserve asset, but the US dollar has remained by far the principal de facto reserve. Global reserves rose sharply in the first decade of the 21st century, partly as a result of the 1997 Asian Financial Crisis, where several nations ran out of foreign currency needed for essential imports and thus had to accept deals on unfavourable terms. The International Monetary Fund (IMF) estimates that between 2000 to mid-2009, official reserves rose from \$1,900bn to \$6,800bn. [16] Global reserves had peaked at about \$7,500bn in mid-2008, then declined by about \$430bn as countries without their own reserve currency used them to shield themselves from the worst effects of the financial crisis. From Feb 2009 global reserves began increasing again to reach close to \$9,200bn by the end of 2010.

As of 2009, approximately 65% of the world's \$6,800bn total is held in U.S. dollars and approximately 25% in Euros. The UK pound, Japanese yen, IMF special drawing rights (SDRs), and precious metals [19] also play a role. In 2009, Zhou Xiaochuan, governor of the People's Bank of China, proposed a gradual move towards increased use of SDRs, and also for the national currencies backing SDRs to be expanded to include the currencies of all major economies.[20] [21] Dr Zhou's proposal has been described as one of the most significant ideas expressed in 2009.

While the current central role of the dollar does give the US some advantages, such as lower cost of borrowings, it also contributes to the pressure causing the U.S. to run a current account deficit, due to the Triffin dilemma. In a November 2009 article published in Foreign Affairs magazine, economist C. Fred Bergsten argued that Dr Zhou's suggestion or a similar change to the international monetary system would be in the United States' best interests as well as the rest of the world's.[23] Since 2009 there has been a notable increase in the number of new bilateral agreements which enable international trades to be transacted using a currency that isn't a traditional reserve asset, such as the renminbi, as the Settlement currency.

Balance of Payments CRISIS

A BOP crisis, also called a currency crisis, occurs when a nation is unable to pay for essential imports and/or service its debt repayments. Typically, this is accompanied by a rapid decline in the value of the affected nation's currency. Crises are generally preceded by large capital inflows, which are associated at first with rapid economic growth. However a point is reached where overseas investors become concerned about the level of debt

their inbound capital is generating, and decide to pull out their funds.[26] The resulting outbound capital flows are associated with a rapid drop in the value of the affected nation's currency. This causes issues for firms of the affected nation who have received the inbound investments and loans, as the revenue of those firms is typically mostly derived domestically but their debts are often denominated in a reserve currency. Once the nation's government has exhausted its foreign reserves trying to support the value of the domestic currency, its policy options are very limited. It can raise its interest rates to try to prevent further declines in the value of its currency, but while this can help those with debts denominated in foreign currencies, it generally further depresses the local economy.

Balancing Mechanisms

One of the three fundamental functions of an international monetary system is to provide mechanisms to correct imbalances.

Broadly speaking, there are three possible methods to correct BOP imbalances, though in practice a mixture including some degree of at least the first two methods tends to be used.

These methods are adjustments of exchange rates; adjustment of nation's internal prices along with its levels of demand; and rules based adjustment. Improving productivity and hence competitiveness can also help, as can increasing the desirability of exports through other means, though it is generally assumed a nation is always trying to develop and sell its products to the best of its abilities.

Rebalancing by Changing the Exchange Rate

An upwards shift in the value of a nation's currency relative to others will make a nation's exports less competitive and make imports cheaper and so will tend to correct a current account surplus. It also tends to make investment flows into the capital account less attractive so will help with a surplus there too.

Conversely a downward shift in the value of a nation's currency makes it more expensive for its citizens to buy imports and increases the competitiveness of their exports, thus helping to correct a deficit (though the solution often doesn't have a positive impact immediately due to the Marshall–Lerner condition).

Exchange rates can be adjusted by government in a rules based or managed currency regime, and when left to float freely in the market they also tend to change in the direction

that will restore balance. When a country is selling more than it imports, the demand for its currency will tend to increase as other countries ultimately [34] need the selling country's currency to make payments for the exports. The extra demand tends to cause a rise of the currency's price relative to others. When a country is importing more than it exports, the supply of its own currency on the international market tends to increase as it tries to exchange it for foreign currency to pay for its imports, and this extra supply tends to cause the price to fall. BOP effects are not the only market influence on exchange rates however; they are also influenced by differences in national interest rates and by speculation.

Rebalancing by Adjusting Internal Prices and Demand

When exchange rates are fixed by a rigid gold standard, or when imbalances exist between members of a currency union such as the Eurozone, the standard approach to correct imbalances is by making changes to the domestic economy. To a large degree, the change is optional for the surplus country, but compulsory for the deficit country. In the case of a gold standard, the mechanism is largely automatic. When a country has a favourable trade balance, as a consequence of selling more than it buys it will experience a net inflow of gold. The natural effect of this will be to increase the money supply, which leads to inflation and an increase in prices, which then tends to make its goods less competitive and so will decrease its trade surplus. However, the nation has the option of taking the gold out of economy (sterilising the inflationary effect) thus building up a hoard of gold and retaining its favourable balance of payments. On the other hand, if a country has an adverse BOP it will experience a net loss of gold, which will automatically have a deflationary effect, unless it chooses to leave the gold standard. Prices will be reduced, making its exports more competitive, and thus correcting the imbalance. While the gold standard is generally considered to have been successful [36] up until 1914, correction by deflation to the degree required by the large imbalances that arose after WWI proved painful, with deflationary policies contributing to prolonged unemployment but not re-establishing balance. Apart from the US most former members had left the gold standard by the mid-1930s.

A possible method for surplus countries such as Germany to contribute to re-balancing efforts when exchange rate adjustment is not suitable is to increase its level of internal demand (i.e. its spending on goods). While a current account surplus is commonly understood as the excess of earnings over spending, an alternative expression is that it is the excess of savings over investment

If a nation is earning more than it spends the net effect will be to build up savings, except to the extent that those savings are being used for investment. If consumers can be encouraged to spend more instead of saving; or if the government runs a fiscal deficit to

offset private savings; or if the corporate sector divert more of their profits to investment, then any current account surplus will tend to be reduced. However in 2009 Germany amended its constitution to prohibit running a deficit greater than 0.35% of its GDP and calls to reduce its surplus by increasing demand have not been welcome by officials, adding to fears that the 2010s will not be an easy decade for the euro zone. In their April 2010 world economic outlook report, the IMF presented a study showing how with the right choice of policy options governments can transition out of a sustained current account surplus with no negative effect on growth and with a positive impact on unemployment

Rules Based Rebalancing Mechanisms

Nations can agree to fix their exchange rates against each other, and then correct any imbalances that arise by rules based and negotiated exchange rate changes and other methods. The Bretton Woods system of fixed but adjustable exchange rates was an example of a rules based system, though it still. John Maynard Keynes, one of the architects of the Bretton Woods system had wanted additional rules to encourage surplus countries to share the burden of rebalancing, as he argued that they were in a stronger position to do so and as he regarded their surpluses as negative externalities imposed on the global economy. [42] Keynes suggested that traditional balancing mechanisms should be supplemented by the threat of confiscation of a portion of excess revenue if the surplus country did not choose to spend it on additional imports. However his ideas were not accepted by the Americans at the time. In 2008 and 2009, American economist Paul Davidson had been promoting his revamped form of Keynes's plan as a possible solution to global imbalances which in his opinion would expand growth all rounds without the downside risk of other rebalancing methods

India's Balance of Payments

Balance of Payments (BoP), being a record of the monetary transactions over a period with the rest of the world, reflects all payments and liabilities to foreigners and all payments and obligations received from foreigners. In this sense, the balance of payments is one of the major indicators of a country's status in international trade. BoP accounting serves to highlight a country's competitive strengths and weaknesses and helps in achieving balanced economic-growth. It can significantly affect the economic policies of a government and the economy itself. Therefore, every country strives to have a favorable balance of payments and maintains its long run sustainability. India's balance of payment position was quite unfavorable during the time of country's entry into liberalized trade regime. Two decades of economic reforms and free trade opened several opportunities that, of course, reflected in the balance of payments performance of the country. This paper, therefore, attempts to

evaluate the trends and emerging challenges of India's Balance of Payments. The discussion is broadly classified into four parts viz. i) India's balance of payments picture since 1991, ii) emerging role of invisibles and software services in balance of payments iii) unhealthy trends in FDI and iv) the vulnerability and challenges ahead.

a) India's Balance of Payments Picture Since 1991

Independent India's external trade and performance had faced severe threats many a times. The most challenging one was that of 1991. The economic crisis of 1991 was primarily due to the large and growing fiscal imbalances over the 1980s. India's balance of payments in 1990-91 was suffered from capital account problems due to a loss of investor confidence. The widening current account imbalances and reserve losses contributed to low investor confidence putting the external sector in deep dilemma. During 1990-91, the current account deficit steeply hiked to \$-9680 million while the capital account surplus was far below at \$ 7188 million. This led to an ever time high deficit in BoP position of India.

India initiated economic reforms to find the way out of the growing crisis. Structural measures emphasized accelerating the process of industrial and import delicensing and then shifted to further trade liberalization, financial sector reform and tax reform. Prior to 1991, capital flows to India predominately consisted of aid flows, commercial borrowings, and nonresident Indian deposits. Direct investment was restricted, foreign portfolio investment was channeled almost exclusively into a small number of public sector bond issues, and foreign equity holdings in Indian companies were not permitted (Chopra and others, 1995). However, this development strategy of both inward-looking and highly interventionist, consisting of import protection, complex industrial licensing requirements etc underwent radical changes with the liberalization policies of 1991.

The post reform period really eased India's struggles with regard to external sector. This is evident from the RBI data summarizing the BOP in current account and capital account. The current account which measures all transactions including exports and imports of goods and services, income receivable and payable abroad, and current transfers from and to abroad remained almost negative throughout the post reform period except for the three financial years. Until 2000-01, the current account deficit that comprises both trade balance and the invisible balance, remained stagnant and stood around \$ 5000 million. However, for the first time since 1991, the current account recorded surplus in its account during three consecutive financial years

From 2001-02, the deficit in current account continued to occur from 2004-05 onwards and the growth rate was comparatively faster. Surprisingly, the current account

deficit grew like anything since 2007-08, the period witnessed financial crisis. The current account balance of India during 2011-12 is recorded to be \$ - 78155 million, signifying a deficit eight times that of the figures of 2007-08. Huge negative debits and comparatively low positive credits caused for this negative value in current account. Another notable feature of current account balance is that the deficit was mounting during the previous years. Two major items of current account are merchandise and the invisibles. These two items generate the value of current account balance of the country. The net merchandise has been always found to be huge negative figure. During 2011-12 it was recorded to be \$ - 189759 million. During the same period, our total merchandise credit was \$ 309774 million while our merchandise debit was \$ 499533 million. This is a common feature of India's merchandise figures during all the years.

The recent crisis of 2008 affected the trade performance of India in a large way. Indian economy had been growing robustly at an annual average rate of 8.8 per cent for the period 2003-04 to 2007-08. Concerned by the inflationary pressures, Reserve Bank of India (RBI) increased the interest rates, which resulted in a slowdown of India's trade flows prior to the Lehman crisis (Kumar and Alex, 2009). The trade flows, which are one of the important channels through which India was affected during the recent global crisis of 2008, started to collapse from late 2008. Merchandise trade, software exports and remittances declined in absolute terms in response to the exogenous external shock.

India's BOP during 1990-91 to 2011-12 (values in US \$ million)

Year	Current Account Balance	Capital Account Balance	Overall Balance
1990-91	-9680	7188	-2492
1991-92	-1178	3777	2599
1992-93	-3526	2936	-590
1993-94	-1159	9694	8535
1994-95	-3369	9156	5787
1995-96	-5912	4690	-1222
1996-97	-4619	11412	6793
1997-98	-5499	10010	4511
1998-99	-4038	8260	4222
1999-00	-4698	11100	6402
2000-01	-2666	8535	5868
2001-02	3400	8357	11757
2002-03	6345	10640	16985
2003-04	14083	17338	31421

2004-05	-2470	28629	26159
2005-06	-9902	24954	15052
2006-07	-9565	46171	36606
2007-08	-15737	107901	92164
2008-09	-27915	7835	-20079
2009-10	-38180	51622	13441
2010-11	-45945	58996	13050
2011-12	-78155	65324	-12832

Source: Reserve Bank of India, www.rbi.org

Lesson 1.3 - Indian EXIM Policy

Learning Objectives

After studying this lesson you are able to:

- Get an outline about the emergence of EXIM policy and various export promotion measures announced over the period of years
- Know the current policy measures
- Understand how to evaluate and control export policy

Indian EXIM Policy

EXIM Policy or Foreign Trade Policy is a set of guidelines and instructions established by the DGFT in matters related to the import and export of goods in India.

The Foreign Trade

Policy of India is guided by the Export Import in known as in short EXIM Policy of the Indian Government and is regulated by the Foreign Trade Development and Regulation Act, 1992.

DGFT (Directorate General of Foreign Trade) is the main governing body in matters related to EXIM Policy. The main objective of the Foreign Trade (Development and Regulation) Act is to provide the development and regulation of foreign trade by facilitating imports into, and augmenting exports from India. Foreign Trade Act has replaced the earlier law known as the imports and Exports (Control) Act 1947.

Indian EXIM Policy contains various policy related decisions taken by the government in the sphere of Foreign Trade, i.e., with respect to imports and exports from the country and more especially export promotion measures, policies and procedures related thereto. Trade Policy is prepared and announced by the Central Government (Ministry of Commerce). India's Export Import Policy also known as Foreign Trade Policy, in general, aims at developing export potential, improving export performance, encouraging foreign trade and creating favorable balance of payments position.

History of EXIM Policy of India In the year 1962, the Government of India appointed a special

EXIM Policy Committee to review the government previous export import policies. The committee was later on approved by the Government of India. Mr. V. P. Singh, the then Commerce Minister and announced the EXIM Policy on the 12th of April, 1985. Initially the EXIM Policy was introduced for the period of three years with main objective to boost the export business in India

Objectives of the Exim Policy

Government control import of non-essential items through the EXIM Policy. At the same time, all-out efforts are made to promote exports. Thus, there are two aspects of EXIM Policy; the import policy which is concerned with regulation and management of imports and the export policy which is concerned with exports not only promotion but also regulation.

The main objective of the Government's EXIM Policy is to promote exports to the maximum extent. Exports should be promoted in such a manner that the economy of the country is not affected by unregulated exportable items specially needed within the country. Export control is, therefore, exercised in respect of a limited number of items whose supply position demands that their exports should be regulated in the larger interests of the country.

In other words, the main objective of the EXIM Policy is:

- To accelerate the economy from low level of economic activities to high level of economic activities by making it a globally oriented vibrant economy and to derive maximum benefits from expanding global market opportunities.
- To stimulate sustained economic growth by providing access to essential raw materials, intermediates, components, consumables and capital goods required for augmenting production.
- To enhance the techno local strength and efficiency of Indian agriculture, industry and services, thereby, improving their competitiveness.
- To generate new employment.
- Opportunities and encourage the attainment of internationally accepted standards of quality.
- To provide quality consumer products at reasonable prices.

Governing Body of EXIM Policy

The Government of India notifies the EXIM Policy for a period of five years (1997-2002) under Section 5 of the Foreign Trade (Development and Regulation Act), 1992. The current

Export Import Policy covers the period 2002-2007. The EXIM Policy is updated every year on the 31st of March and the modifications, improvements and new schemes became effective from 1st April of every year.

All types of changes or modifications related to the EXIM Policy is normally announced by the Union Minister of Commerce and Industry who co-ordinates with the Ministry of Finance, the Directorate General of Foreign Trade and network of DGFT Regional Offices.

EXIM Policy: 1992-97

The EXIM policy 1992-97 focused on liberalisation openness transparency and globalisation. the policy also provided incentives through promotion schemes.

1. EXIM Scrips

The replenishment licences for exporters were replaced by EXIM scrips, which were basically import licences, issued on the basis of 30% of the FOB value of exports, irrespective of the nature of the export product, for most of the exports. this was completely abolished on 1.3. 1992 when the dual exchange rate for the exports proceeds and remittances came into being.

2. Decimalization

A number of items of export and import which were being canalized through public sector agencies have been decimalized by the new policy.

3. Approval

Automatic approval for technical collaboration and foreign equity participation upto 51% in Indian companies in 34 high priority industries has been approved

a. Equity

it was made essential than 51% in Indian trading companies primarily engaged in export activities.

b. FIPB

Foreign investment promotion board has been constituted to process and give speedy approvals for foreign investment.

c. Technology Imports

It was agreed automatic approvals of foreign technology agreements, if the technology is to be imported for the 34 high priority industries provided the fee does not exceed US\$385,000 and royalty does not exceed 5% of domestic and 8% of export sales.

d. Foreign Technicians

Hence forth, there is no need for prior approval of the reserve bank of India to engage foreign technicians by Indian firms/companies, if the terms of appointment conform to specific guide-lines.

e. Foreign Companies

Here after the foreign companies can open liaison and branch office in India if they bring exchange for their activities. the branch offices will be allowed to carry on trading activities

f. FERA Companies

General permission has been granted by RBI to FERA companies:

- a) To use overseas trade marks
- b) To accept appointment as an agent or technical or management adviser of any person or company in India
- c) To borrow money and accept deposits in India

Foreign Investment- Up to 100% equity is permitted for setting up power plants in India

In the budget announced on the floor of the parliament on 29.2.1992, the finance minister introduced a new system of partial convertibility, in order to give a powerful

boost to exports. Under the new system which came into being on 1.3.1992, all foreign exchange remittances whether earned through export of goods or services, or remittances are converted 40% of the foreign exchange remitted is converted at the official exchange rate, while the remaining 60% is converted at a market determined rate. In August 1994 the government of India made supply fully convertible into foreign exchange.

The foreign exchange surrendered at official exchange rates is made available to meet the foreign exchange requirements of essential imports such as, petroleum and oil products, defense and life saving drugs. All other imports of raw material, components and also capital goods will be made freely importable on OGL, but the foreign exchange for these imports will have to be obtained from the market. A specified negative list of raw material, components and capital goods has been released which will continue to be importable only against licences. There is no change in the import policy for consumer goods.

It will remain restricted at present. Foreign exchange required for other payments on private account including travel, debt service payments, dividends, royalties and other remittances will also have to be obtained at the market rate.

This new system completely replaced the issuance of EXIM scrips for exports. Since August 1994 those who earn foreign exchange have also an option to retain 50% of earnings in a foreign currency account in India for all permissible uses as were previously available in the blanket permit and another permit altogether.

Export Promotion Measures Introduced

They include:

1. Advanced Licence Scheme

An advance licence is now granted for the duty free import of raw material, components, intermediaries, consumables, and parts, spares, including mandatory spares and packing materials. Such licences are subject to the fulfillment of a time bound export obligation and value addition as may be specified. Advance licences may be based on either value or quantity. An exporter may apply for a value based or quantity based advanced licence.

2. International Price Disbursement Scheme (IPRS)

This was introduced to make available to exporters raw materials at international prices. In the case of raw materials, notified by the Government as coming under the IPRS,

the difference between the international prices as notified by the government and the domestic price, is reimbursed to the exporters.

3. Cash Compensatory Support (CCS)

In existence till 1 July, 1991 this scheme provided cash payment to exporters at a predetermined percentage on the FOB value of exports. This incentive was removed when the rupee was devalued in the 1st week of July 1991.

4. Drawback of Duties

There is a substantial element of customs duty paid on imported components, as well as excise duty on the indigenous purchase.

In the manufacture of many export products, these are evaluated on a yearly basis, and the exact quantum of these drawback duties is published by the Ministry of Finance. Accordingly, they are refunded to the exporter after the completion of the export.

5. Marketing Development Fund (MDF)

Founded in 1963-64, its nomenclature was changed to Marketing Development of Assistance (MDA) in 1975. It is administered bodies, also for special for providing grants/ assistance to Export Promotion Councils promotion efforts. As other export schemes approved for specific set export in recent years the fund sufficient amount has not been apart is on the decline.

6. Fiscal Benefit

The government has exempted export profits from tax under 80HHC provisions of the I.T. Act to promote exports and enable the exporters to plough back into the export trade their profits for higher exports.

For an exporter who is engaged in the sale of goods, both in the export and domestic market, the proportion of profits is now taken in the same ratio of the export turnover to total turnover items like petroleum products, fertilizers, news print, sulphur, nonferrous metal, etc., on the rupee payment basis It has helped to diversify Indian exports to these countries and balance the trade by substantial exports from India on a rupee basis.

Exim Policy 1997-2002

The Export and Import Policy 1997-2002 was aimed at:

- a. Giving a major thrust to acceleration of India's exports through restructuring and revamping of various export promotion schemes and wide ranging measures for simplification and streamlining of procedures with a view to making them more transparent and easy to administer.
- b. The Policy aims at continuing process of trade reforms and trade liberalisation with a view to achieving a higher rate of export growth.
- c. The EXIM Policy focused on the need to allow the exporters to concentrate on the manufacture and marketing of their products globally in an environment unhindered by discretionary controls and procedural bottlenecks.
- d. The policy aimed at enabling the industry to enhance its competitiveness in the global market and to achieve its full potential in the areas of its strength. The Policy has been modified from time to time.
- e. The major thrust areas of this EXIM Policy have been promote to agricultural exports, take Market Access Initiative provided separate incentives for Special Economic Zones, removal of quantitative restriction to facilitate imports and exports, liberalisation and streamlining of other existing schemes.

The principal objectives of this Policy include—.

- a) To accelerate the country's transition to globally orient vibrant economy with a view to deriving maximum benefits from expanding global market opportunities.
- b) To stimulate sustained economic growth by providing access to essential raw materials, intermediates, components, consumables and capital goods required for augmenting production.
- c) To enhance the technological strength and efficiency of Indian agricultural. Industry and services, thereby improving their competitive strength while generating new employment opportunities, and to encourage the attainment of internationally accepted standards of quality.
- d) To provide consumers with good quality products at reasonable prices.

It was decided to achieve these objectives through the coordinated efforts of all the departments of the general of Government in and the Ministry of Commerce and Industry, and the Directorate General Foreign Trade and its network of Regional Offices in particular, with a shared vision and commitment, in the interest of export promotion.

EXIM Policy & Procedures— 2002-2007

Salient Features

1. Agricultural Export Zones

With a view to providing the remunerative returns to the farming community in a sustained manner, it has been decided to make efforts India's Foreign policy procedures Trade and to provide improved access to the produce/products of the Agricultural and Allied sectors in the international market. The State Governments may identify Agri—export zone for end—to—end development for export of specific products from a geographically contiguous area.

State Government may evolve a comprehensive package of services provided by all State Government Agencies, State Agricultural Universities and all institutions and agencies of the Union Government for intensive delivery in these zones. Such services would include provision of pre/post harvest treatment and operations, plant protection, processing, packaging, storage and related research & development, etc. The service providers, setting up common infrastructural facilities such as sorting, grading, polishing, packaging, cold storage, transport equipment/refrigerated vans, vapor treatment heat treatment, plant, X-ray screening facility etc., shall be entitled for EPCG Scheme. Agri-exporters shall be entitled for recognition as Export House/Trading House, Star Trading House/Super Star Trading House on achieving 1/3”of the threshold limit prescribed for exporters of goods.

2. ‘Market Access Initiative (MAI)

The Government would assist the industry in research & development, market research, specific market and product studies, warehousing and retail marketing infrastructure in select countries and direct market promotion activities through media advertising and buyer—seller meets.

A Plan Scheme has been evolved for this purpose.

3. Special Economic Zones

- a) A new Chapter on Special Economic Zones has been introduced in the new policy.
- b) Special Economic Zones developers are allowed duty free import/ procurement from DTA for development of SEZ to give a boost for development of integrated infrastructure for exports.
- c) Duty free import/procurement from DTA of goods for setting up of factory in the Zone permitted.
- d) Items reserved for SSI do not require any licence for setting Li units in SEZ.
- e) Units in SEZ can bring back their export proceeds in 365 days: 3 against normal period of 180 days and can retain 100% of till proceeds in the EEFC account
- f) Special Economic Zones trading units permitted to sell goods in the DTA in accordance with the import policy in force
- g) Subcontracting of part of production abroad permitted.
- h) To facilitate greater flexibility and to attract capital intensive units into Special Economic Zones, amortization of value of imported Capital Goods is being spread over a period of 8 years instead of 5 years at that time
- i) SEZ developer is given infrastructure status under Income Tax Act as provided in the Finance Bill, 2001.

4. Removal of Quantity Restrictions (QRs)

The process of removal of import restrictions, which began in 1991 has completed in phased manner this year with removal of restriction on 715 items. Out of these 715, 342 are textile products, 147 an agricultural products including automobiles.

Import of agricultural products like wheat, rice, maize, other corals cereals, copra and coconut oil has been placed in the category of Stat', Trading. The nominated State Trading Enterprise will conduct the imports of these commodities solely as per commercial considerations similarly; import of petroleum products including petrol and ATF has also been placed in the category of State Trading. Import of urea will also be done through the mechanism of State Trading.

Care has been taken to ensure a level playing field to domestic producers vis-a-vis imports. In conformity with the "National Treatment Principle" of GAIT, imports have also made subject to the following domestic regulations.

- a) Import of all food products will be subject to compliance of a provision of Food Adulteration Act and Rules there under.
- b) Import of meat and poultry products will be subject compliance of all the provisions of Meat Food Product Order.
- c) Import of Tea Waste will be subject to compliance of Tea Waste (Control) Order.
- d) No import of textile material using the prohibited dyes like azo dye shall be allowed. For this purpose, a pre-shipment inspection certificate has been made mandatory.

In view of road safety and environment considerations, imports of second hand automobiles have been allowed subject to the following conditions.

- i. Import of automobiles older than three years is not allowed.
- ii. Imported vehicles need to conform to Central Motor Vehicle Rules.
- iii. Import of left—hand drive vehicles not allowed
- iv. For ensuring the requirements, pre shipment as well as post shipment certification made mandatory
- v. Imported automobiles to have a minimum and service during this residual life of five years and the importer to ensure supply of spares period; and
- vi. Such imports of new automobiles allowed subject to following conditions.

Similarly, import of new automobiles allowed subject to following conditions

- a) Import allowed only from the country of manufacture
- b) Import of left hand drive vehicles not allowed
- c) Imported vehicles to conform to the provisions of Motor Vehicles Act, 1988
- d) Prototype of vehicle to be approved by notified agencies in India; and abroad.

To ensure that import of agricultural products do not lead to unwanted infiltration of exotic diseases and pests in the country, it has been decided to subject to import of primary products of plant and animal origin to 'Bio Security & Sanitary and Phyto-Sanitary Permit' to be based on Import Risk Analysis of the product to be conducted on scientific principles, in accordance with the WTO agreement, on application of Sanitary and Phyto-Sanitary Measures.

5. Introduction of Export Promotion under Capital Goods Scheme

- a) Imports of jigs, fixture, dies, moulds to be allowed for the value full CIF value of the licence, instead of restricting to 20% of the CIF of licence.
- b) Time limit of 180 days prescribed for final is at ion of nexus by EPCG Committee failing which the nexus applied by the applicant becomes final.
- c) Extension in export obligation period under EPCG for Bank licences issued during 1990-1996 up to 31.3.2002, upon execution of Guarantee with the licensing authority..
- d) Extension in export obligation period for two years in respect and of EPCG issues under customs notification 29/1997 dated 1.4.97 and 49/2000 dated 27.4.2000.
- e) No penalty for value wise shortfall under EPCG except for the customers' duty together with interest.
- f) Facility for partial fulfillment extended under EPCG scheme to reduce transaction time.
- g) For redemption, the licence holder has been extended the facility to submit either a consolidated statement signed by all banks or separate statements signed by individual banks.

6. Introduction of Annual Advance Licence

- a) Extension of Annual Advance Licence facility for deemed exports and intermediate supplies.
- b) The entitlement for Annual Advance Licence increased from 125% to 200% of the FOB value of preceding year exports.
- c) Extension of Annual Advance Licence to other Standard Input Output- Norms exports.
- d) Clubbing facility for Annual Advance Licence.
- e) Dispensing with the need of technical characteristics for inputs except for items in the sensitive list.

7. Extension of Advance Licence

- a) Duty free import/ procurement of fuel cost is more than allowed under Standard Input/ Output Norms for sectors where the same 10% of the manufacturing cost.

- b) The facility of Advance Licences extended the buyer, even to the cases where some of the inputs are supplied free of cost by
- c) The entitlement for Advance Licence where 0 year SION does not exist increased from 100% to 200% of the FOB value preceding exports for Exports House/Trading House/Star trading House/Super Star Trading House.
- d) Additional facility for Advance Licence where SION does not exist beyond entitlement as well against execution of Bank Guarantee.
- e) Dispensing with the need of technical characteristics for inputs except for items in the sensitive list.
- f) The facility of back to back LC for Advance extended to cover Licence, which is presently confined to one bank and one branch, any bank and branch.
- g) Revalidation of expired Advance Licences, where export obligation has been completed, by six months.
- h) 506 new Standard Input Output Norms fixed during 2000-01.
- i) No penalty for value wise shortfall under the licence Advance Licence except for the customs duty together with interest provided holder has achieved positive/minimum value addition.
- j) Coverage of additional ports under Advance Licence.
- k) Simplification of form relating to Advance Licence on SION.

8. Extension of Duty Free Replenishment Certificate Scheme (DFRC)

- a) Validity of DFRC to be extended from 12 months to 18 months.
- b) Dispensing with the need of technical characteristics for inputs except for items in the sensitive list.
- c) Automatic calculation of CIF value under DFRC scheme without reference to international price of individual inputs.
- d) Provision incorporated for claim of DFRC against advance payment.
- e) Coverage of additional ports under DFRC.
- f) Split up facility extended to DFRC scheme to give operational flexibility to the holder of DFRC.

9. Extension of Duty Entitlement Passbook Scheme

- a) Provision made for claiming DEFB against advance payment.
- b) Validity of DFEB extended up to the last day of the month; in which the same is expiring.
- c) Rationalisation of DEPB rates in line with changes in Customs duty on account of Union Budget.
- d) Coverage of additional of DFPB rates in line with changes in Customs duty on account of Union Budget.
- e) TRA facility extended to all notified ports under DEFB scheme.

10. Extension of EOU/EPZ/EHTP/STEP Units

- a) Gem and Jewellery provisions relating to EOU/EPZ units contained in Chapter 8 merged into Chapter 9 for greater clarity.
- b) Supplies made to bounded warehouses set up under para 11.14 and 9.21 of the policy by EOU/EPZ units to be treated as exports for the purpose of domestic sales entitlement.
- c) Sub-contracting of production process abroad permitted. At present sub-contracting is permissible only with the country.
- d) DTA sales against foreign exchange, which is counted toward NEFP/IEP is being confined to payment made from EEFC account of the buyer only.
- e) Simplification of procedure regarding utilization of goods. EOUI EPZ units now have to account for duty free goods in overall terms and not consignment-wise. This is expected to facilitate ease in operation.
- f) E-Mail address is being made compulsory for approving EOU/EPZ units from 1.4.2001.
- g) Greater delegation to Development Commissioners to approve EOU/EPC projects. At present, Development Commissioners cannot approve project beyond US \$20 million. This value restriction is being withdrawn.
- h) Suitable procedure provided for conversion of DTA units into EOU under advance licensing scheme having outstanding export obligation scheme by carrying forward goods imported under Advance Licensing Scheme.
- i) Joint Monitoring of EOU/EPZ units by a Committee consisting of DC and customs

11. Extension of Gems & Jewellery Sector

- a) Extension of Diamond Dollar Account Scheme (DDAS) to diamond studded jewellery exporters, having an average annual turnover of ₹ 5 crore or above during the preceding earlier and allowing non- DDAS holder to supply cut and polished diamonds to DDAS holder, which would be counted towards discharge of his export obligations or entitle for a Replenishment licence, as the case may be.
- b) With a view to facilitate certification/ grading by international laboratories/agencies cut and polished diamonds weighing 0.50carats and above, have been permitted for export and return of such diamonds for certification purposes.
- c) More flexibility to exporters under the Gold Loan Scheme by allowing exporters to fix the price and repay the gold loan within 180 days from the date of export of subject to this price being also confirmed by the final buyer and the nominated agency supplying the gold.
- d) Exporters allowed to personally carrying gems and jewellery of a value not exceeding US\$2 million for purposes of holding/participating the gold.
- e) To foreign buyer scheme wherein precious metals can be supplied free of cost to the Indian manufacturers for job working, has been extended to exporters having an annual “average turnover of ₹ 5crores during the preceding three years.
- f) The provisions of personal carriage of gems and jewellery export and import parcels are now available from Bangalore Airport also in addition to Delhi, Mumbai, Kolkata and Chennai.

12. Extension of Deemed Exports

- a) The suppliers have been given the option to file application either project wise or covering supplies to all projects during a month quarter, or half yearly while claiming Terminal Excise duty Drawback facility. They have also been given the option to file claim covering all the supplies to a project.
- b) Standard format prescribed for receipt of payment through normal banking channel.
- c) For supplies under paragraph 10.2(d) (e) (f) and (g) of the Policy, the sub-contractor has been given the facility to file Terminal Excise Duty Refund without for payment from the main contractor.

13. Extension of Computerization

- a) The facility of electronic filing of applications extended to 29 out of 31 offices of DGFT.
- b) The facility of off-line filing introduced.
- c) The electronic filing shall be extended to all categories of licences.

14. Extension Of Procedural Simplification

- a) Profit of importer/exporter to be submitted once and to be submitted thereafter only in case of any change in the information already furnished.
- b) facility of clarifications/interview through E-Mail
- c) no time limit for filing application for golden status
- d) Restricted import licensing committee, export licensing committee, classification committee abolished.

15. More Jobs And More Exports Promised (On A High Growth Trajectory)

For industry and commerce, foreign trade is not just about earning foreign exchange and expanding the trade basket for Indian goods and services. going by the UPA's common minimum programme, it has promised the creation of one crore jobs while boosting export revenues to \$150 billion during the next 4 years. Commencing from 2004-2005

Unveiling the annual supplement to the five0-year trade policy, the reverend committee to add 25lakh jobs each year while setting an export growth target of 15% for 2005-06 in quantitative terms, exports will touch \$92 billion during 2005-2006 as against \$80 billion in 2004-2005, making a 24% growth. Previous year, exports have surpassed the \$75 billion target.

According to this policy, about 10 lakhs additional jobs were created in 2004-2005 owing to enhanced exports lone. Citing the finding of a study commissioned by industry ministry, the minister said about one crore new added during last year alone.

The focus areas indentified for boosting export revenues and jobs creation are: agriculture products, dairy and poultry, marine products, pharmaceutical, auto components, gems and jewellery.

A package of incentives and comprehensive strategy has been put together for each sector. for instance, the export cess currently being levied on agricultural and plantation exports has been abolished. export concessions currently available to fruits, flowers vegetables, minor forest produce and value added farm products have been extended to poultry and dairy products.

Stringent quality norms have been put in place for tea exports to retain India's share in world tea markets and brand the unique quality of Indian tea.

A package has also been announced for boosting marine exports, hit by the Tsunami. it includes allowing the import of duty-free inputs, chemical and favoring oils used in processing seafood for export markets.

For the gems and jewellery sector duty free import of samples up to ₹ 3 lakh has been allowed in a year. The earlier limit was ₹ 1 lakh to ensure availability of high quality fold purity over 0.995 per cent, designated agencies (MMTC and STC) have been directed to provide the metal for export purposes.

16. High Growth Trajectory

- exports zoom to record high of \$80 billion & double India's share in World trade
- steps to enhance competitiveness of manufacturing sector and employment generation
- Big thrust on agri-export, removal of export cess on agri, plantation, and commodities proposed.
- New initiative on infrastructure to reduce congestion at major ports, EOCG extended.
- Imports under several from India scheme to allow bulk sourcing.
- Focus on marine sector in the wake of Tsunami.
- DEFB to continue, replacement scheme being finalized.
- Setting up of Interstate trade council mooted.
- Procedures simplified to cut transaction costs. 'aayat niryat' form introduced.

17. Renewed Thrust to Export Promotion

The governments announced initiatives to give a renewed thrust to export promotion capital goods schemes. Underlining the significance of EPCG scheme as an important

building block for sustained export growth, commerce and industry ministry announced that firms fulfilling 75 per cent or more of export obligation shall be freed from the balance export obligation.

To simplify the procedures for availing the benefits under EPCG, the annual supplement to foreign trade policy stated that hereafter all EPCG licenses issued under the same customs notification can be clubbed, considerably reducing the paper work of exporters.

In order to create modern infrastructure in the retail sector concessional duty benefits under the EPCG scheme shall be extended for import of capital goods required by the retailers. the retailers with a shopping area of 1000 square meters are expected to fulfill their export obligations from payments received against counter sales in foreign exchange through banking channels.

Extending the benefits of EPCG to agriculture and small scale sector, it said import of capital goods at concessional rates will be allowed with a reduced export obligation. agro units would now have to fulfill export obligation of six times, the duty saved over a 12 year period, instead of the normal window of eight times duty saved in eight years.

The SSI sector has been allowed to import capital goods at five per cent customs duty subject to a fulfillment of an export obligation equivalent to six times the duty saved on capital goods imported under EPCG scheme over 8 years.

Evaluation and Control of Export Policy

Before the company actually enters into export operations, it will evaluate its export policy. The various components of the export policy must be thoroughly screened to ensure that they are mutually consistent. The various policies should also be related to the business environment at home and to the target export market. Finally, a continuous review of the export policy should be made to keep it in line with changing conditions

India's Foreign Trade Policy 2009-14

In the wake of global economic slowdown, India's merchandise exports faced significant adverse impact. Exports, which had grown by 48.1% during April to September, 2008, suffered a decline during the next 12 months from October, 2008 to September, 2009, due to the shrinkage of the demand worldwide and particularly the contraction in demand in the traditional markets of our exports.

In May, 2009, the exports declined by as high as 34.2% in US\$ terms. The downward trend was arrested from October, 2009 onwards and our exports ended up with an export figure of US\$ 178.75 billion in 2009-10 against US\$ 185.30 billion in 2008-09, which indicates an overall decline of 3.5% in dollar terms.

The growth in exports since October, 2009 can be attributed to growth in some sectors, but is primarily due to the lower base effect of the exports in the corresponding months of previous financial year. This year, exports have registered a growth of about 27% in US\$ terms and it is expected that we exceed the merchandise export target of US\$ 200 billion by the end of 2010-11.

Foreign Trade Policy, 2009-14

The Foreign Trade Policy (FTP), 2009-14 was announced on 27th August, 2009 in the backdrop of a fall in India's exports due to global slowdown. The immediate and the short term objective of the policy was to arrest and reverse the declining trend of exports as well as to provide additional support especially to those sectors which were hit badly by recession in the developed world. The Policy envisaged an annual export growth of 15 per cent with an annual export target of US \$ 200 billion by March 2011 and to come back on the high export growth path of around 25 per cent per annum in the remaining three years of this Foreign Trade Policy i.e. up to 2014. The long term policy objective for the Government is to double India's share in global trade by 2020.

What is Foreign Trade Policy?

The Union Commerce Ministry, Government of India announces the integrated Foreign Trade Policy FTP in every five year. This is also called EXIM policy. This policy is updated every year with some modifications and new schemes. New schemes come into effect on the first day of financial year i.e. April 1, every year. The Foreign trade Policy which was announced on August 28, 2009 is an integrated policy for the period 2009-14.

Objectives of Foreign Trade Policy 2009-14:

1. To arrest and reverse declining trend of exports is the main aim of the policy. This aim will be reviewed after two years.
2. To Double India's exports of goods and services by 2014.
3. To double India's share in global merchandise trade by 2020 as a long term aim of this policy. India's share in Global merchandise exports was 1.45% in 2008.

4. Simplification of the application procedure for availing various benefits
5. To set in motion the strategies and policy measures which catalyse the growth of exports
6. To encourage exports through a “mix of measures including fiscal incentives, institutional changes, procedural rationalisation and efforts for enhance market access across the world and diversification of export markets.

Aim in General

The policy aims at developing export potential, improving export performance, boosting foreign trade and earning valuable foreign exchange. FTP assumes great significance this year as India's exports have been battered by the global recession. A fall in exports has led to the closure of several small- and medium-scale export-oriented units, resulting in large-scale unemployment.

Targets:

1. Export Target: \$ 200 Billion for 2010-11
2. Export Growth Target: 15 % for next two year and 25 % thereafter.

EPCG Scheme:

1. Obligation under EPCG scheme relaxed.
2. To aid technological upgradation of export sector, EPCG Scheme at Zero Duty has been introduced.
3. Export obligation on import of spares, moulds etc. under EPCG Scheme has been reduced by 50%.

Refixation of Annual Average Export Obligation

Taking into account the decline in exports, the facility of Re-fixation of Annual Average Export Obligation for a particular financial year in which there is decline in exports from the country, has been extended for the 5 year Policy period 2009-14. Support for Green products and products from North East extended.

Announcements for FPS, FMS, MLFPS

1. 26 new markets added in this scheme.
2. Incentives under FMS raised from 2.5 % to 3 %
3. Incentive available under Focus Product Scheme (FPS) raised from 1.25% to 2%.
4. Extra products included in the scope of benefits under FPS
5. Market Linked Focus Product Scheme (MLFPS) expanded by inclusion of products like pharmaceuticals, textile fabrics, rubber products, glass products, auto components, motor cars, bicycle and its parts.etc. (However, benefits to these products will be provided, if exports are made to 13 identified markets (Algeria, Egypt, Kenya, Nigeria, South Africa, Tanzania, Brazil, Mexico, Ukraine, Vietnam, Cambodia, Australia and New Zealand).
6. Focus Product Scheme benefit extended for export of 'green products' and some products from the North East.
7. A common simplified application form has been introduced to apply for the benefits under FPS, FMS, MLFPS and VKGUY.

Announcements for MDA & MAI

Higher allocation for Market Development Assistance (MDA) and Market Access Initiative (MAI) has been announced.

Towns of Export Excellence (TEE)

The following cities have been recognized as towns of export excellence (TEE)

1. Handicrafts: Jaipur, Srinagar and Anantnag
2. Leather Products: Kanpur, Dewas and Ambur
3. Horticultural Products: Malihabad

Scheme for Status Holders (Status Holders means Star Status Holders)

1. Additional Duty Credit Scrips shall be given to Status Holders @ 1% of the FOB value of past exports accelerate exports and encourage technological upgradation.
2. This facility shall be available for sectors of leather (excluding finished leather), textiles and jute, handicrafts, engineering (excluding Iron & steel & non-ferrous metals in primary and intermediate form, automobiles & two wheelers, nuclear

reactors & parts, and ships, boats and floating structures), plastics and basic chemicals (excluding pharma products).

3. This facility shall be available up to 31 March, 2011.
4. Transferability for the Duty Credit scrips being issued to status holders under VKGUY Scheme permitted only for the procurement of cold chain equipments.

Extension of Income Tax Exemption to EOU and STPI

Income Tax exemption to 100% EOUs and to STPI units under Section 10B and 10A of Income Tax Act has been already extended for the financial year 2010-11 in the Budget 2009-10.

Extension of ECGC

The adjustment assistance scheme initiated in December, 2008 to provide enhanced ECGC cover at 95%, to the adversely affected sectors, is continued till March, 2010. Announcements For Marine sector:

1. Fisheries exempted from maintenance of average EO under EPCG Scheme (along with 7 sectors) however Fishing Trawlers, boats, ships and other similar items shall not be allowed for this exemption.
2. Additional flexibility under Target Plus Scheme (TPS) / Duty Free Certificate of Entitlement (DFCE) Scheme for the marine sector.

Announcements for Gems & Jewellery Sector

1. Duty Drawback is allowed on Gold Jewellery exports to neutralize duty incidence.
2. Plan to establish “Diamond Bourse (s) with an aim to make India and International Trading Hub announced.
3. Introduction of a new facility to allow import on consignment basis of cut & polished diamonds for the purpose of grading/ certification.
4. 13 value limits of personal carriage have been increased from \$ 2 million to US\$ 5 million in case of participation in overseas exhibitions.
5. The limit in case of personal carriage, as samples, for export promotion tours, has also been increased from US\$ 0.1 million to US\$ 1 million.

6. Time limit of 60 days for re-import of exported gems and jewellery items, for participation in exhibitions has been extended to 90 days in case of USA.

Announcements for Agro Exports

1. Introduction of a single window system to facilitate export of perishable agricultural produce with an aim to reduce transaction and handling cost.
2. This system will involve creation of multi-functional nodal agencies. These agencies will be accredited by APEDA.

Announcements for Leather Exports

On the payment of 50 % applicable export duty, Leather sector shall be allowed re-export of unsold imported raw hides and skins and semi finished leather from public bonded ware houses.

Announcements for Tea Exports

1. The existing Minimum value addition under advance authorisation scheme for export of tea is 100 %. It has been reduced from the existing 100% to 50%.
2. DTA (Domestic Tariff Area) sale limit of instant tea by EOU units increased from 30% to 50%.
3. Export of tea has been included under VKGUY Scheme benefits.

Announcements for Pharma Exports

1. Export Obligation Period for advance authorizations issued increased from existing 6 months to 36 months.
2. Pharma sector included under MLFPS for countries in Africa and Latin America & some countries in Oceania and Far East.

Announcements for Handloom Exports

The claims under Focus Product Scheme, the requirement of “ Handloom mark” was required earlier. This has been removed.

Scheme for Export Oriented Units

1. EOUs have been allowed to sell products manufactured by them in DTA (Domestic Tariff Area) up to a limit of 90% instead of existing 75%, without changing the criteria of 'similar goods', within the overall entitlement of 50% for DTA sale. (This means that instead of 75% these units can sell up to 90 % of their products in the domestic markets)
2. EOU allowed procuring finished goods for consolidation along with their manufactured goods, subject to certain safeguards.
3. Extension of block period by one year for calculation of Net Foreign Exchange earning of EOUs kept under consideration.
4. EOU allowed CENVAT Credit Facility.

Announcements for Value Added Manufacturing (VAM)

- To encourage Value Added Manufactured export, a minimum 15% value addition on imported inputs under Advance Authorization Scheme.

Announcements for Project Exports

- Project Exports and a large number of manufactured goods covered under FPS and MLFPS.

Fuel included in DEPB Scheme:

- Custom duty component on fuel where fuel is allowed as a consumable in Standard Input-Output Norm included in factoring.

Easy Import of Samples

- Number of sample pieces has been increased from the existing 15 to 50. This will facilitate the the duty free import of samples by exporters.

Convertibility of Shipping Bills

Greater flexibility has been permitted to allow conversion of Shipping Bills from one Export Promotion scheme to other scheme. Customs shall now permit this conversion within three months, instead of the present limited period of only one month.

Reduction in Transaction Costs

1. Dispatch of imported goods directly from the Port to the site has been allowed under Advance Authorisation scheme for deemed supplies. (Presently the duty free imported goods could be taken only to the manufacturing unit of the authorisation holder or its supporting manufacturer.
2. Maximum applicable fee for 18 Authorisations/ licence applications (except those mentioned in Chapter 3 of FTP) has been reduced to ₹ 100,000 from the existing ₹ 1,50,000 (for manual applications) and ₹ 50,000 from the existing ₹ 75,000 (for EDI applications).
3. No fee shall now be charged for grant of incentives under the Schemes in Chapter 3 of FTP.

Disposal of Manufacturing Wastes

1. Disposal of manufacturing wastes / scrap will now be allowed after payment of applicable excise duty also before fulfillment of export obligation under Advance Authorisation and EPCG Scheme. Earlier it was allowed after fulfillment of export obligation.

Announcements for Sports Weapon

1. Licenses for the import of sports weapon will be issued now by Regional Authorities provided a NOC (No Objection Certificate) is issued by Ministry of Sports & Youth Affairs. (Earlier DGFT Headquarters had to be approached for this)

Announcements for Medical Devices

1. To solve the problem of medical device industry, the procedure for issue of Free Sale Certificate has been simplified and the validity of the Certificate has been increased from 1 year to 2 years.

Announcements for Automobile Industry

1. Those Automobile industries which have their R&D establishment will be allowed free import of reference fuels (petrol and diesel), up to a maximum of 5 KL per annum, which are not manufactured in India. Simplification in EPCG for automobile industry.

Announcements for EDI Initiatives

1. Export Promotion Councils & Commodity Boards have been advised to issue RCMC through a web based online system.
2. It is expected that issuance of RCMC would become EDI enabled before the end of 2009.

Set up of Directorate of Trade Remedy Measures Announced

- A Directorate of Trade Remedy Measures shall be set up, which will enable support to Indian industry and exporters, especially the Micro Small & medium Enterprises MSMEs in availing their rights through trade remedy instruments,

Duty Credit Scrips

- Earlier the payment of customs duty for Export Obligation (EO) shortfall under Advance Authorisation, DFIA or EPCG Authorisation was allowed in cash only. Now this payment can be done in the way of debit of Duty Credit scrips.

Import of Restricted Items

- Restricted Items can be imported now (as replenishment) against transferred DFIA's (Duty Free Import Authorisations) as the present DFRC (Duty Free Replenishment Card) scheme.
- There is a provision for state-run banks to provide dollar credits

Dollar Credits

Thereafter, as promised in FTP, to continue regular interaction with stakeholders to maintain a close watch on the performance of the policy in the field, a number of interactions were held with members of Board of Trade, Open Houses with exporters and sectoral reviews with EPCs. Constant dialogues were held with all key stakeholders in industry and the exporting community for sectoral assessment of exports at regular intervals. The first review was undertaken in December 2009 and thereafter in February 2010, which demonstrated that some sectors were still facing difficulties. Need-based additional support measures were announced in January, 2010, March, 2010 and on 11th February, 2011 for certain product groups / products.

The recovery has been fragile and economies around the world are still emerging out of the shadows of a grim recessionary period. The IMF projections indicate that the world economy is recovering at varying speeds for different regions. Though, there had been marginal improvement in some of the developed economies like US, UK, Germany, France, Japan etc., the nervousness continued in the markets about the fiscal situation and sovereign indebtedness in several high income countries of Europe. In this setting, it was expected that the developed countries would aim at economic recovery through consolidation and export led growth, which would pose a challenge to Indian exporters in accessing overseas markets for their products. The uncertainty surrounding Indian exporters' prospects, therefore, continued to linger.

Though the exports growth moved towards the positive trajectory from October, 2009 onwards, our exports were not yet out of the woods.

Under this global situation of slow recovery, it was necessitated to take stock of the situation so as to make mid course corrections. Accordingly, sectoral reviews were continued in the current financial year 2010-11, and the first such review for 2010-11 was undertaken in July 2010. It was observed that despite the measures announced in the FTP and additional support extended in January and March, 2010, some sectors continued to face difficulties. It was also realized that there was a shroud of uncertainty continuing over the fragile nature of global economic recovery. Even as global economic rebalancing had been proceeding apace, it was not going to be an easy patch for Indian exporters. In view of resource constraints, it was not simply possible to sustain support to all sectors and there was need to calibrate the support measures appropriately. On the other hand, exports of certain products had been placed under restriction in view of domestic situation i.e. inflationary pressures and unemployment. It was also essential to be conscious of the need for and the inevitability of fiscal consolidation. Keeping all these factors in mind and based on the sectoral review held in July, 2010, need based additional initiatives were undertaken in the Annual Supplement 2010-11 to FTP 2009-14, announced on 23rd August, 2010. While emphasis on stability of policy regime was continued, additional measures were announced to support exports particularly for the labour intensive sectors. In order to promote technological upgradation, zero duty EPCG and Status Holder Incentive Schemes were expanded and validity extended. It will add to expansion and modernization of production base at a time when investment is drying up in export industry.

A new facility of Annual EPCG authorization was introduced.

While exports have shown a rising trend during the last few months, certain sectors are still not out of woods. Further, fragile economic recovery and consequent slower demand

growth in the developed markets has necessitated greater emphasis on improving the competitiveness of our exports. To assess the export performance of various sectors, second sectoral performance review was conducted during November-December, 2010. Accordingly, to enhance competitiveness for products which are labour intensive, technology intensive and value added, further export incentives were undertaken on 11th February, 2011 for more than 600 products for sectors viz. Agriculture, Chemicals, Carpets, Engineering, electronics and plastics. In addition, as a continuing endeavor for procedural simplification and trade facilitation, a few measures were taken.

Self Assessment Questions

1. Discuss the new trends in trading and investment policy of globalisation.
2. Describe the new trends in India's global trading pattern with future prospects.
3. Describe the new policy and investment environment for India global trading.
4. Briefly explain the export promotion measures in India.
5. Write a note on impact of exports in the development process.
6. Briefly explain the different theories of International trade.
7. Discuss the impact of exports in the development of an economy.
8. Explain the factors affecting the balance of trade.
9. Briefly discuss how trade balances effects upon nation's GDP
10. Describe composition of the balance of payments sheet.
11. What are the causes of bop imbalances
12. Give a note on balancing mechanisms.
13. What do you mean by EXIM policy?
14. Briefly explain the objectives of EXIM policy.
15. Write a short note on export promotion measures introduced in India.
16. Give a detailed discussion on India's foreign trade policy 2009-14.

UNIT – II

Unit Structure

- Lesson 2.1 - Export and Import Finance
- Lesson 2.2 - Export – Import (EXIM) Bank of India
- Lesson 2.3 - Export Credit Guarantee Corporation
- Lesson 2.4 - Import Licensing

Lesson 2.1 - Export and Import Finance

Learning Objectives

Having gone through this lesson, you are able to

- Understand INCO terms
- Comprehend Export finance importance, methods and issues
- Know the RBI initiatives

Introduction

Export means any goods which are to be taken out of a country to a place outside the country. The exports are classified into the following categories:

- a. Merchandise Exports;
- b. Services Exports;
- c. Project Exports;
- d. Deemed Exports.

Export finance mechanism and institutional support are vital for the promotion of exports. Today,

A number of financial institutions exist that provide financial assistance for export. The various institutions involved in the provisions of finance in India are:

- Reserve Bank of India,
- Export – Import Bank of India,
- Commercial Bank,
- Export Credit and Guarantee Corporation and
- Industrial Development Bank of India.

The RBI formulates the lending policies and guidelines and all the nationalized banks, private and foreign banks are required to operate within the policies and guidelines laid down by the former. It provides re-financing facilities of the short term credit sanctioned by various commercial banks and thereby it facilitate the lending operation of the latter.

The EXIM bank is the main source of long term export finance to the exporters of India. It either solely or in participation with other commercial banks constitutes the primary source of export finance. Generally, funds given by these banks are in the form of both pre – shipment and post – shipment finance.

Next to commercial banks, the fourth financial institution involved in export financing is ECGC. Their main functions are: providing insurance cover to Indian exporters; extending financial guarantees to banks that extends credit to exporters etc.

Finally, IDBI has been operating several schemes for providing credit to Indian exporters. Further, refinancing facilities are also provided by IDBI to commercial banks against the medium term export credit given to exporters.

The EXIM Bank of India came into existence on 1st January 1982, and started functioning from March 1st 1982. It has its headquarters' in Mumbai and its branch offices in important centre in India and abroad. EXIM Bank is a wholly government – owned financial institution, set up for the purpose of financing, facilitating and promoting India's foreign trade. The main focus of the EXIM bank of India is export finance related to export of capital goods and other manufactured goods, consultancy and technology services involving deferred payment terms. The bank also provides Pre – shipment finance where the production process exceeds months. In addition to extending non fund based assistance by way of guarantees on behalf of Indian exporters for construction, turnkey and consultancy projects abroad, the EXIM bank provides various financial assistance for the export of Indian goods under its various schemes of assistance such as direct assistance

to exporters includes post – shipment term finance; pre – shipment credit; term loans for export – oriented units; overseas investment finance; finance for export marketing, loans to foreign government, importers and financial institutions include overseas buyers' credit; lines of credit; re-lending facility to banks abroad, re- finance facility for banks in India include rediscounting of export bills; small- scale industry export bills; refinance of export credit; bulk import finance.

Finance is the basic requirement of all business activities. The need for export finance arises as soon as the exporter received export order. Export financing transactions come to an end when the goods are loaded on the vessel and export proceeds received from importer. Exporters should plan in advance is arranging export finance from the beginning and to the end of the export trade for sanctioning export finance. Export financing is a complicated lending transaction because is involved traders of two countries and foreign exchange transactions. it export trade, buyers and sellers are far away and sellers do not know the socio, economic and cultural environment of the end users of their products. Exporters have to exercise greater care is allowing credit to importers in other overseas market. They should be very careful regarding terms of payment. Export document procedures should be duly fulfilled.

competition in world market, both for consumer and capital goods, is becoming increasingly intensified and, in this situation, the bargaining power has shifted from the seller to the buyer, who tend to dictate terms with regard to price, quality and delivery schedules and above all, insists on appropriate credit terms. The availability of an adequate supply of credit as reasonable rate, therefore, greatly facilitates the task of the exporter and serves as an incentive to augment his export effort. he depleting foreign exchange position in many developing countries makes it imperative for importers to ask for credits of varying duration, and the credit terms offered often influence the buyer's choice of supplier and thus the source of supply.

According to David Kinley, "by credit we mean the power which one person has to induce another to put economic goods at his disposal for a time on promise of future payment. Credit is thus an attribute of power of the borrower". Thus the main elements of credit are: the element of trust, the element of capital and asset, the element of amount of credit and element of duration of credit.

INCO Terms

Price quotations to the overseas buyer are quoted in following internationally accepted terms

Ex-Works (EXW)

‘Ex-works’ means that the seller’s responsibility is to make the goods available to the buyer at works or factory. The full cost and risk involved in bringing the goods from this place to the desired destination will be borne by the buyer this term thus represents the minimum obligation for the seller. It is mostly used for sale of plantation commodities such as tea, coffee and cocoa.

Free Carrier (FC)

‘Free carrier’ means the seller’s obligations are fulfilled when the goods are delivered to the carrier named by the buyer at the named place. The term may be used for all modes of transport including multimodal transport.

Free Alongside Ship (FAS)

Once the goods have been placed alongside the ship, the seller’s obligations are fulfilled and the buyer notified. The seller has to contract with the sea carrier for the carriage of goods to the destination and pay the freight. The buyer has to bear all costs and risks of loss or damage to the goods from that point. The seller is required to clear the goods for export.

Free On Board (FOB)

The seller’s responsibility ends the movement the contracted goods pass the ship’s rail at the port of shipment named in the sales contract. This means that the buyer has to bear all costs and risks of loss or damage to the goods from that point. The seller is required to clear the goods for export.

Cost and Freight (CFR)

‘Cost and Freight’ means that the seller delivers when the goods pass the ship’s rail in the port of shipment. The seller must on his own risk contract for the carriage of the goods to the port of destination named in the sale contract and pay the freight. This being a shipment contract, the point of delivery is fixed to the ship’s rail and the risk of loss or damage to the goods is transferred from the seller to the buyer at the very point. As will be seen though the seller bears the cost of carriage to the named destination, the risk is already transferred to the buyer at the port of shipment itself.

Cost, Insurance, Freight (CIF)

the term is basically the same as CFr, but with the addition that the seller has to obtain the insurance at his cost against the risk of loss or damage to the goods during the carriage.

Cost Paid To CPT

‘CPT’ means that the seller delivers the goods to the carrier nominated by him, but the seller must, in addition pay the cost of carriage necessary to bring the goods to the named destination. The buyer bears all risks and any other costs after the point of delivery. The seller is required to clear the goods for export.

Carriage and Insurance Paid To (CIP)

CIP is the same as CPT, with the addition that the seller is also required to produce the insurance at the buyer’s risk of loss of or damage to the goods during the carriage.

Delivered At Frontier (DAF)

The term is primarily intended to be used when the goods are to be carried by rail or road. 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.

Delivered Ex-Ship (DES)

This is an arrival contract and means that the seller makes the goods available to the buyer in the ship at the named port of destination as per sales contract. The seller has to bear to the full cost and risk involved in bringing the goods there. The sellers’ obligations are fulfilled before the customs border of the foreign country and it is for the buyer to obtain necessary import licence at his own risk and expense.

Delivered Ex-Quay (DEQ)

Ex-quay means that the seller makes the goods available to the buyer at the named quay. As in the term ‘ex-ship’ the points of divisions of cost and risks coincide, but they have now been moved one step further from the ship in the quay or wharf i.e. after crossing the customs border at destination. Therefore, in addition to arranging for carriage and paying freight and insurance the seller has to bear the cost of discharging the goods at the quay.

The buyer is required to clear the goods for import and to pay for all formalities, duties, taxes and other charges upon import.

Delivered Duty Unpaid (DDU)

‘DDU’ means that the seller delivers goods to the buyer, at the port of destination. The seller has to bear the costs and risks involved in bringing the goods thereto. The buyer has to get the goods unloaded and cleared for import, by paying the applicable duty.

Delivered Duty Paid (DDP)

This term may be used irrespective of the transport involved and denotes the seller’s maximum obligations as opposed to ‘ex-works’. The seller has not fulfilled his obligation till such time that the goods are made available at his risk and cost to the buyer at his premises or any other named destination. In the latter case the necessary documents (e.g., transport document or warehouse warrant) will have to be made available to the buyer to enable him to take delivery of the goods.

Export Finance

Finance is the life blood of any business activity. Finance is the most significant aspect in export trade. Once the exporter order is received, production of exportable commodities should take in time is required adequate finance for procuring the needed raw materials and other components. In some cases, materials are to be imported from foreign is required foreign currency. Unless the financial requirements for exports are fulfilled, export order cannot be met in the scheduled time,. Further, getting payment for the export cargo will take some time. Adequate credit facilities are to be extended to the exporters till they receive export proceeds from foreign courtiers. Realizing the significance of export finance and to encourage exports, the RBI has come forward to extend export finance to the Indian exporters as concessional rate.

There are two types of export finance. They are,

- i) Pre-shipment credit or packing credit and
- ii) Post- shipment credit

The RBI has defined pre-shipment credit as “as any loan to an exporter for financing the purchase, processing, manufacturing or packing of goods.”

Pre shipment credit is given by the commercial banks for purchasing and processing of materials, manufacturing of exportable commodities and packing of such commodities pre-shipment credit is granted by the commercial banks for a period of 180 days from the date sanctioning the credit. Further extension will be given for a period of 90 days, provided adequate reasons are given by the exporters for such extension a period of 90days provided adequate reasons are given by the exporters for such extension.

Interest rate for the Pre-shipment credit is lower than the normal rate of interest. Concessional interest rate is charged for pre-shipment credit in order to maintain price competitiveness in the overseas market and to reduce interest burden to the exporters Commercial banks charge a rate of 11 percent of pre-shipment credit up to 180 days pre-shipment credit between 180 days to 270 days will cost exporters 12 to 15 the interest rate for post-shipment credit of usance bill beyond 90 days is 11 percent. The concessional rate of interest is one of the important incentives provided by the Government for export trade. In order to reduce the interest rate for export credit, the RBI has reduced the export refinance rate 9% to 7% exporters should fulfill all the procedures prescribed by the commercial banks for export credit. Exporters should submit export order of letter of credit along with the application form for pre-shipment credit.

Exporters should give an undertaking that the advance will be used exclusively for the purpose of procuring /manufacturing/ shipping of commodities means for export as given in export order of Letter of Credit. Banks will sanction the pre-shipment credit after verifying all the documents required for it. the credit worthiness of the exporter, their capacity to produce exportable commodities and the reputation of the organisation are also assessed by the banks before sanctioning pre-shipment credit. Exporters are advised to get appropriate insurance policy for export credit from the Export Credit Guarantee Corporation (ECGC). Exporters should get Packing Credit Guarantee also from the ECGC. Insurance Policy and guarantee from the ECGC are insisted by the commercial banks for sanctioning pre-shipment credit Exporters can avail pre-shipment credit in foreign currency also.

Post-shipment credit refers to any loan or-any other credit provided by any institution to an exporter of goods from India from the date of extending the credit after shipment of goods o the date of realization of export proceeds and included any loan on advance granted to an exporter, on consideration of or on the security of any drawback of any case receivable by way of incentives from the Government.

Dr.Varma and Agarwal, in their book Foreign Trade Management have specified the need for export finance.

- i. Procuring raw materials and components to process and product exportable commodities,
- ii. Refinancing facilities so as to get the proceeds of bill after the shipment,
- iii. Making availability of funds until the export benefits are realized and
- iv. Refinancing facilities for long term credit offered for the export of products.

The RBI in its letter dated January 31 03 informed banks to use foreign currency funds borrowed in terms of Para 4(2)(i) of notification no FEMA 3.2 000 as also foreign currency funds generated through by sell swaps in the domestic forex market for granting export credit, subject to the aggregate gap limit approved by it in simple terms, it means that banks can give such loans by exporters. The directive to this effect from the industrial and export credit department of RBI was meant to provide flexibility to banks to source foreign currency funds for granting PCP/EBR to exporters.

Pre-shipment means any loan or advance granted or any other credit provided by a bank to an exporter for financing the purchase, processing, manufacturing or packing of goods prior to shipment, on the basis of letter of credit opened in his favor or in favor of some other person, by an overseas buyer or a confirmed and irrevocable order for the export of goods from India or any other evidence of an order for export from India having been placed on the exporter or some other person, unless lodgment of export orders o letter of credit with the bank has been waived.

Post-shipment Credit means any loan or advance granted or any other credit provided by an institution to an exporter of goods from India from the date of extending credit after shipment of goods to the date of realization of export proceeds.

Banks are allowed to rediscount export bills abroad at rates linked to international interests' rates in the post shipment stage. With a view to making credit available to exporters at internationally competitive rates, authorised dealers have been permitted to extend Pre-shipment Credit in Foreign Currency (PCFC) to exporters for domestic and imported inputs of exported goods at LIBOR/EURO LIBOR/EURIBOR related rates of interest.

An Exporter has the Following Export Finance Options

To avail of pre-shipment credit in rupees and then the post-shipment credit either in rupees or discounting/ rediscounting of export bills under EBR Scheme. If the pre-shipment credit is n foreign currency, the post shipment credit has necessarily to be under the EBR scheme since the foreign currency pre-shipment credit has to be liquidated in foreign currency

Choice of currency The facility may be extended in one of the convertible currencies viz. US Dollars, Pound Sterling, Japanese Yen, Euro, etc. To grant exporters greater operational flexibility, it will be in order for banks to extend PCFC in one convertible currency in respect of an export order invoiced in another convertible currency. For example, an exporter can avail of PCFC in US Dollar against an export order invoiced in Euro. The risk and cost of cross currency transaction will be that of the exporter.

The foreign currency balances available with the bank in Exchange Earners Foreign Currency (EEFC) Accounts, Resident Foreign Currency Accounts (RFC) and Foreign currency (Non-Resident) Accounts (Banks) Scheme could be utilized for financing the pre-shipment credit in foreign currency and EBR.

Hence banks allow an exporter to book forward contracts on the basis of a confirmed export order prior to availing PCFC.

Finance and Export Trade

The reserve bank of India export import banks of indie development finance institutions and commercial banks both private and public sector banks are actively involved in providing export finance. The RBI regulates interests' rate for export finance. The export credit and guarantee corporation of India is also involved in the process of export finance transaction. Commercial banks provide two types of export finance. They are pre-shipment finance and post-shipment finance.

Commercial banks are directed by the RBI to provide 12% of their new bank credit for export finance. Export finance is needed to exporters to identify emerging export market and to develop exportable products, establish production infrastructure and facilities, procure raw materials and other assemblies for producing export cargo, undertake export promotion activities and fulfill financial requirements during the period between shipment of goods and the actual receipt of payment.

RBI Initiatives for Export Finance

While the bank rate has come down to 7 percent, export credit remains comparatively costlier as 10 per cent in the case of both pre-shipment as well as post-shipment credit. The Federation of Indian export organisation (FIEO) president KK Jain met RBI governor Dr Bimal Jalan to seek reduction in export credit and also waives of bank processing charges in the case of exports. Industry sources said the apex bank's chief has given positive indications regarding reduction in export credit, without going into details of the quantum of reduction.

Interest charges of export credit stood as 11 per cent as of April 1998 while the bank rate stood as 1 per cent. Subsequently, bank rate came down first to 8 percent and then to 7 per cent. Interest charged on export credit came down to 10 percent with effect from April 1 1991 but has been staying at the same level despite a two percentage point reduction in bank rate since then.

Exporters have also pointed out that rival exporters based in other countries enjoy cheaper export credit and this blunts the competitiveness of the Indian industry. China for example, charges only 3.2 percent interests on export credit while Japan offers credit to exporters at 1.38 percent.

Indonesia charges 2.17 percent interest on export credit while Singapore and Taiwan charge, respectively, 5.7 percent and 4.9 percent.

The FIEO president also informed the RBI chief that service charges imposed by banks stand at 13.97 per cent and this is in addition to the cost of export credit which stands at 10 per cent. Export credit outstanding increased from ₹ 38885 crore in 1998-99 to ₹ 44 872 crore in 1999-2000 in line with the growth in the country's exports. The export community accounted for 10.7 per cent of the total new bank credit outstanding in 1999-2000 as compared to 11 per cent in 1998-99.

Exporters have been demanding that the government should provide cheaper credit so that Indian export could become internationally competitive. However, officials feel that any subsidy of export credit may not be in line with norms laid out by the world trade organisation.

The central bank slashed export credit rates by one percentage point across the board, raising hopes of a further reduction in key interest rates. Expectation of a cut in the bank rate pushed down forward premium on the dollar immediately after the export rate cut was announced.

In addition, the RBI in consultation with the government, announced a special financial package for large value exports of six products pharmaceuticals, agri chemicals, transport equipment, cement, iron and steel and electrical machinery, which are internationally competitive and gave high value addition.

Manufacturers exporters in these products with export contracts of ₹ 100 crore and above in one year will be eligible for the special financial package. This will be valid for one year from October 1, 2001.

Exporters covered under the special financial package will be extended credit for an extended period up to 365 days as the pre-shipment as well as post-shipment stage the rates of interest which are now decided by banks on a commercial basis up to a maximum of prime lending rate plus 4 percentage points, has now been capped at PLR+0.5 per cent for the extended period of pre shipment and post shipment credit. This measure, applicable for large value exports is over and above the reduction in ceiling rates on export credit. Export will also be allowed to import raw material on credit terms for periods beyond 180 days as one percentage point above the prevailing Libor rate. EXIM bank has been permitted to extend buyers credit of ₹ 200 crore without reference to RBI. Similar permission will also be granted to the participating banks.

Importance of Export Finance

The importance of export finance is present below

- 1) **It enhances exports in the competitive market;** export finance paves the way to increase exports. Increasing exports are essentials for a developing as well as developed country. But export market is operating in the competitive environment. Hence, the government or banking institutions usually extend concessional credit to its exporters, who are in need of such credits to fulfill their export obligations.
- 2) **Technological Development:** the degree of technical know-how is very low in less developed and developing countries. So, less developed countries hire the services from other developed countries but their charges are very high. Huge finance is needed to the less developed countries to repay service charges. Export finance is needed to pay such charges.
- 3) **Easier terms and conditions:** if the credit is available on easier terms, exporters will be in a position to sell the goods to the importer on easier payment terms.
- 4) It is a source for the economic development of nation. Developing countries are having deficiency of foreign exchange reserve to cope with their development needs. Exporters obtain long-term export credit from specialized financial institutions to meet import commitments. Thus, export finance does not create pressure over foreign exchange position and help for economic development.
- 5) **Balanced growth.** The deficiency of finance is one of the main constraints for economic development of developing countries. In this context, export finance contributed to economic development and helps to establish balanced industrial development of different nations

- 6) It reduces adverse balance of payments. Adverse balance payment creates serious consequences on development activities of any nation. With sufficient export finance, the manufacturers of a country may produce more and export more to different markets in the world. Increase in export earnings will help to solve balance of payment of crisis.
- 7) It helps for sales promotion. The various sales promotion programme like advertising, publicity, trade fairs and exhibitions, etc., need adequate finance. Export finance can be used for undertaking aggressive export promotion measures to increase export market.
- 8) It enhances customer service. Export finance is needed for product adaptation, improvement of quality, adding new uses to the product and to use an appropriate pricing method to increase export performance.
- 9) Export finance fulfils short, medium and long-term financial needs. Exporters need short-term medium-term and long term finance to meet their production and distribution requirements. Banks provide short-term credit extending to a period up to one year, and other terms of financial needs are met from other national and international financial institutions. Long-term credit helps to bring modernization and adoption of latest technology.

Methods and Sources of Export Finance

The main methods of export finance can be grouped into two. They are

- 1) Short-term Finance, and
- 2) Medium and Long-term Finance

Short-Term Finance

Short term finance facility is extended for a period from 30 days to 180 days. It is granted by the commercial banks for import-export trade in consumer goods and industrial goods like small machines, commercial vehicles, spare parts, etc.

The main importance of short term finance to export is presented below:

- 1) Producing raw materials,
- 2) Manufacturing and processing of making advances to other producers from whom the exportable goods are ordered.

- 3) Meeting expenses of packing, handling, internal transport and to meet insurance and warehousing charges, and
- 4) Shipment and other related needs.

The requirement of short-term finance to the importer is as follows

- 1) For payment of advance to the exporter
- 2) For meeting the shipping charges, insurance etc.
- 3) To pay duty is obtaining import licence etc.

The main short term credit or finance included pre-shipment finance and post shipment finance. They are explained below.

Pre-Shipment Finance

Pre-shipment means any loan or advance granted or any other credit provided by a bank to an exporter for financing the purchase, processing, manufacturing or packing of goods prior to shipment, on the basis of letter of credit opened in his favor or in favor of some other person, by an overseas buyer or a confirmed and irrevocable order for the export of goods from India or any other evidence of an order with the exporter. the maximum period for which any loan on advance may be granted or any other credit facility may be provided does not usually exceed 180 days, on such extended period as the central bank of the exporting country may allow. normally, there are two ways open to an exporter to obtain license as the pre-shipment stage. they are anticipatory letters of credit and packaging credits.

Preshipment Finance in Foreign Currency

Exporters can get pre-shipment finance in foreign currency from commercial banks. Exporters can use the foreign currency for the purpose of importing necessary raw materials and other inputs for manufacturing exportable commodities. Pre-shipment finance in foreign currency is made available to the exporters who have a fire export order or a letter of credit. This type of financial arrangement is provided by banks for a maximum period of 180 days. Pre-shipment finance in foreign currency can be obtained any authorised dealers in foreign exchange.

Commercial banks provide pre-shipment finance to the exporters against the security of (i) Pledge,(ii) Hypothecation(iii) Export Trust Receipt, (iv) Incentives Receivables, (v) Red Clause Letter and (vi) Back-to-Back Letter of Credit

Banks will insist exporters to take appropriate export credit, insurance policy from the export credit guarantee corporation of India limited, for providing pre-shipment finance. the following documents are required for getting pre-shipment finance from banks;(i) Confirmed export order,(ii) letter of credit,(iii) policy of export credit guarantee corporation,(iv) copy of audited financial statement and income tax assessment, v) copy of the CNO exporter code number and (vi) copy of the registration –cum membership certificate issued by an exporter promotion council.

Anticipatory Letters of Credit

Anticipatory letters of credit is also known as red clause letters of credit. it is a normal letter of credit, which contains a special clause (usually typed in red) authorizing the negotiating or confirming bank.

The red clause of letter of credit is generally opened to enable the exporter to procure material and executed the foreign buyer's order without looking up to much of his own funds. the advance made to the exporter is of course as the risk of the opening bank and in restricted to the amount authorised in the red clause letter of credit. The bank must ensure that there are proper instructions on the red clause letter of credit as regards reimbursement of the amount to be advanced to the exporter. Generally, the reimbursement of the amount to be advanced to the exporter under a red clause letter of credit is provided by the negotiation of clear draft under the letter of credit, in which case the invoice submitted as the time of the negotiation of the documents should show a deduction to the extent of the drawings already made. Before advancing against a red clause letter of credit, it is advisable to ensure that the bank will be in a position to negotiate the bills drawn under the letter of credit.

Packing Credit

Packing credit is essentially a loan or advance granted a bank to an exporter to assist him in buying, packing and shipping the goods. These advances are generally made by commercial banks in different forms.

Forms of Advances

The main form of financing the exports as the pre-shipment stage is:

- (1) Loans
- (2) Overdrafts, and
- (3) Case credit

(1) Loans

Under loan account, the entire amount is paid to the borrower either in cash or by transfer to his current account as one time. Generally, its repayment is stipulated by installments. The main advantage of the loan system is that the loans are for predetermined short periods and have a built-in programme of repayment. They are automatically reviewed by banks on the due dates. The main disadvantage of the system is its inflexibility and the need for borrowers to negotiate fresh loans every time. Verification of the ultimate use of funds is difficult in this system compared to the case credit system.

(ii) Overdrafts

An overdraft is a fluctuating account and its balance is sometimes in credit and sometimes in debit. Cheques drawn on a current overdraft arrangement enable a customer to draw over and above his own balance up to the extent of the limit stipulated. Drawings and repayments are permitted as needed by the customer, provided the total amount overdrawn does not exceed the agreed limit.

(iii) Case Credit

Case credits are ordinarily allowed against pledge or hypothecation of goods against personal security. If there is a good turnover in the account and quick movements of goods, a case credit limit is renewed periodically. The case credit system has the advantage of flexibility. It enables the borrower to route all their case earnings through the account and keep drawings at the minimum level, thereby minimizing interest charges. The main disadvantage of the system is that the banks may find it difficult to ensure the end-use of funds due to its emphasis on the security aspect and the roll-over nature of credits.

Operational Mechanisms for Pre-Shipment Financing

Pre-shipment finance is essentially a working capital finance made available for the specific purpose of manufacturing of goods meant for export. All costs prior to shipment would be eligible for financing under packing credits. The following points will usually be examined by the banks when considering proposals for export packing credits.

1. The capacity of the exporter to execute the orders within the stipulated delivery schedules
2. The ability of the exporter to absorb export business loss.

3. Whether the quantum of finance asked for is on or equal rate with the company's turnover.
4. The degree of arrangements made for the import of raw materials and its component
5. The spread of risk
6. Whether the exports are covered by irrevocable letters of credit
7. The status of the issuing banks
8. The status of the buyer's country in terms of economic and political conditions
9. The availability of security such as export credit insurance cover
10. Covering of exchange risk.

Post-Shipment Finance

Post-shipment finance is defined as any loan of advance granted or any other credit provided by an institution to an exporter of goods from India from the date of extending the credit after shipment of goods to the date of realization of export proceeds, in consideration or on the security of any drawback or any cash payment by way of incentive from the market development assistance or any other relevant source. Thus post-shipment finance is given against.

1. Export bills drawn on foreign buyers, and
2. Export cash incentives to be received by the exporter.

Negotiation of Bills

Bills of exchange either in Indian rupees or foreign currencies under a letter of credit or otherwise are offered to banks for negotiation such as sale or discount. Normally, the bills drawn against a letter of credit are accepted without any difficulty due to the fact that banks do not have any risk involved, the negotiation of bill depends upon the following factors:

- i. Credit Rating: Status report on both drawee and drawer in terms of both financial and moral standing is the prime consideration in accepting a bill for negotiation.
- ii. Product characteristics: The nature, quality and price of the export product also influence the banker's decision in accepting a bill. For instance, banks will accept the bill if the product is of international standard and quality and offered at most competitive rates and has good demand abroad.

- iii. Documentary requirements: in case of documentary bill, the banks will examine the documents like bill of lading and invoice or various aspects such as whether the bill is supported by all the documents mentioned in the letter of credit.
- iv. Credit of negotiation: if the amount does not generally exceed the credit limit of the drawee fixed by the bank, then the bills are accepted
- v. Rate of Negotiation: the rate of negotiation mainly depends upon the currency in which the bill is drawn, the banking organization in the country concerned period of maturity etc. the banker treats the negotiation until the final remittance is received. the banks consider the following factors in calculating such a rate:
 - i. Prevailing rate of interest,
 - ii. The period which the bill has to run before maturity,
 - iii. Stamp duty to which the bill is liable in the foreign centre,
 - iv. Charges for collection which the foreign banks may make,
 - v. An appropriate allowance for possible delays of mails or other contingencies and the banker's own profit over the transaction.
- vi. Collection of bills: the Sight Documents against payment as well as usance bills documents against acceptance can be offered to the banks on collection basis. banks send such bills to their foreign branch for collection of payment. Banks may give advance against such bills and it may take the following forms:
 - i. Cent percent advance: Bank may discount the bill of exchange by advancing to the drawer the full face value of the bills if a rupee bill of exchange has been drawn and received by the bank for discount with instructions from the drawee that in addition to face amount of the bill, the drawee is to pay interest, collection charges and foreign bill stamps.
 - ii. Percentage of advance; the usual procedure is that the bank will advance up to a certain percentage of the amount of cash bill of exchange depending upon the integrity and financial standing of the drawer. Besides, the collection charges are made on the full value of the bill.
 - iii. Percentage advance against pending collection; under this system the drawer limit is calculated as a percentage times of outstanding amount and the customer can draw, if he needs, up to the amount indicated by the drawing limit.

Sources of Short-Term Export Finance

The main source of short-term export finance is presented below;

1. Foreign Trade Financed by Exporter

This is one of the sources of export credit but very few exporters will employ their capital to finance for export. Exporter will employ this method when he is financially sound and he may consider supplying goods to the importer on the basis of credit. In this situation, exporter will provide credit to the importer on the following terms:

- i. **Open Current Account:** Generally, this method will operate between the exporter and importer who have long-term dealings. Exporter sends the letter of rights to the importer. Importer makes payment within appointed time on the basis of the exporter's letter of rights. Interest is charged at certain rates if the importer delays the payment beyond the agreed time limit.
- ii. **Open Account:** Exporter ships the goods without financial documents to his advantage except commercial invoice. Sales on open account are settled through agreed periodic remittances. Considerable risk is involved in the open account method as seller carries no documentary evidences of transaction with him. Hence, this method is generally confined to interrelated companies.
- iii. **Payment by return mail:** Under payment to return mail method, the seller ships the goods and a shipment advice is sent to the importer. The importer must make the remittance immediately on receipt of shipment advice.
- iv. **Payment against bills of exchange:** Under this method, the exporter ships the goods to the importer on the basis of bills of exchange drawn on importer's name. In addition to documentary bill of exchange, invoice, shipping bill and insurance are enclosed. The exporter sends the bills of exchange directly or through the bank for collection of payment.

2. Foreign Trade Financed by the Exporter with the Assistance of his Bank

Under this category, exporter obtains bill of exchange from the importer which will remain with him for a certain period of time. After the expiry period the exporter accepts payment from the importer. Besides, the exporter can discount the bill from any commercial bank for finance if he needs finance before the expiry period of the bill.

3. Foreign Trade Financed by the Importer

Sometimes, the importer imports the goods of paying case is advance. The following are the main types of short-term credit given to the exporter by the importer.

- (i) Payment of placing orders: The importer makes full payment in advance of placing fire orders with the exporter
- (ii) Cable transfers: Under this system, a cable message will be send to the importer by the exporter once the goods are ready for dispatch. On the receipt of the cable message, payments are made to the exporter
- (iii) Payments through confirming houses: Resident Buyer or a Forwarding Agent may be confirming houses. The payment will be made by the confirming houses to the exporter on the basis of fire order by the importer. However, exporter will be prepared to accept payment on the basis of credit worthiness of confirming houses.

4. Foreign Trade Financed by Importer with Bank Assistance

The exporter can get import finance through a bank by any of the following two methods:

- (i) Bills of Exchange: Documentary bill of documentary draft is one of the main methods of payment in export trade. Under this system, the exporter has to draw a bill of exchange on the buyer, payable as sight when no trade credit is being extended or payment as some future date to take care of inherent credit terms. The exporter is supposed to submit the bill with documents of title namely, commercial and custom invoices marine insurance policy. The sets of document are to be surrendered to the importer of the payment of the bill in respect to sigh bill the amount is realized and remitted back to the exporter's bank account. But, in time bill, after the bill in accepted by the importer is returned to the exporter's bank to be presented again to the buyer for payment on the date of maturity.
- (ii) Letter of credit Under letter of credit method, the exporter why desired to get an assurance of payment against documents usually stipulated in his contract with the overseas imported by means of banker's letter of credit which enables the exporter to obtain immediate payment of his invoice against shipping documents. The two main kind (i) irrevocable letter of credit and (ii) Revocable letter of credit, at Irrevocable letter of credit in one which after issuance cannot be cancelled without the consent of parties concerned- A Revocable letter of credit can be altered or cancelled as any time without any consent or reference to the beneficiary or seller or exporter

5. Foreign Trade Financed by Banks

Under this category, on the basis of the request of the importer, the bank opens documentary credit and makes payment to the exporter by obtaining the documents. The bank accepts the bills drawn by the exporter and the exporter gets the accepted bills discounted and gets the short-term finance

6. Foreign Trade Financed by Accepting Houses

The main function of an accepting house is to accept the bills drawn by the exporters. Normally, the importer and Accepting house will have a written agreement in which the house accepts the bill drawn by an exporter. Accepting house accepts commission for its work from the importer. After sending the acceptance from Acceptance house, the exporter gets such bills discounted and gets Payments-

7. Foreign Trade Financed by Discount Houses

Discount houses are trading houses engaged in discounting of bills. The Discount houses discount the bill if it is accepted by any accepting house. Further, the Discount house discounts the bill on the basis of credit worthiness and financial soundness of the exporter as well as importer even if the bill is non-accepted by an Accepting house

Medium and Long-Term Finance

Long-term finance refers to the credit facility extended up to a period from five to twenty years. It is provided for long-term development activities such as purchase of capitalized heavy items such as ship-building purchase of electric machines, heavy engineering goods, etc. Long-term finance generally involved higher levels of risk than short-term finance. Hence the interest rate for long term finance is more than other forms of credit. The World Bank International Monetary Fund, international Development Association and Asian Development Bank are some of the international financial institutions granting long term credit. The main purposes of long-term credit for both exporter and the importer are presented below:

- (1) To import and export of capital goods.
- (2) To provide credit facility on liberal terms to the importer.
- (3) To execute the export promotion programme.
- (4) To establish new enterprise and
- (5) To make capital investment in other countries.

The medium and long term credit can be divided into two. They are:

- (1) Supplier's Credit. and
- (2) Buyer's Credit

Suppliers Credit: Under this system the Indian exporter will offer credits to the overseas buyer. The exporter can on the other hand secure reciprocal credits from the commercial banks which in turn can get refinance from the EXIM Bank.

Buyer's credit: It is a means of financing an export transaction involving capital goods and equipment of large value or complete turnkey projects on long term credit. Loan is extended by a bank or other financial institutions in the supplier's country to the overseas buyer who is thus in a position to pay cash for the supplier received. The loan is guaranteed by the buyer's bank or often extended to the buyer's bank itself for the specific purpose in view. The main two points to be made in this connection are: (i) supplier gets his money if he fulfils his responsibility, and (ii) there is no involvement of transfer of funds from one country to another.

Forfaiting

The term Forfait is derived from the French meaning the surrender of rights. Forfaiting is non-recourse discounting of export bills. Forfaiting is one of the forms of financing to the exporters. The export-import bank of India authorised by RBI to undertake forfaiting for export financing. Alan C Shapiro in his book "Multinational Financial Management" has defined Forfaiting as "the discounting as a fixed rate without recourse of medium term export receivables denominated in fully convertible currencies."

Example. ABC Co Ltd has exported to a buyer in London and ABC Co Ltd will get export payment after 5 months. In this situation, under forfaiting, ABC Co Ltd can get export bill discounted with a forfaiting agency, through EXIM Bank. The forfaiting agency will pay the amount after deducting a few commitment fee, discount fee and documentation fee prescribed for forfaiting.

Lesson 2.2 - Export – Import (EXIM) Bank of India

Learning Objectives

Having gone through this lesson you are able to:

- Understand export services
- Clearance of export problems
- Know the various fund based and non fund based facilities
- Learn import finance procedures

Introduction

The globalised world economy in the post-WTO era has been increasingly characterized by dismantling of protective barriers to trade and investment. While increase in trade opportunities in global markets would necessitate external competitiveness, opening of economies to global trade would entail reduction in protective barriers in the domestic trade areas, resulting in the need for countries to enhance their domestic competitiveness concomitantly. In such a scenario, the ability to compete in both domestic and world market would depend on a country's relative competitive strength vis-à-vis other nations.

In this context, international competitiveness would encompass higher exports, diversifying the export basket, sustaining higher rates of export growth over time, upgrading the technological skill content of export activity, and expanding the base of domestic firm, which are able to compete globally, as well as in the domestic market.

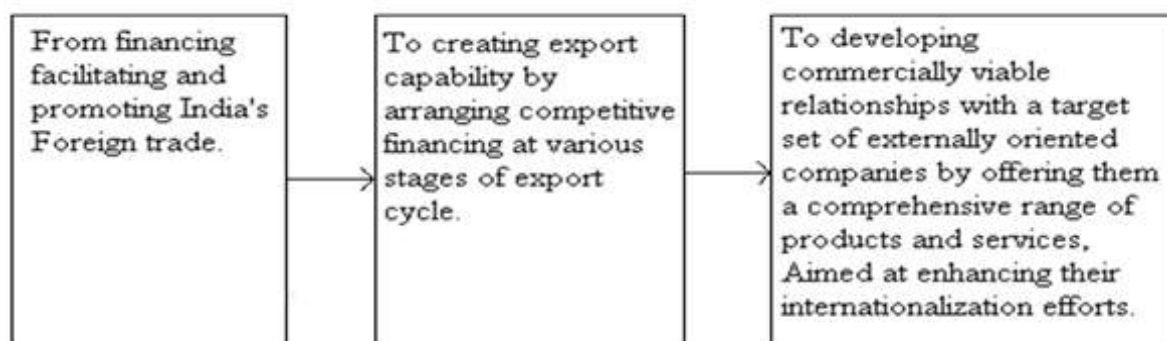
Fostering international competitiveness and thereby sustaining long run growth would entail, inter alia, technological progress, innovation and human skill development. In today's world and more so in the years ahead, competitive strength of countries would increasingly depend on the strategic behavior of firm in adapting to the changing environment and building up core competencies on the lines of comparative advantage.

Meeting the challenges on the policy front also assumes importance in a global economy, as the competitiveness and efficiency of firms is facilitated by the nature of policy environment under which firm operate, and whether macroeconomic policies allow them

to achieve the requisite economies of scale and allocate efficiency in production. Growth strategies of developing economies, therefore, should be based upon policies which ensure internal and external stability in the economy, through maintaining sustainable policies and putting in place a proper safeguard system against adverse international shocks and limiting exposure to risks.

Building up competitiveness is a high priority for both developed and developing countries. Given the dynamic changes characterising key industries and the rising competition among countries, the need for countries to continuously move up the value chain and improve the attractiveness out of their vocational advantages is a challenging task for policy makers in developing countries. Competitiveness, both domestic and international, is important and challenging and should be seen not as an end in itself but as a means to an end – which is economic development.

An act of parliament setup the export – import bank of India in September 1981. It commenced operations in March 1982. The government of India wholly owns this bank. The bank was set up for the purpose of financing, facilitating and promoting foreign trade in India. EXIM bank is the principal financial institution in the country for coordinating working of institutions engaged in financing of exports and imports. Organization of EXIM bank can well be understood as given in below representation.

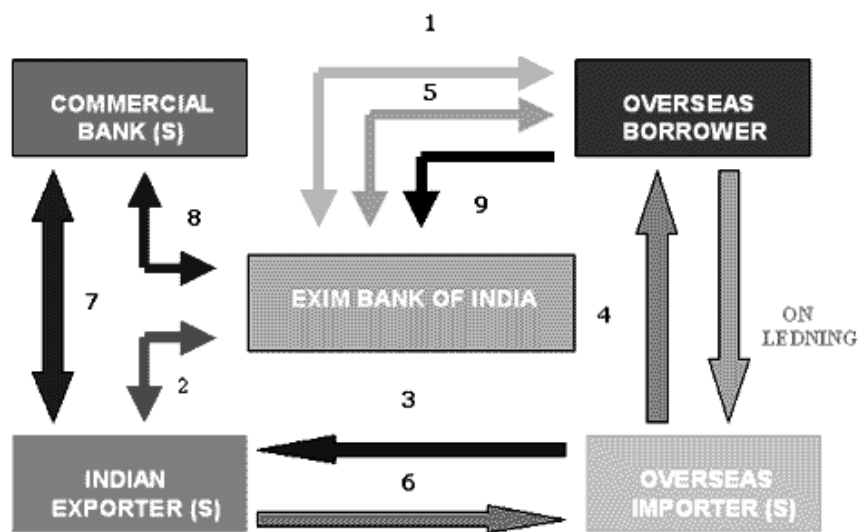


The operations of the EXIM Bank are grouped as follows:

Export Credits

The bank provides exports of Indian machinery, manufactured goods and consultancy services on deferred payment terms. It also makes available lines of credit/buyer's credit to overseas entities, i.e. governments, central banks, commercial banks, development finance institutions, regional development banks etc for financing export of goods and services from India. Export credits include project finance and trade finance.

Procedural Flow Chart



1. **EXIM Bank** signs agreement with **Borrower** and announces when effective.
2. **Exporter** checks procedures and Service fee with **EXIM Bank** and negotiates contract with **Importer**.
3. **Importer** consults **borrower** and signs contract with **exporter**.

Range of Products and Services



4. **Borrower** approves contract.
5. **EXIM Bank** approves contract and advises **borrower** and also **exporter** and **commercial bank**.
6. **Exporter** ships goods.
7. **Commercial bank** negotiates shipping documents and pays **exporter**.
8. **EXIM Bank** reimburses **Commercial bank** on receipt of claim by debit to **borrower**.
9. **Borrower** repays **EXIM Bank** on due date.

Export Capability Creation

The assistance of finance under this category includes the following:

- Finance for export product development
- Finance for export marketing finance
- Finance for export oriented units which includes Project finance and working capital
- Production equipment finance
- European Community Investment Partners (ECIP)
- Asian Country Investment Partners (ACIP)
- Overseas Investment Finance
- Export Facilitation Programmes
- Software training institutes
- Minor Port Development

Export Services

In addition to finance, bank provides a range of information and advisory services to Indian companies to supplement their efforts aimed at globalization of Indian business.

Supporting Groups

- Planning and research
- Accounts/MIS/EDP
- Legal
- Coordination
- HRD
- Establishment

Project and Services Exports

Under section 47 of foreign Exchange Management Act, 1999, RBI has issued the following guidelines:

The Types of Exports Covered

- a. Export of goods on Deferred Payment Terms
- b. Turnkey Projects
- c. Construction projects
- d. Consultancy & Technical Services

In terms of regulation 9 of the foreign exchange management act 1999, the amount representing the full export value goods exported must be realized and repatriated within 6 months from the date of export. Export where there is more than 10 percent of the value is realized beyond the prescribed period, i.e. 6 months from the date of shipment are treated as Deferred Payment Exports.

While dispersing the pre-bid clearance of project export proposals, RBI advises exporters to ensure, in their own interest, that conditions laid down in memorandum PEM for submission of bids are complied with.

Project exporters, at the time of submission of bids/offers for execution of projects or export contract overseas, seek in principle commitment from EXIM Bank and other banks for post award facilities to ensure tie up of facilities. EXIM Bank issues guarantees required for execution of project export contract through overseas bank or favouring overseas clients.

Exporter submit application in prescribed form along with copies of contract through its commercial bank for post - award Clearance. Exporters can directly approach EXIM Bank for proposals of value limit up to ₹ 200 crores.

On receipt of application and contract copies from the commercial bank, EXIM Bank approves the proposal if the same falls within its delegated powers or convenes Working Group meeting.

In approved cases, EXIM bank/working group, final approvals for fund based and non fund based facilities are granted by concerned institution and export banks.

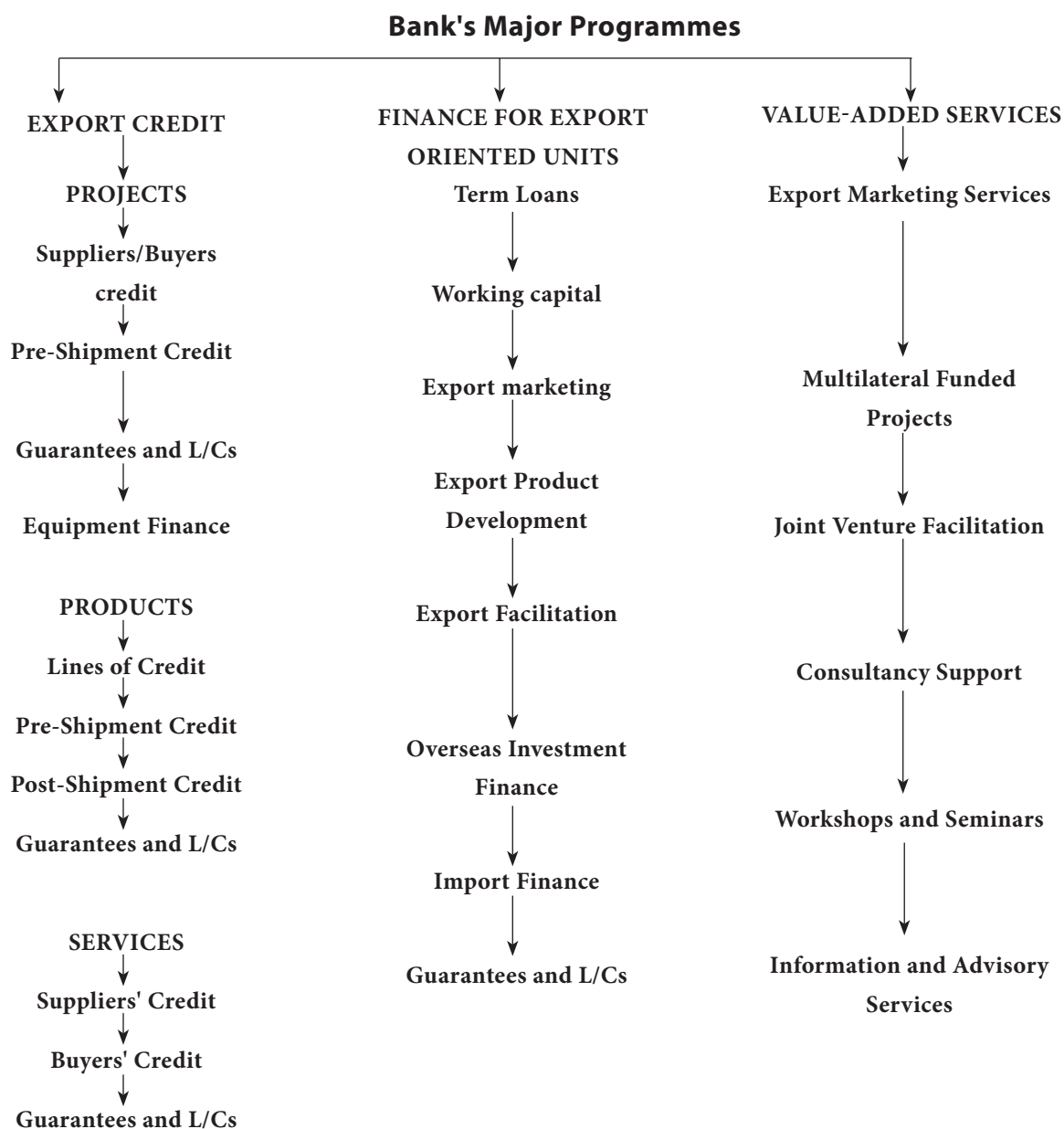
Clearance of Export Proposals – Criteria

These include the following:

- a. Exporter's financial position, track record
- b. Status of overseas client—Government/private
- c. Break-up of contract value—Indian/Third country/Local
- d. Risk assessment by of buyer's country
- e. Estimate of cost and profitability
- f. Currency of Payment—Convertible Currency/Local currency
- g. Security including Letter of Credit, Bank Guarantee, Government Guarantee, Externalisation undertaking of central bank.
- h. Foreign Exchange Outgo, and
- i. Facilities required by the exporter.

Clearance of Export Proposals—Appraisal factors

- a. Payment terms include Advance Payment, Progress/Down Payment, Deferred Payment, retention Money
- b. Security including Letter of Credit, Bank Guarantee, Government Guarantee, Externalisation undertaking of central bank.
- c. Availability of ECGC cover, where necessary
- d. Important contractual clauses:
 - Pre – shipment Inspection
 - Arbitration
 - Force Majeure
 - Status of exporter is prime contractor/sub contractor/consortium member
 - Penalty/liquidated Damages for delay in contract execution
 - Price escalation



Funded Schemes of Financing

EXIM Bank provides the following sources of assistance:

1. Lines of credit
2. Suppliers credit
3. Overseas buyer's credit
4. Loan under Financing Rupee Expenditure for Project Export contracts (FREPEC) programme.
5. Pre shipment Credit
6. Refinance of Export Loans
7. Forfaiting

Non – Funded Schemes of Financing

1. Bid Bond
2. Advance Payment Guarantee
3. Performance Guarantee
4. Guarantee for release of Retention Money
5. Guarantee for raising Barrowing overseas
6. Other Guarantees
7. Confirmation of letter of credit under the Trade Facilitation Program of the European Bank for Reconstruction and development.

Fund Based Facilities

Lines of Credit

EXIM Bank extends line of credit to overseas government/nominated by them or the overseas financial institutions to enable the buyers in those countries to import capital/ engineering goods, industrial manufactures and related services from India on deferred payment terms.

This facility enables importers in those countries to import from India on deferred credit terms as per the terms and conditions already negotiated between EXIM Bank and the overseas agency. The Indian exporters can obtain payment of eligible value from EXIM bank against negotiation of shipping documents, without recourse to them

Features

The lines of credit are denominated in convertible foreign currencies or Indian rupees and extended to sovereign governments/agencies nominated by them or financial institution. Such government/agencies/institution is the borrowers and EXIM bank the lender.

Terms and condition of different lines of credit vary and details in respect of each line of credit have come into effect and unconditional balances are still available for utilization. Indian exporters also need to ascertain the quantum of services fees payable to EXIM bank on account of pro-rata export credit insurances premium and/or interest rate differential cost which they can then pay up in their prices to their importers.

Mechanism

The mechanism of the working of this type of fund-based facility is described below:

- The buyers arrange to obtain allocation of funds under the credit line from the borrower. The exporter then enters into contracts with the buyers, for the eligible items covered under the line of credit. The contracts would need to conform to the basic terms and conditions of the respective credit lines.
- The delivery period stipulated in the contracts should be such that credit can be drawn from EXIM bank within the terminal disbursement date stipulated under the respective line of credit arrangement also, all contracts should provide for pre-shipment inspection by the buyer or agent nominated by buyer.
- The buyer arranges to comply with procedural formalities as applicable in his country and then submits the contracts to the borrower for approval. The borrower in turn forwards copies of the contracts to EXIM bank for approval.
- EXIM bank advice approval of the contracts to the borrower, with copy to exporter, indicating approval number, eligible contracts value, last date for disbursement and other condition subject to which approval is granted.
- The buyer on advice from the borrower establishes an irrevocable sight letter of credit (L/C). A single L/C is to be opened, covering the full eligible value of the contract including, freight and/or insurances as laid down in the contract. The letter of credit is advised through a bank in India designed by EXIM bank.
- Exporter ships the goods covered under the contracts and presents documents for negotiation to the designed bank. The bank forwards negotiated document to the buyer.
- On receipt of clean non-negotiable set of shipment documents along with the relative invoices, inspection certificate, that document negotiated are as per terms of L/C and without reserve from the negotiating bank and after having satisfied itself, that all formalities have been complied with in conformity with the terms of the credit agreement, EXIM bank reimburses the eligible value of shipment in equivalent rupees at spot exchange rate to the negotiating bank for payment to the exporter.
- EXIM bank debits the borrowers account and arranges to collect interest and principal receivable on due dates as per the terms of the credit agreement between EXIM bank and the borrower.

- Any bank charges, commission expenses payable in India as also pro-rata export credit insurance premium and/or interest rate differential cost, as may be applicable shall be to the account of the exporter. The exporter is advised to ascertain from EXIM bank the amount of services fee payable by the exporter, before entering into commercial contracts with the overseas buyer. EXIM bank will not be liable to pay interest for period between dates of negotiation and actual reimbursement from EXIM bank.

Supplier's Credit for Deferred Payment Exports

EXIM bank offers supplier's credit in rupees or in foreign currency at post-shipment stages to finance export of eligible goods and services on deferred payment terms. Supplier credit is available both for supply contracts as well as projects exports; the latter includes construction, turnkey or consultancy contracts undertaken overseas.

Exporters can seek supplier's credit in rupees/foreign currency from EXIM bank in respect of export contracts on deferred payment terms irrespective of value of exports contracts.

General Terms

The terms of the supplier's credit are summarized below:

- a. Extent of supplier's credit is 100 percent of post-shipment credit extended by exporter to overseas buyer.
- b. Supplier's credit from EXIM bank is available in Indian rupees or in foreign currency.
- c. The rate of interest for suppliers credit in rupees is a fixed rate and is available on request. EXIM bank offers suppliers credit in foreign currency on a floating rate basis at a margin over LIBOR, depending upon cost of funds.
- d. Adequate security by way of acceptable letter of credit and/or guarantee from a bank in the country of import or any third country is necessary, as per RBI guidelines.
- e. Period of credit is determined for each proposal having regard to the value of contracts, nature of goods covered, security and competition. Repayment period for supplier's credit facility is fixed coinciding with the repayment of post-shipment credit to EXIM bank as per agreed repayment schedule, irrespective of whether or not the overseas buyer has paid the Indian exporter.

Utilization of Credit

EXIM bank enters into suppliers credit agreement with Indian exporter as also with exporters commercial bank in the event of the latter's participation in the suppliers credit. The agreement covers details of draw down repayment and includes an affirmation by the Indian exporter that repayment to EXIM bank would be made on due date, regardless of whether due payment have or have not been received from overseas buyer.

Commercial bank negotiates export document and seeks reimbursement of suppliers credit amount. Commercial bank seeks reimbursement of suppliers credit from EXIM bank along with annexure containing particulars of shipments made (drawal form and annexure format are provided to bank at the time of issue of sanction). On satisfying itself that the disbursement claim is in order. EXIM bank either credits the amount in rupees under rupees suppliers credit into the account of commercial bank, maintained with reserve bank of India (RBI) at Mumbai, or the commercial banks NOSTRO account under foreign currency suppliers credit and advises details of the amount credited to bank/exporter.

The exporter repays principal amount of credit to EXIM bank as per agreed repayment schedule. Interest amounts are payable to EXIM bank half-yearly without any moratorium. RBI has laid down guidelines for project exports and exports of goods from India on deferred payment terms. RBIs guidelines relating to project export contracts are contained in memorandum PEM published by RBI. It is priced publication and available at any time of the regional offices of RBI throughout India.

Overseas Buyers Credit

Under this type of facility credit is offered directly to overseas buyers for a specific project/contract.

Frepec

This programme Financing Rupee Expenditure For Project Contracts (FREPEC), seeks to provide for expenses incurred by Indian companies. The purposes of this credit is to enable Indian project exporters to meet rupees expenditure incurred/required to be incurred for execution of overseas project export contracts such as for mobilization/purchase/acquisition of materials and equipment, mobilization of personnel, payments to be made in India to staff, sub-contractors, consults and to meet project related overheads in India rupees.

Indian project exporters who are to execute project contracts overseas secured on cash payment terms or those funded by multilateral agencies will be eligible for this type of facility. The purpose of the new lending programme is to give boost to project export efforts of companies with goods track record and sound financials.

As to the quantum of assistance extended under this programme, it will be up to 100 percent of peak deficit as reflected in the rupee cash flow statement prepared for the project. EXIM bank will not normally take up cases involving credit requirement below ₹ 50 lakhs. Although, no maximum amount of credit is being proposed. While approving overall credit limit, credit-worthiness of the export=borrower would be taken into account where feasible credit may be extended in participation with sponsoring commercial banks.

Disbursement is made under this programme in rupees through a bank account of the borrower-company against documentary evidence of expenditure incurred, accompanied by a certificate from chartered accountant. Repayment of credit would normally be out of project receipts. Period of repayment would depend upon the project cash flow statement, but will not exceed 4 years from the effective date of project export contracts. The liability of the borrower to repay the credit and pay interest and other monies will be absolute, and will not be liability of the borrowers to repay the credit and pay interest and other monies will be absolute, and will not be dependent upon actual realization of project bills.

As regards security, hypothecation of project receivable and project moveable are considered where available, personal guarantees of directors of the company are also considered. The facility is available through collateral security and where cost is not prohibitive or where the borrower- company is prepared to bear the cost, packing credit guarantee of ECGC may be obtained.

Pre-Shipment Rupee Credit

Refinances of Export Credit Pre-shipment rupee credit is extended to finance temporary funding requirement of export contracts. This facility enables provision of rupee mobilization expenses for construction/turnkey projects. Exporters could also avail of pre-shipment credit in foreign currencies to finance cost of imported inputs for manufacture of exports products to be supplied under the projects. Commercial banks also extended this facility for definite periods. Authorized dealers in foreign exchange can be obtain from EXIM bank, 100 percent refinance of deferred payment loan extended for export of eligible Indian goods

Forfaiting – An Export Finance Option

Forfaiting is a mechanism of financing exports by discounting export receivables evidenced by bill of exchanges or promissory notes without recourse to the seller carrying to long term maturities on a fixed rebate basis up to 100 percent of the contract value.

The word 'forfait' is derived from French word 'a forfait' which means the surrender of rights. Simply put, forfaiting is the non-recourse to him, his rights to claims for payment on goods delivered to an importer, in return for immediate cash payment from a forfaiter. As a result, an exporter in India can convert a credit sale into a cash sale, with no recourse to the exporter or his banker.

Features of Forfaiting

Eligibility: All exports or capital goods and other goods made on long term credit are eligible to be financed through forfaiting.

Document: Receivables under a deferred payment contract for export of goods, evidenced by bills of exchanges or promissory notes, can be forfeited. Bill of exchange or promissory notes, backed by co-acceptance from a bank are, endorsed by the exporter, without recourse, in favour of the forfaiting agency in exchange for discounted cash proceeds. The bankers' co-acceptance is known as avalization. The co-accepting bank must be acceptable to the forfaiting agency. For the purpose of forfaiting it is essential that the bill of exchange or promissory note is in the prescribed format. The role of EXIM bank will be that of a facilitator between the Indian exporter and the overseas forfaiting agency.

Facilitation: The EXIM bank facilitates a forfaiting transaction in the following manner:

On a request from an exporter, for an export transaction, which is eligible to be forfeited EXIM bank will obtain indicative and firm forfaiting quotes – discount rate, commitment and other fees from overseas agencies. EXIM bank will receive availed bill of exchange or promissory notes, as the case may be, and send them to the forfaiter for discounting and will arrange for the discounting proceeds not be remitted to the Indian exporters. The bank will issue appropriate certificate to enable Indian exporters to remit commitment fees and other charges.

Approved Method: Forfaiting is an approved method of export financing in India. EXIM bank has been authorized by the reserve bank of India to facilities export financing through forfaiting.

Cost of forfaiting: A forfaiting transaction has typically three cost element such as commitment fee, discount fee, and documentation fee.

A *commitment fee* is payable by the exporter to the forfaits for the latter's commitment to execute a specific forfaiting transaction at a firm discount rate within a specific time (normally not more than one year). The commitment fee generally ranges between 0.5 percent and 1.5 percent per annum of the unutilized amount to be forfeited and is charged for the period between the date the commitment is given by the forfaiter and the date on which discounting takes places or until the validity of the forfait contract, whichever is earlier. The commitment fee is payable regardless of whether or not the export contract is ultimately executed.

Discount fee is the interest cost payable by the exporter for the entire period of credit involved and is deducted by the forfeited from the amount paid to the exporter. The discount rate is established at the time of executing a forfait contract between the exporter and the forfaiting agency.

Generally no *documentation fee* is incurred in straight forwards forfaits transaction. However, if extensive documentation and legal work is necessary, a documentation fee may be charged. In addition to the above mentioned costs, there are also other types of costs that are incurred such as service fee for facilitating the forfaiting transaction which will be payable in Indian rupees. There may be additional costs levied by a forfaiter such as handling charges penalty etc. however, these costs are transaction specific and will be specified where applicable.

The above mentioned costs of forfaiting need to be transferred to the overseas buyer. Discount fee, documentation fee and any other costs levied by a forfaiter must be transferred to the overseas buyer. Commitment fee should also be passed on to the overseas buyers to the extent possible. The exporter should finalize the export contract in a manner which ensures that the amount received in foreign exchange by the exporter after payment of forfaiting discount and other fee is equivalent to the price which he would obtain if goods were sold on cash payment terms. Duty drawback will be computed only on FOB cost of goods, invoice value less freight, insurance, if any and forfait discount and other related fees.

Benefits of forfaiting: The following benefits accrue to an exporter from forfaiting:

- Conversion of a deferred payment export into a cash transaction, improving liquidity and cash flow.

- Freeing the exporter from cross border political or commercial risks associated with exports receivables
- Financing up to 100 percent of the export value is possible as compared to 80-85 percent financing available from conventional export credit programmes.
- As forfaiting offer "without recourse" finance to an exporter, it does not impact the exporters borrowing limits. The forfaiting represent an additional source of funding, contribution to improved liquidity and cash flow.
- Providing fixed rates finances; hedges against interest and exchanges risks arising from deferred export credit.
- Exporter is freed from credit administration and collection problems.
- Forfaiting is transaction specific. Consequently a long term banking relationship with the forfaiter is not necessary to arrange a forfaiting transaction.
- Exporter saves on insurance costs as forfaiting obviates the need for export credit insurance.
- Simplicity of documentation enables rapid conclusion of the forfaiting arrangement.

Other features: Other features of forfaiting are as follows:

- a. **Duration:** Duration of receivable eligible for forfaiting normally ranges between 1 years and 5 years.
- b. **Currency:** The export contracts can be executed in any of the major convertible currencies e.g. U.S dollar, pound sterling, deutsche mark, Japanese yen.
- c. **Minimum Value:** The minimum value of an export contract eligible for forfaiting and acceptable to a forfaiting agency will generally be the equivalent of U.S.\$100,000.
- d. **Eligible Exports:** Eligibility of an export transaction for forfaiting can be determined when the forfaiting agency is approached for a forfait quote. The availability of a forfaiting quote for a particular country will depend on the forfaiting agency's perception of risk quality of export receivable from that country. The forfaiting agency will indicates the maximum amount and the period of discount while giving the quote.
- e. **Details:** An exporter who is desirous of getting his receivables forfeited should furnish the following details.
 - Name and address of foreign buyer

- Country to which exports are to be made
- Name of the guarantor bank, if known to the exporter
- Nature of goods
- Order quantity
- Amount of order- base price, interest rate
- Delivery of order – base price, interest rate
- Name of the authorized dealer who will handle the export transaction for the exporter in India

The above information will enable EXIM bank to establish, prima-facie, eligibility receivable for forfaiting.

Operating Procedure

The operating mechanism for a forfait transaction is outlined below:

- **Negotiation:** Indian exporter initiates negotiation with prospective overseas buyer with regard to order quantity, price, currency of payment, delivery period and credit terms.
- **Approaching EXIM banks:** exporter approaches EXIM banks to obtain an indicative forfaiting quote from the forfaiting agency. For this purpose, the exporter is required to provide the abovementioned details.
- **Indicative quotas:** EXIM bank obtains indicative quotas of discount, commitment fees and documentation fees if any, and communicates these to the exporter.
- **Contract finalization:** exporter finalizes the terms of the contract with the buyer. The final export offer must be structured in a manner which ensures that the amount received in foreign exchanges by the exporter after payment of forfaiting discount and other fees is equivalent to the price which he would obtain if goods were sold on cash payment terms. If the terms are acceptable to the overseas buyer, the Indian exporter informs EXIM banks accordingly and requests the banks to obtain a firm quote from the forfaiting agency.
- **Firm quotes:** EXIM banks obtain a firm quote from the following agency and convey this information to the exporter and his authorized dealer, with a request to the exporter to confirm acceptance of the forfaiting terms within a specified time limit.

- Confirmation: Indian exporter confirms acceptances of forfaiting terms to EXIM banks. The exporter will enter into a commercial contract with the overseas buyer and also execute a forfaiting contract with the forfaiting agency through EXIM banks.
- Certificate: on execution of the forfaiting contract EXIM bank issues a certificate to the exporter with a copy to the authorized dealer, regarding the commitment fee to be paid by the exporter to the forfaiting agency. This certificate will enable the exporter to remit commitment fees to the forfaiting agency, in accordance with the schedule indicated in the forfaiting contract. In terms of the reserve bank of India guidelines governing forfaiting contracts, commitment fees will be regarded as being analogous to bank charges, and will not be required to be mentioned in GR form or shipping bill prepared by the exporter, subject to the commitment fee not exceeding 1.5 percent of the contract value.
- A certificate detailing the discount payable to the forfaiting agency to enable the Indian customs authorities to verify deduction towards forfaiting discounts declared by the exporter on GR form and shipping bill.
- Shipment: the Indian exporter ships the goods as per the schedule agreed with the overseas buyer. The forfaiting transaction will be reflected in the following three documents associated with an export transaction as stated below.
- Invoice forfaiting discount, commitment fees, etc., need be shown separately; instead, these could be built into the FOB price, stated on the invoices.
- Shipping bill and GR form details of the forfaiting costs will be included along with the other details such as FOB price, commission, and insurance, normally included in the “analysis of export value” on the shipping bill. The claim for duty drawbacks if any, will be certified only with references to the FOB value of the exports stated on the shipping bill.
- Avalised bills and notes the export contract will provide for the overseas buyer to furnish avalised promissory notes. If the contract note provides for the bills of exchange, the exporter will withdraw a series of bills of exchange and send them along with shipping documents to his banker for presentation to importer, for acceptance through the latter’s banker will hand over the shipping documents to importer against acceptance of bills of exchange by the importer and the signature of the aval. Avalised and accepted will be returned to exporter through his banker. Exporter will endorse avalised bills of exchange with the words “without recourse” and forward them through his bank to EXIM bank, which in turn will send them to the forfaiting agency.

- **Payment** The forfaiting agency effects the payment of the discounted value, in accordance with EXIM bank's instruction after verifying the aval's signature, and other particular. Normally, EXIM bank will direct the forfaiter to credit the payment to the NOSTRO account of the exporters' bank in the country where the forfaiter is absed. The bank receiving the discounted proceeds will arrange to remit the funds to India. The exporter will be issued a certificate for foreign inward remittance. The GR form will also be released. The export contract, which provides for more than one shipment can also be forfeited under a single forfaiting contract. However, where the export is affected in more than one shipment, avalised promissory notes/bills of exchange in respect of each shipment could be forfeited, subject to the minimum value requiments laid down by the forfaiter. Presentation on maturity of the bills of exchange/ promissory notes, the forfaiting agency presents the instruments to the aval for payment.

Non-Fund Based Facilities

The non-fund based facilities extended by the EXIM bank takes the form of guarantees provided directly or in participation with other banks, for project export contract following are the various non-fund based facilities offered by the EXIM bank. A. bid bond bid bond is generally issued for a period of six months.

- Advance payment guarantee exporters to secure a mobilization advance of 10-20 percent of the contract value, which is normally released against bank guarantee and is generally recovered on a pro-rata basis from the progress payments during project execution.
- Performance guarantee performance for 5- 10percent of contract is issued, valid up to completion of maintenance period normally one year after completion of contract period and or grant of final acceptance certificate (FAC) by the overseas employer. Format of guarantee is expected to be furnished by exporter, at least four weeks before actual issue, to facilitate discussions for formal approval.
- Guarantee for release of retention money this enables the exporter to obtain the release of retention money (normally 10 percent of contract value) before obtaining final acceptance certificate (FAC) from client.
- Guarantee for raising borrowings overseas bridges finance may be needed at the earlier phases of the contracts to supplement the mobilization advances. Bridges finance up to 25 percent of the contract value may be raised in foreign currency from an overseas bank against this guarantee issued by a bank in India. Request for

overseas borrowings must be supported by currency wise cash flows, also indicating the outstanding letters of credit and L/C drawl schedule.

- Other guarantees the EXIM bank of India in lieu of customs duty or security deposit for expatriate labor grants other guarantees. Guarantee commission is charged at rates stipulated by the Foreign Exchange Dealers Association of India (FEDAI) or as stipulated by guarantee issuing bank. Banks generally waive margin requirement for issue of guarantee for export performance guarantee. However, appropriate securities are availed of.

The proposal is to be submitted in the prescribed application form along with implementation schedule, currency-wise cash flows and write-up with regard to site and infra-structural condition, and sub-contracting arrangements envisaged. In case of non-government buyer, status report on the client/prime contractor would first need to be obtained. The completed application is to be submitted to the sponsoring bank, for consideration, within fifteen days of entering into contract. It would also be necessary to consult ECGC in advance in cases where corporation's insurance cover and or counter guarantees are required.

Export Capability Creation programmes

The EXIM bank operates the following programmes for creating export capabilities:

1. Lending Programs for Export Oriented Units
2. Production Equipment Finance Program
3. Overseas Investment Finance Programs
4. Equity Investment in Indian Venture Abroad
5. Asian Countries Investment Partners Programs
6. Export Marketing Finance Programs
7. Export Product Development Programs
8. Export Vendor Development Programs
9. Programs For Export Facilitation
10. Foreign Currency Pre-Shipment Credit
11. Working Capital Term Loan Programs for Eou's
- 12 Bulk Import Finance
13. Finance for Research And Development for Eou's
14. Long Term Working Capital
15. Import Finance

Lending Programs for Export Oriented Units

The objective of these lending programs is to create and enhance export capabilities of Indian companies. Eligible companies include units set up/proposed to be set up in export processing zones, units under the 100 percents Export Oriented Units Scheme, units importing capital goods under promotion capital goods scheme, units undertaking expansion/modernization/ upgradation/diversification programmes of existing export oriented units with export orientation of minimum 10 percent or sales of ₹ 5 crores per annum whichever is lower.

The lending program takes the form of term loans in Indian rupees/foreign currency. In addition deferred payment guarantee for import of capital goods also form a part of it. As to the interest rates, rupees term loan linked to banks minimum lending rates whereas foreign currency term loans is at floating or fixed interest rates based on banks cost of funds. Interest is payable semi-annually on reducing balances. Interest tax is as applicable. Services fee of one per cent of loan payable upfront. Repayment period is up to ten years, based on projected cash flows inclusive of suitable moratorium.

As regards security, appropriate charge on fixed assets of the company's/ project plus any other security acceptable to EXIM banks is applicable. Finance can be accessed by way of the bank having preliminary discussions with the promoters to determine scope for EXIM banks finance. To facilitate discussions, project profile identifying financial requirement needs to be sent to the bank. EXIM bank offers comprehensive package to externally oriented companies by way of finance, information, and value added services.

Production Equipment Finance Program (PEFP)

Under the production equipment finance program, EXIM banks seeks to finance non-project related capital expenditure of export-oriented units. PEFP is structured as an arrangement under which various equipment, imported and indigenous, can be financed thus obviating the need to arrange finance for every such procurement. It is not necessary to identify specific equipment sought to be financed at the time of application; this could be done at the time of disbursement. PEFP is a fast-disbursing window available to export oriented units.

Companies with good track record and sound financiers are eligible for assistance. Existing export oriented units with minimum export orientation (present or targeted) of 10 percent of total sales or ₹ 5 crores in values whichever is lower are eligible. The facility is granted by way of term loan in Indian rupees/foreign currency. As regards interest rates, rupees term loan linked to banks minimum lending rates and foreign currency term loan at

floating rates or fixed interest rates based on banks cost of funds. Interest is payable semi-annually on reducing balances. Interest tax is payable as applicable. Services fee of one percent of loan amount payable upfront. The facility is available up to one year from the date of sanction. Ten percent margin is maintained.

As regards security, hypothecation of equipment, plant and machinery financed by the bank is the popular mode of security. Additional security by way of personal guarantee, any other assets of Borrowers Company, corporate guarantee of group company/parent Company and appropriate charge on any other security on a case to case basis is also in vogue. Finance can be accessed with preliminary discussions with the promoters to determine scope for EXIM banks term finance under PEFP.

Overseas Investment Finance

This includes lending programs for overseas joint ventures/wholly owned subsidiaries by Indian companies. The objective to finance by way of equity loan to Indian companies for settings up of overseas joint ventures wholly owned subsidiaries. Any Indian promoter making equity investment in an existing company or a new project overseas with the requisite approval for such investment from the Reserve Bank Of India(RBI) / government of India as also from the government and other concerned authorities in the host country is eligible for this financing.

Government guidelines following are the guidelines issued by the government of India is regard to this type of financing:

- **Proposals** for setting up JV/WOS abroad require approval of the RBI in accordance with the guidelines for Indian direct investment in JVs and Wos abroad notified by the government of India. Ministry of commerce.
- Proposals for direct investment in a JV/WOS abroad form a company will be eligible for automatic approvals by RBI provided the total value of the investment by the Indian company does not exceed U.S.\$15 million in respect of Indian investment in SAARC countries and total value of investment does not exceed U.S.\$ 30 million in Myanmar; in respect of Indian rupees investment in Nepal and Bhutan, total value of investment does not exceeds ₹ 120 crores. The amount of investment is up to 25 percent of annual average export earning of the company in the preceding three years. The amount of investment is repatriated in full by way of dividends, royalty, technical service fee, etc within a period of five years

- Proposals involving investments beyond U.S.\$ 4 million but not exceeding U.S.\$15 millions or those not qualifying on the basis of the applicable criteria outlined above will be processed in the RBI through a special committee appointed by RBI. A technical appraisal could preferably accompany such proposal by any one of the designated agencies (including EXIM banks). Large investments proposals for overseas investment in exceeds of U.S.\$15 millions will be considered if the required resources beyond U.S.\$ 15 million are raised through the GDR route. Up to 50 percent of the GDR resources require may be invested as equity in overseas JV/WOS subject to specific approval of the government. Application for investment beyond U.S.\$ 15 million would be received in the RBI and transmitted to the ministry of finance for examination with the recommendation of the special committee. For investment out of EEFC, Authorized dealers would grant permission balances up to a maximum of U.S.\$ 15 million.

As to the mode of overseas investment, Indian companies are allowed to invest equity in overseas joint ventures/wholly, owned subsidiaries by way of capitalization of export proceeds of plant and machinery, technical knowhow, fee, royalty, and forex remittance of equity contribution. The assistance is available in the form of rupee term loan to Indian companies for financing their equity investment overseas, rupees term loan for lending further to their overseas joint venture/wholly subsidiaries, guarantee for raising finance overseas for equity investment and for working capital requirement for overseas joint venture/wholly subsidiaries. As regards interest rate rupee term loan is linked to bank minimum lending rate and foreign currency term loan is floating or fixed rates based on banks cost of funds. Interest is payable on reducing balances at half yearly rates. Additionally interest tax as applicable will be payable.

As regards margin, it is 80 percent of the Indian company's equity contribution in overseas JV/WOS. EXIM banks finance will be secured by an appropriate charge on the borrowers assets in India and/ or any other security acceptable to EXIM bank, pledge of borrowers shares of Indian promoter companies. In addition, an overseas investment insurance policy can also be obtained by the company from ECGC/MIGA and assigned in favor of EXIM bank. In case of assistance by way of guarantee, counter guarantee from India promoter company will serve as security.

Refinance to commercial banks EXIM banks provide 100 percent refinance to commercial banks in respect of rupees term loans extended by them to Indian promoter company for equity contribution in overseas JV/WOS. As per prevailing RBI guidelines, commercial banks can consider loan for equity investment only under EXIM banks refinance scheme. Finance can be accessed on preliminary discussions with the promoters

to determine scope for EXIM banks finance. To facilitate discussions details on project profile identifying financial requirement should be sent.

Equity Investment in Indian Ventures Abroad

The objective of this program is to catalyze overseas investment by the Indian companies to enhance visibility of Indian overseas ventures. Quantum of EXIM banks equity participation will be up to 25 percent of equity capital of the JVs involving Indian companies. This is subject to a ceiling U.S.\$ 5 million per proposal. As weightage will be giving to the following factors:

- Background and track record of Indian and foreign promoters
- Synergy of overseas operations with business in index
- Financial viability and technical feasibility
- Return on EXIM banks investment
- Benefits to India in terms of trade enhancement, technology transfer, foreign exchange earnings, etc.
- Spin-off benefits such as brand marketing and penetration of new markets
- 'EXIT ROUTE' for EXIM banks equity investment (which could take place within 5 years from the date of investment. EXIM banks equity may be offloaded to Indian promoter, other interested Indian companies, stock exchange in host country etc.)
- Buyback arrangement between EXIM banks and Indian company
- EXIM bank welcomes discussions with Indian Promoter Company seeking EXIM banks equity participation in their overseas joint venture.

Asian Countries Investment Partners Programme (ACIP)

The objective of this lending program is to promote joint venture in India between India companies from Asian countries through four facilities that address stages of the project cycle. ACIP seeks to catalyze investment flows into India by creation of joint venture in India between Indian companies and companies from East Asian countries. ACIP is proposed to be a funding instrument providing finance at various stages of a joint venture project cycle viz. sector study, project identification, feasibility study, prototype development, set up, and technical and managerial assistance. Finance is available for identification of potential joint venture project and partners, and operations prior to launching a joint venture like pilot

plant-feasibility study. Project expenditure covers human resources development, training and management assistance. The beneficiaries of this program are chambers of commerce, industrial/investment promotion agencies and other eligible bodies. Indian companies seeking joint venture companies set up under ACIP and joint venture companies set up under ACIP. The instruments of assistance include grant, soft loan and term loan. Assistance could be accessed through preliminary discussions with the promoters to determine scope for EXIM banks finance.

Export Marketing Finance Programme

The objective of this program is to create and enhance export capabilities and international competitiveness of Indian companies. Under the lending programme for export marketing finance, the bank addresses the term finance requirement for a structural and strategic export marketing and development effort of Indian companies. Eligible companies include companies who have a strategic international marketing plan. Further, companies should have established presence in the domestic market and satisfactory financials. The activities eligible for assistance are activities associated with export marketing and export capability creation. Typically activities eligible for finance under this programme are desk/field research, minor product adaptation, overseas travel, training quality certification, product launch, investment in machinery and equipment, testing/quality control equipment, and factory premises.

Assistance takes the form of term loan in Indian rupees/ U.S Dollar. As regards, interest rates, rupees term loans are linked to EXIM banks minimum lending rate and foreign currency term loan are linked floating or fixed interest rate. Additionally interest tax applicable will be payable. Services fee of one percent of loan amount sanctioned, is payable upfront and is non-refundable. Repayment period up to five years inclusive of moratorium is allowed. The margin is 20 percent. The security includes hypothecation of moveable fixed assets of the company, mortgage of immovable fixed assets of the company or any other security acceptable to EXIM banks. Banks welcome preliminary discussions with the promoters to determine scope for EXIM banks financing arrangement.

Export Product Development Programs

The objective of this program is to support systematic export product development plans with focus on industrialized markets. Eligible companies include established export enterprises with product development programme dedicated to export. The company must also have an established track record and satisfactory financials. The activities eligible for assistance include product design and development activities, research and development

activates including cost of manufacturing of prototypes and development, pilot plants, product testing, development of tooling's, jigs and fixtures, process development cost, and product launch. Assistance is granted in the form of rupees term loans on soft term basis. Interest rates will be decided on case- to case by way of first charge on the fixed assets of the borrower and any other security as may be considered appropriate on the merits of the case.

Banks welcomes preliminary discussions with the promoters to determine scope for EXIM banks finance; to facilities discussions, details about the project identifying financial requirement should be sent to the EXIM bank.

Programme for Financing Export Vendor Development (EVD)

The objective of the program is to finance export strategic vendor development plans for export companies with a view to enhancing exports through creation and strengthening of backwards with vendors. Eligible companies are export companies and trading houses, manufacturer-exporters with satisfactory track record and financial. In addition, companies with strategic plans for vendor development for exports are eligible to seek finance under these programmes. Companies purchasing finished, semi-finished or intermediate products from vendors with the exporters adding value to the product in the form of further processing or marketing them are also eligible for assistance.

The eligible activities are those undertaken by exporters to develop and upgrade vendors that will lead to export additionally are eligible for finance under EVD. Example of such activities includes acquisition of production machinery, purchase of tooling, moulds, jigs, dies and ancillary equipment, core working capital assistance extended by exporter to vendors 'soft ' expenditure on vendor development such as vendor training, technical assistance to vendor, etc. assistance is available in the form of rupees term loans including soft loan component. As regards interest rates, they are linked to banks minimum lending rate. As regards soft loans the rate applicable is 7.5 percent p.a (subject to change) subject to maximum of ₹ 50lakhs. Repayment period is up to 7 years with a margin of 20 percent. Security for the loan is first charged on the borrower company's assets. Bank welcomes preliminary discussions with the promoters to determine scope for EXIM banks term finance.

Programme for Export Facilitation

EXIM bank offers term finance and non-funded facilities to Indian corporate to create infrastructure facilities to promote India's international trade and thereby enhance their export capability. The various infrastructural facilities covered under the programme

are software and post development or any other infrastructural facility for promoting India international trade are as follows:

a. Financing Port Development

The objective of this program is to finance development of minor ports with related infrastructural activities, which would facilitate India's international trade. Eligible companies include Indian companies undertaking minor port projects and suppliers of equipments to minor port development projects. Eligible activities are construction of port/jetties, acquisition of fixed assets for individual activities such as stevedoring, cargo handling, and storage and related activities like dry docks, ship reeking.

Interest rates are linked to banks minimum lending rate. As regards term loans in foreign currency interest rates are at floating or fixed rate. In the case of non-funded facilities, applicable rate of commission is charged. Repayment period is 7 to 10 years inclusive of moratorium. Security for this type of financing includes first charge on fixed assets pertaining to the project/company being financed. Additional security by way of assets or corporate guarantee of promoter company/personal guarantees may also be stipulated. Bank welcomes preliminary discussions with the promoters to determine scope for EXIM bank's finance.

b. Lending Programme for Software Training Institutes

The objectives of this program are to address the perceived constraint in availability of trained high-end software professionals to support the fast growing exports. The programme aims at financing the establishment/expansion of software. Eligible borrowers are established software exporting company with good export track record and sound financials, and reputed software training institutes engaged in high end software training. Activities eligible for assistance are acquisition of fixed assets Including land, building, hardware, software and related equipment, extending loans towards tuition fees and other charges, and any other activity connected with training that may be agreed by EXIM banks.

The assistance is granted in the form of term loans in Indian rupees/foreign currency. As regards interest rates, rupees term loan is linked to bank's minimum lending rate and foreign currency term loans is at floating or fixed interest rates based on banks cost of funds.

Interest is payable semi-annually on reducing balances. Interest tax is as applicable. Service fee of 1 percent of loan amount is payable upfront. The repayment period is up to 5 years, based on projected cash flows inclusive of suitable moratorium. The security

is appropriately charged on fixed assets of the company/project plus any other security acceptable to EXIM bank. Bank welcomes preliminary discussions with the promoters to determine scope for EXIM bank's finance.

Foreign Currency Pre-Shipment Credit (FCPC)

Under this programme, short-term foreign currency finance is available to eligible exporters for financing inputs for export production such as raw materials, components and consumable. The finance is repayable in foreign currency from proceeds of the relative exports.

FCPC programme represents another funding source to the exporter for expanding export volumes, particularly of manufactured and value added goods. It eliminates two ways exchanges conversion costs and exchange risks, thus enhancing export competitiveness. FCPC can be a cost effective funding source as compared to rupee export credit as well as overseas suppliers' credit depending on market conditions for loans under FCPC. As far as commercial banks are concerned, loans availed from EXIM banks are exempt from cash reserve ratio, statutory liquidity ratio and incremental credit deposit ratio requirements.

Eligible borrowers are exporting companies and commercial banks for lending further to exporting customers. Interest rates are not to be exceeds 2 percent over London Inter Bank Offer Rate (LIBOR). In case FCPC is extended through commercial banks, which does not have foreign branches, the interest rate should not exceeds 2.5 percent over LIBOR or any other rate as specified by reserve bank of India from time to time.

Interest on refinance to commercial banks will be mutually agreed. The assistances is granted in the form of short term foreign currency loans and the repayment period is a maximum of 180 days from the date of disbursement. As regards security, EXIM banks have pari passu charges on current assets in case of direct loans. Banks welcomes preliminary discussions with the promoters to determine scope for EXIM banks finance.

Working Capital Term Loan Programme for Export Oriented Units (WCTL)

WCTL programme seeks to create, enhance export capabilities of Indian companies. Under the programme, the bank addresses the working capital requirement of export oriented units. Eligible companies are units set up proposed to be set up in export processing zones, units under the 100 percent export oriented units scheme, units importing capital goods under export promotions capital goods scheme and units undertaking expansion/modernization/upgradation/ diversification programmes of existing export oriented units

with export orientation of 10 percent of sales or export sales ₹ 5 crores per annum whichever is lower.

Working capital terms loans in Indian rupees or in foreign currency up to 80 percent of the demand loan component of working capital with a minimum 20 percent margin are granted. Interest rates for rupee term loan are linked to banks minimum lending rate and foreign currency term loans attract floating or fixed rates based on banks cost of funds. Interest is payable semi annually on reducing balances. Interest tax as applicable is payable. As regards security, appropriate charges on the fixed and or current assets, personal guarantees of promoter/director, corporate guarantee of group concern if considered necessary. Bank welcomes preliminary discussions with the promoters to determine scope for EXIM banks finance. To facilitate discussions, details of the project identifying financial requirement are to be sent to EXIM banks.

Bulk Import Finance Programme (BIF)

The objective of this program is to provide short term working capital finance to manufacturing companies to import consumable inputs. Under the programme, BIF is offered for import of eligible items with a minimum order size of ₹ 1 crore. This is granted as short term loans in Indian rupees and foreign currency. As regards interest rates, 1 percent is charged on cash credit facility in rupees loans charged by the commercial banker subject to a minimum interest rate fixed by EXIM banks. The interest rate on foreign currency loans depends on costs of funds to EXIM bank with a maximum of 0.75 percent over LIBOR. The loan are to be repaid within 1 year, the security being pari passu charge on current assets. Bank conducts preliminary discussions with the promoters to determine scope for EXIM banks finance. To facilitate discussions, details about the project profile identifying financial requirements should be sent to the bank.

Programme For Financing Research and Development

The objective of the purpose is to provide integrated financing for research and development activities by export oriented companies. EXIMs banks finance is available to financially sound companies with a minimum export oriented of 20 percent of their net sales for the following eligible activities and eligible expenditure.

Eligible R & D activities for the purpose of assistance, the following are the eligible activities:

- Development and commercialization of a new product/process/application
- Significant improvements in existing product/process/application/design

- Development of technology or design to satisfy domestic or international environment, technical requirements/standards, specifications
- Setting up, expansion of pilot plants
- Research studies necessary for obtaining regulatory approvals, product registrations, cost of Filing and maintaining international patents and R & D centers

Eligible R&D expenditure the eligible expenditure for the purpose of assistance is as follows:

- Acquisition of technology at the 'proof of concept' or design stage which will be used to develop new product/process
- Land and building, civil works for housing eligible R&D activities
- Dies, tools, laboratory and other R&D equipment, mould, computer hardware, software,
- Miscellaneous
- Salaries of R&D personnel, support staff during the R&D project phase including training costs
- Costs of regulatory approvals, filing and maintenance of patent registration
- Expenditure on external consultants for outsourcing a component of R&D project
- Product documentation and allied costs during the R&D project phase
- Costs of materials, surveys, technology demonstration studies, fields trials

Basic research with no identified application, academic research and normal process control, quality control, inspection, repairs and maintenance, contract research will not be eligible under the programme, term loan in Indian rupees subject to a maximum of ₹ 15 crores per company is granted. As regards interest rate, concessional interest rate at 50 percent of the normal interest that the borrower company would be eligible for subject to a minimum of 8 percent p.a payable with quarterly rests. Defaults in loan servicing will attract liquidated damages/penal charges @ 2 percent over the normal interest rate. Service fee of one percent of loan amount is payable upfront. Repayment is generally not to exceed 7 years, with appropriate moratorium. As regards security one or more of the following is applicable:

- Appropriate charge on the assets of borrower company
- Assignment of intellectual property rights(IPR) and mandate assigning all IPR related Receivable
- Any other acceptable security

Bank welcomes preliminary discussions with the company officials to determine scope for EXIM banks finance, exported benefits from proposed R&D expenditure, fit with company's corporate business plans. In particular, export plans mutual business possibility with EXIM in other areas and financial information on the company.

Long-Term Working Capital Programme for Export Oriented Units

The objective of the program is to provide finance for long term working capital.

The EXIM banks finance is available to financially sound companies with a minimum export orientation of 10 percent of their net sales or export sales of ₹ 5 crores, whichever is lower. Loans are made available in the form of term loan in Indian rupees, and term loans in foreign currency. As regards interest rate, the rupees term loan linked to banks minimum lending rate and the foreign currency term loan is linked to floating or fixed interest rates based on banks cost of funds. Interest is payable on reducing balances at half-yearly rates. Additionally interest tax as applicable will be payable.

Service fee will be to the extent of 1 percent of loans amount payable upfront. Loans are repayable in 1-5 years, determined on the basis of projected cash flows with suitable moratorium. Security will be one or more of the following:

- An appropriate charge on part/whole of the fixed assets of the company, present and future
- Personal guarantees of promoter director/corporate guarantee of group company
- Pledge of marketable securities with appropriate margin based on average of high and low of market quotations during the preceding 6 months (this will not be accepted as exclusive security)
- Any other acceptable security

Import Finance

Under this program, finance is provided for import of capital goods/plant and machinery, technology/know-how. EXIM banks finance is available to Indian manufacturing companies. Finance is available by way of term loans in Indian rupees/foreign currency. Interest rate is based on prevailing market rates. Rupees term loan is linked to banks minimum lending rate and the foreign currency term loan at floating or fixed interest rates based on banks cost of funds. Interest is payable on reducing balances at half yearly rates. Interest tax is payable as applicable. Services fee of one percent of loan amount is payable upfront.

Repayment is over a period up to 7 years, determined on the basis of projected cash flow with suitable moratorium. Security is in the form of appropriate charge on the asset acquired out of the loan. In addition, the following additionally security is also required:

- A first pari passu charge on part/whole of the fixed assets of the company, present and future.
- Personal guarantees of promoter director/corporate guarantee of group company
- Pledge of marketable securities with appropriate margin based on average of high and low of market quotations during the preceding 6 months (this will not be accepted as exclusive security)
- Any other acceptable security

Bank welcomes preliminary discussions with the company officials to determine scope for EXIM banks finance. To facilitate discussions details of the proposed project are to be sent identifying requirements.

Lesson 2.3 - Export Credit Guarantee Corporation

Learning Objectives

After reading this lesson you are able to

- Understand the role and functions of ECGC
- Know the various types of export guarantee available and how to avail them.

Introduction

In order to provide export credit insurance support to Indian exporters, the government of India set up the export risks insurance corporation in July, 1957. It was transformed into export credit and Guarantee Corporation limited in 1964. To bring the Indian identity into sharper focus, the corporation's name was once again changed to the present export credit corporation of India limited in 1983. ECGC is a company wholly owned by the government of India is functions under the administrative control of the ministry of commerce and in manager by a board of directors represent government, banking, insurance, trade, industry, etc.

The cover issued by ECGA can be divided broadly into four groups.

1. Standard policy issued to exporters to protect they against payment risks involved in exports on short-term credit and small exporter's policy issued for the same purpose to exporters with small export;
2. Specific policies designed to protect Indian firms against payment risks involved (a) exporters or deferred terms of payment (b) service rendered to foreign parties and (c) construction works and turnkey projects undertaken abroad.
3. Financial guarantee issued to banks in India to protect they from risks of loss involved in their extending financial support to export to exporters as the pre-shipment as well as post-shipment stages and
4. Special schemes, viz., transfer guarantee means to protect banks which add confirmation to letters of credit opened by foreign banks. Insurance cover for buyer's

credit, line of credit, overseas investment insurance and exchange fluctuation risk insurance.

Shipments Comprehensive Risks Policy - (SCR) or Standard Policy

Shipments (comprehensive Risks) policy, which is commonly known as the standard policy, is the one ideally suited to cover risks in respect of goods exported on short-term credit, i.e. neither credit nor exceeding 180 days.

This policy covers both commercial and political risks from the date of shipment. It is issued to exporters whose anticipated export turnover for the next 12 months is more than ₹ 25 lakhs. The appropriate policy for exporter with an anticipated turnover of less than ₹ 25 lakhs is the small exporters' policy, which is described in the next section.

Risks Covered Under the Policy

Under the shipments (Comprehensive Risks) Policy, the corporation covers from the date of shipment, the following risks:

Commercial Risks

- Insolvency of the buyer
- Failure of the buyer to make the payment due within a specified period, normally 4 months from the due date.
- Buyer's failure to accept the goods, subject to certain conditions.

Political Risks

- Imposition of restriction by Government of the buyer's country or any Government action which may block or delay the transfer of payment made by the buyer.
- War, civil war, revolution or civil disturbance in the buyer's country.
- New import restriction or cancellation of a valid import license.
- Interruption or diversion of voyage outside India resulting in payment of additional freight or insurance charges which cannot be recovered from the buyer.
- Any other cause of loss occurring outside India, not normally insured by general insurers and beyond the control of both the exporter and the buyer.

Risks not Covered

The policy does not cover losses due to the following risks

- Commercial disputes including quality disputes raised by the buyer, unless the exporter obtains a decree from a competent court of law in the buyer's country in his favor.
- Causes inherent in the nature of the goods.
- Buyer's failure to obtain necessary import or export authorization from authorities in his country.
- Insolvency or default of any agent of the exporter or of the collecting bank.
- Loss or damage to goods which can be covered by general insurers.
- Exchange rate fluctuation.
- Failure of the exporter to fulfill terms of the export contract or negligence of his part.

Shipments

The shipments (comprehensive Risks) policy is meant to cover all the shipments that may be made by an exporter of credit terms during a period of 24 months ahead. In other words, as exporter is required to get the insurance provided by the policy for each and every shipment that may be made by him in the next 2 months on DP, DA or open delivery terms to all buyers other than his own associates, the policy cannot be issued for selected shipments, selected buyers or selecting market.

Exclusions

An exporter may of course, exclude shipments made against advance payments of those which are supported by irrevocable letters of credit, which carry the confirmation of banks in India, since he faces no risk in respect of such transactions. Where an exporter is dealing with several distinct items, ECGA may agree to exclude all shipments of certain agreed items, provided that what is offered for insurance consists of all items of allied nature and offers the corporation a reasonable portion of the exporter's total business with a fair spread of risks.

Shipment Against Letters of Credit

Unless they are confirmed by banks in India, payments under irrevocable letters of credit are subject to political risks. Exporters, therefore, will be well advised to get them also

covered under the policy. Such shipments, which are excluded from the scope of the policy, can be covered under it if an exporter so desires. Lower premium rates are applied to them because they do not involve commercial risks and only the political risks have to be covered.

For shipment made against irrevocable letter of credit, an exporter has option to obtain either political risk cover only or cover for comprehensive risks, i.e. for all political risks and the risks of insolvency or default of the bank opening the irrevocable letter of credit. If either case, cover will be provided by the corporation only if the exporter agreed to get all the shipments made against irrevocable letters of credit covered under the policy. Cover will not be available for selected transactions.

Shipments to Associates

Shipments to associates, i.e., foreign buyers in whose business the exporters have a financial interest are normally excluded from the policy. They can, however, be covered against political risks under the policy if an exporter so desires. Where the associate is in a public limited company in which the exporter's share holding does not exceed 40% cover can be provided against insolvency risks in addition to all the political risks.

Shipment on Consignment Basis

Shipment which are made to an overseas agent under an agreement that he will receive the goods as agent of the exporter and remit the proceeds of their being sold by him are excluded from the scope of the policy. However, if an exporter wants it, the corporation can get them included under the policy. However, if an exporter wants it, the corporation can get them included under the policy. Cover will be provided only against political risks, since the agent acts for the exporter. If however, goods are sold to ultimate buyers or credit terms, comprehensive risks cover can be provided for sales to such ultimate buyer if the exporter wants such cover.

Shipment Made by Air

Where shipments are made by air, the buyers are often able to obtain delivery of the goods from the airlines before making payment of the bills of lading, as the case may be. If the buyer fails to make the payment subsequently as per the contract, the risk of loss will not be covered under the policy if premium has been paid on the shipment for DP or DA terms of payment. An exporter can, however get cover for such contingencies also if he obtains credit limit of such buyers or open delivery terms and also pays premium at rates applicable to open delivery terms.

Additional Cover for Shipments to Government Buyers

All shipments made to government buyers are covered under the policy the corporation and pay premium as rates applicable for covering political risks. The corporation's specific approval should be obtained where the country is in the list of restricted cover countries. This cover does not extend to commercial risks like default or non-acceptance of goods.

If an exporter wants these risks also to be covered, then he should write to the corporation asking that risk number described in the policy be also covered. In his letter the exporter should give information about the name and address of the buyer, the status of the buyer and the details of the contract. If the corporation approved the request, the shipments concerned will be covered against comprehensive risks if the exporter pays premium of those shipments as rates applicable for comprehensive risks. It may be noted that the corporation will consider the following as government buyers; (a) a department of the central government and (b) if the buyer will be a government body like a board, state government, municipality of government owned corporations companies, if the performance of the contract is guaranteed by the central government.

Contract Cover

The standard policy provides covers only for the post-shipment stage, i.e. from the date of shipment cover for pre-shipment losses, i.e. losses which may be sustained by an exporter due to impossibility of exporting goods already manufactured or purchased for reasons like ban of export of the item restrictions or import of the item into the buyer's country or war, civil war, etc, are not covered under the policy because the risk is very low in respect of raw materials, primary products, consumer goods or consumer durables which can easily be resold. Where however the export involved an item which is manufactured to the non-standard specifications of a buyer, cover can be provided for pre-shipment risks as well as the post shipment risks, by means of an endorsement to the standard policy.

Shipment made on Credit Exceeding 180 Days

The policy is meant to provide cover for shipments neither involving a credit period nor exceeding 180 days. In exceptional cases, however cover may be granted for shipments with longer credit period provided that such longer credits are justifiable for the export items concerned.

Small Exporter's Policy

The small exporter's policy is basically the standard policy, incorporating certain improvement in terms of cover, in order encourage small exporters to obtain and operate the policy. It will be issued to exports whose anticipated export turnover for the next 12 months does not exceed ₹ 25 lakhs.

The small exporter's policy differs from the standard policy in the following respects.

- I. Period of policy: small exporter's policy will be issued for a period of 12 months as against 24 months in the case of standard policy
- II. Minimum premium: minimum premium payable for a small exporter's policy will be an amount equal to .3% of the anticipated turnover of D/P and D/A terms of payment plus where the exporter seeks cover also for L/A shipment, .0% of the anticipated turnover of L/A terms of ₹ 1000 whichever is higher.
- III. Declaration of shipment need to be declared only twice. In the seventh month of shipments made in the first six months of the policy period and in the 13th month for shipments made in the last six months of the policy period.
- IV. Declaration of overdue payments: small exporters are required to submit monthly declarations of all payments remaining overdue by more than 60 days from the due date, as against 30 days in the case of exporters holding the standard policy
- V. Percentage of cover: for shipments covered under the small exporter's policy, the corporation will pay claims to the extent of 95% where the loss is due to commercial risks and 00% if the loss is caused by any of the political risks under the standard policy, the extent of cover is 90% for both commercial and political risks.
- VI. Waiting period for claims: the normal waiting period of months under the standard policy has been halved in the case of claims arising under the small exporters' policy.
 - a. Change in terms of payment or extension in credit period: in order to enable small exporters to deal with their buyers in flexible manner, the following facilities are allowed a small exporters may, without the prior approval of the Corporation, convert a D/P bill into D/A bill, provided that he has already obtained suitable credit limit on the buyer of D/A terms
 - b. Where the value of the bill is no more than ₹ 3 lakhs, conversion of d/p bill is permitted even if credit limit of the buyer has been obtained on d/p terms only, but not more than one claim, can be considered during the policy period on account of losses arising following such conversions.

- c. A small exporter may, without the prior approval of the corporation, extend the due date of payment of a d/a bill provided that a credit limit on the buyer of terms is in force as the time of such extension.
- d. Resale of unaccepted goods: if, upon non-acceptance of goods by a buyer, the exporter sells the goods to an alternate buyer without obtaining prior approval of the corporation as required under the policy, the corporation may consider payment of claims up to an amount considered reasonable by the corporation, provided that the corporation is satisfied that the exporter did his best under the circumstances to minimize the loss.
- e. Claims due to loss of damage to goods. The corporation may also consider payment of claims up to an amount considered by is as reasonable where loss is due to loss or damage to the goods due to certain risks which neither are nor normally included in general insurance policies. The exporters should, in such cases, have exercised normal care in obtaining the general insurance policies.

In all other respects, the small exporter's policy is the same as the standard policy.

Specific Policy

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 export 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 Authorized 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.

Applications for the purpose are to be submitted to the Authorized 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.

Specific policy for supply contracts may take any of the following

- Specific Shipment (Comprehensive Risks) Policy;
- Specific Shipments (Political Risks) Policy;
- Specific Contract (Comprehensive Risks) Policy; and
- 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 (For details of risks, [click here](#)). It is, therefore, 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.

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, 15% 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.

In order to be sure about the availability of the cover, exporters are advised to get in-principle 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. The entire premium is normally payable in advance. Installment 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.

Guarantees to Banks

Timely and adequate credit facilities at the pre-shipment stage are essential for exporters to realize their full export potential. Exporters may not, however, be easily able to obtain such facilities from their bankers for several reasons, e.g. the exporter may be relatively new to export business, the extent of facilities needed by him may be out of proportion to the equity of the firms or the value of collateral offered by the exporter may be inadequate. The Packing Credit Guarantee of ECGC helps the exporter to obtain better and adequate facilities from their bankers. The Guarantees assure the banks that, in the event of an exporter failing to discharge his liabilities to the bank, ECGC would make good a major portion of the bank's loss. The bank is required to be co-insurer to the extent of the remaining loss. To meet the varying needs of exporters, the corporation has evolved the following types of Guarantee

1. Packing Credit Guarantee
2. Export Production Finance Guarantee
3. Post shipment export Credit guarantee
4. Export Finance Guarantee
5. Export Performance Indemnity; and
6. Export Finance (Overseas Lending) Guarantee

Packing Credit Guarantee

Any loan given to an exporter for the manufacture, processing, purchasing or packing of goods meant for export against a firm order or Letter of Credit qualifies for Packing Credit Guarantee. Pre-shipment advances given by banks to parties who enter into contracts for export of services or for construction works abroad to meet preliminary expenses in connection with such contracts are also eligible for cover under the Guarantee. The requirement of lodgement of Letter of Credit or export order for granting packing credit advances is waived if the bank grants such advances in accordance with the instructions of the Reserve Bank of India in that respect.

The Guarantee, issued for a period of 12 months based on a proposal from the bank, covers all the advances that may be made by the bank during the period to an individual exporter within an approved limit. The bank is required to submit monthly declarations of advances and repayments and to pay premium at the rate of 13 paise per ₹ 100 per month on the highest amount outstanding on any day. Approval of ECGC has to be obtained if the period for repayment of any advance is to be extended beyond 360 days from the date of advance. If the bank apprehends a loss, it is required to call back the outstanding advances and to take suitable action to prevent or to minimize the loss including any action that may be suggested by ECGC. The bank will be entitled to claim 66 2/3% of its loss from ECGC if the entire amount due from the exporter is not recovered within a period of four months from the due date of repayment. The claims are payable if ECGC is satisfied that the bank had conducted the account with normal banking prudence and has also complied with the terms and conditions of the Guarantee. Any amount that is recovered by the bank after the settlement of the claim has to be shared between the Corporation and the bank in the same ratio in which the loss was originally borne by them.

ECGC issues Whole-turnover Packing Credit Guarantee (WTPCG) to banks which undertake to obtain cover for packing credit advances granted to all its customers on all-India basis. In consideration of the large volume of business offered for cover and the spread of risks that will thus become available to it, the Corporation grants a higher percentage of cover, lower premium rate and considerable reduction in procedural formalities. A differential premium rate is now applicable for the banks, which have opted for WTPCG. The rates vary between 7 paise to 10 paise per ₹ 100 per month payable on the average outstanding for the month. The rate for each bank is fixed based on the actual claim premium ratio for the bank for the period of immediately preceding five years. The percentage of cover is normally 75% for most of the banks (except a few banks for which it is 65%, taking into account the extremely high claim premium ratio of those banks). There is a reduction of 10% in the cover if the total advance sanctioned to any particular exporter exceeds the total premium received from the bank (for all the accounts put together) in the immediately preceding year; even in respect of such exporters, the lower percentage of cover will apply only for the advances sanctioned over and above the value of such total premium.

Export Production Finance Guarantee

The purpose of this Guarantee is to enable banks to sanction advances at the pre-shipment stage to the full extent of cost of production when it exceeds the f.o.b. value of the contract/order, the differences representing incentive/duty drawback receivable.

Post-Shipment Credit Guarantee

Post-shipment finance given to the exporters by banks through purchase, negotiation or discount of export bills or advances against bills sent on collection basis qualifies for this guarantee. It is necessary, however, that the exporter concerned should hold suitable policy of ECGC to cover the overseas credit risks.

The premium rate for this guarantee is 7 paise per ₹ 100 per month. The percentage of loss covered under the Individual Post-Shipment guarantee is 75.

This guarantee can also be issued on whole turnover basis, offering a higher percentage of cover at a reduced rate of premium. The percentage of cover under the Whole-turnover Post shipment Guarantees is 90 for advances granted to exporters holding ECGC policy. Advances to non-policyholders are also covered with the percentage of cover being 65. The premium rate is 5 paise per ₹ 100/- per month if advances against L/C bills are also covered under the guarantee and 6 paise otherwise.

Individual Post-Shipment Credit Guarantee can also be obtained for finance granted against L/C bills, even where an exporter does not hold an ECGC Policy, provided that the exporter makes shipments solely against Letters of Credit. The premium rate for this cover is 10 paise per ₹ 100 per month on the highest amount outstanding on any day during the month and the percentage of cover is 75. Advances against bills under Letters of Credit/ confirmed orders from banks/buyers in countries placed under restricted cover shall, however, be subject to prior approval of the Corporation.

Export Finance Guarantee

The guarantee covers post-shipment advances granted by banks to exporters against export incentives receivable in the form of cash assistance, duty drawback, etc.

The premium rate for his guarantee is 7 paise per ₹ 100/- per month and the cover is 78 percent. Banks having WTPSG are for concessionary premium rate and higher percentage of cover.

Export Performance Indemnity

Exporters are sometimes 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 in the form of a bid bond. If he

wins the contract, he may have to furnish bank guarantees to 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 or capital goods, exporters may have to execute an undertaking to export goods of a 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 may also be required to furnish guarantees in support of export obligations to Export Promotion Councils, Commodity Boards, The State Trading Corporation of India, the Minerals and Metals and Metals Trading Corporation of India or recognised export Houses.

An export proposal may be frustrated if the exporter's bank is unwilling to issue a guarantee, which the exporter may be required to furnish. The Export Performance Guarantee provided by ECGC is aimed at helping the exporter in such cases. The Guarantee, which is in the 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 exporters. This protection is intended to encourage banks to give guarantees on a liberal basis for export purposes.

Normally, cover is extended upto 75 percent of loss 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. In the 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 by the bankers if the exporter succeeds in the bid and gets the contract.

While the premium rate for guarantee issued to cover bond relating to exports on short-term credit is 0.90% p.a. for 75% cover, it is lower for bonds relating to exports on deferred credit and projects, namely 0.80% p.a. for 75% cover and 0.95% p.a. for 90% cover.

Export Finance (Overseas Lending) Guarantee

If a bank financing an overseas project provides a foreign currency loan to the contractor, it can protect itself from the risk of non-payment by the contractor by obtaining Export Finance (Overseas Lending) Guarantee. The premium rate is 0.90% per annum for

75% cover and 1.08% per annum for 90% cover. Premium is payable in Indian Rupees. Claims under the Guarantee will also be paid in Indian Rupees.

Special Schemes

Transfer Guarantee

When a bank in India adds its confirmation to a foreign Letter of Credit, it binds itself to honour the drafts drawn by the beneficiary of the Letter of Credit without any recourse to him provided such drafts are drawn strictly in accordance with the terms of the Letter of Credit. The confirming bank will suffer a loss if the foreign bank fails to reimburse it with the amount paid to the exporter. This may happen due to the insolvency or default of the opening bank or due to certain political risks such as war, transfer delays or moratorium, which may delay or prevent the transfer of funds to the bank in India. The Transfer Guarantee seeks to safeguard banks in India against losses arising out of such risks. Transfer Guarantee is issued, at the option of the bank to cover either political risks alone, or both political and commercial risks. Loss due to political risks is covered up to 90% and loss due to commercial risks upto 75%.

Premium will be charged as rates normally applicable to the corporation's insurance policy covering export of goods.

Overseas Investment Guarantee

ECGC has evolved a scheme to provide protection for Indian Investments abroad. Any investment made by way of equity capital or untied loan for the purpose of setting up or expansion of overseas projects will be eligible for cover under investment insurance.

The investment may be either in cash or in the form of export of Indian capital goods and services. The cover would be available for the original investment together with annual dividends or interest receivable.

The risks of war, expropriation and restriction on remittances are covered under the scheme. 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 Indian investments.

The period of insurance cover will not normally exceed 15 years in case of projects involving long construction period. The cover can 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 investment. Amount insured shall be reduced progressively in the last five years of the insurance period.

Exchange Fluctuation Risk Cover

The Exchange Fluctuation Risk Cover is intended to provide a measure of protection to exporters of capital goods, civil engineering contractors and consultants who have often to receive payments over a period of years for their exports, construction works or services. Where such payments are to be received in foreign currency, they are open to exchange fluctuation risk as the forward exchange market does not provide cover for such deferred payments.

Exchange Fluctuation Risk Cover is available for payments scheduled over a period of 12 months or more, upto a maximum of 15 years. Cover can be obtained from the date of bidding right up to the final instalment.

At the stage of bidding, an exporter/contractor can obtain Exchange Fluctuation Risk (Bid) Cover. The basis for cover will be a reference rate agreed upon. The reference rate can be the rate prevailing on the date of bid or rate approximating it. The cover will be provided initially for a period of twelve months and can be extended if necessary. If the bid is successful, the exporter/contractor is required to obtain Exchange Fluctuation (Contract) cover for all payments due under the contract.

The reference rate for the contract cover will be either the reference rate used for the Bid Cover or the rate prevailing on the date of contract, at the option of the exporter/contractor. If the bid is unsuccessful 75 percent of the premium paid by the exporter/contractor is refunded to him.

The Exchange Fluctuation Risk (Contract) Cover can be issued, if the payments under the contract are scheduled to be received beyond 12 months from the date of contract but in such cases, the cover will apply for any instalment falling due within 12 months as well. Cover will be available for all amounts receivable under the contract, whether it is payment for goods or services or interest or any other payment. Contracts coming under Buyer's credit and Line of Credit are also eligible for cover under the schemes.

Cover under the schemes is available for payments specified in US Dollar, Pound Sterling, Deutsche Mark, Japanese Yen, French Franc, Swiss Franc, UAE Dirham and Australian Dollar. However, cover can be extended for payment specified in other convertible currencies at the discretion of ECGC.

Exchange Fluctuation Risk Cover will normally be provided along with suitable credit insurance cover. There is, however, provision to grant the cover independently also in which case premium will be loaded by 20%.

The contract cover provides a franchise of 2 percent loss or gain within a range of 2 percent of the reference rate will go to the exporter's account. If the loss exceeds 2 percent, ECGC will make good the portion of loss in excess of 2 percent but not exceeding 35 percent of the reference rate. In other words, loss/gain upto 2 percent and beyond 35 percent of the reference rate will be to the exporter's account. If there is gain in excess of 2 percent and upto 35 percent it will be to ECGC account.

The rate of premium is 40 paise per ₹ 100/- per year or 10 paise per ₹ 100/- per quarter for the bid cover. The total premium is payable at the time of issue of the Policy. Premium for contract cover is also payable at the rate of 40 paise per ₹ 100/- per annum. Ten percent of the total premium payable and premium for the first two years should be paid at the time of issue of the Policy. Thereafter, the annual premium will have to be paid in such a manner that premium for

Lesson 2.4 - Import Licensing

Learning Objectives

After reading this lesson, you could:

- Understand import licensing procedures.
- Learn what is letter of credit, its types and utilities.
- Know various import trade finance services.

Introduction

While the majority of the goods are freely importable, the EXIM Policy (2007) of India prohibits import of certain categories of products as well as conditional import of certain items.

In such a situation it becomes important for the importer to have an import license issued by the issuing authorities of the Government of India.

In India, Import License is issued by the Director General of Foreign Trade. DGFT Delhi office is situated in Udyog Bhawan, New Delhi 110011. Import Licenses are valid for 24 months for capital goods and 18 months for raw materials components, consumable and spares, with the license term renewable.

Sample of Import License

A typical sample of import license consists of two copies

Foreign Exchange Control Copy: To be utilized for effecting remittance to foreign seller or for Opening letter of credit

Customs Copy: To be utilised for presenting to Customs authority enabling them to clear the goods. In the absence of custom copy, import will be declared as an unauthorised import, liable for confiscation and or penalty.

Categories of Import

All types of imported goods come under the following four categories:

- Freely importable items: Most capital goods fall into this category. Any product declared as Freely Importable Item does not require import licenses.
- Licensed Imports: There are number of goods, which can only be importer under an import license. This category includes several broad product groups that are classified as consumer goods; precious and semi-precious stones; products related to safety and security; seeds, plants and animals; some insecticides, pharmaceuticals and chemicals; some electronically items; several items reserved for production by the small-scale sector; and 17 miscellaneous or special-category items.
- Canalised Items:
 - There are certain canalised items that can only be importer in India through specified channels or government agencies. These include petroleum products (to be imported only by the Indian Oil Corporation); nitrogenous phosphatic, potassic and complex chemical fertilizers (by the Minerals and Metals Trading Corporation) vitamin-
 - A drugs (by the State Trading Corporation); oils and seeds (by the State Trading Corporation and Hindustan Vegetable Oils); and cereals (by the Food Corporation of India).
 - Prohibited items: Only four items-tallow fat, animal rennet, wild animals and unprocessed ivory-are completely banned from importation.

Category of importer

On the basis of product to be imported and its target buyer, importers categories are divided into three groups for the purpose of obtaining import licensing:

1. **Actual Users** - An actual user applies for and receives a license to import of any item for personal use rather than for business or trade purpose.
2. **Registered exporters**; defined as those who have a valid registration certificate issued by an export promotion council, commodity board or other registered authority designated by the Government for purposes of export-promotion.
3. **Others**

The two types of actual user license are:

1. **General Licenses:** This license can be used for the imports of goods from all countries, except those countries from which imports are prohibited;
2. **Specific Licenses:** This license can only be used for imports from a specific country.

Custom Inspection

Any violation in the import license is usually scanned by the custom officials of the custom department. Customer inspector and other custom officials have authority to inspect and evaluate the goods to be imported. It's a part of their job to determine whether imports conform to the description in the import License or not. Custom official even have right to charge fines and penalties if any violation in the import license is found to be done by the importer.

Import License

Permit that allows an importer to bring in a specified quantity of certain goods during a specified period (usually one year). Import licenses are employed

- (1) As means of restricting outflow of foreign currency to improve a country's balance of payments position;
- (2) To control entry of dangerous items such as explosives, firearms, and certain substances; or
- (3) To protect the domestic industry from foreign competition. See also import restrictions.

Import Procedure

Imports to India are governed by the Foreign Trade (Development and Regulation) Act 1992. Under this Act, imports of all goods are free except for the items regulated by the policy or any other law in force. The present, foreign trade arrangements for different commodities are stated in the EXIM Policy of 2004 - 2009. This policy is announced once every five years with annual supplements coming out every year. It is also known as the Foreign Trade Policy or Export Import Policy.

Items on the 'Prohibited' list like tallow, fat or oils of any animal origin, animal rennet and wild animals including their parts and products and ivory cannot be imported.

For import of items that appear in the 'Restricted' list you need secure an import licence. Import of items that are enumerated in the canalised list of items are permitted to be imported through canalising Agencies. All other products can be freely imported.

Registration with a regional licensing authority is a precondition for the import of goods. Customs officials will not permit clearance of goods unless the importer gets an Import Export Code (IEC) number from the regional licensing authority.

Import Trade Finance

International trade continues to grow every year as nations expand their global sales and new nations join in. Today, over 225 nations are active in trade resulting in over \$9 Trillion dollars in global business every year. Trade related financial services have developed and expanded in depth, complexity and effectiveness to support the expansion of world trade. Many trade finance options are now available.

However, in North America the Small to Mid- sized Enterprises (SME) trading community is relatively unaware of many of the more sophisticated and/or the sources of the more effective trade finance services. Traders commonly believe that the major international banks are the primary providers of these services. For the SME community this is no longer the case. A fragmented market of trade finance organizations has grown over the last 20 years to fill the void left by the major international banks which retreated from trade finance service in the 1980's.

This tutorial is intended as an introduction to import trade transactions settlement terms and the key types of import trade finance. Understanding these options will help businesses select the most appropriate and effective import trade financing to fit a company's unique financial circumstances.

For additional information and assistance, Trade Port makes available the services of Trade & Export Finance Online (TEFO), a trade finance service provider for international trade businesses. TEFO structures trade deals and provides access to a variety of trade finance resources and capital for small and mid-sized enterprise companies (SMEs), their buyers, suppliers and partners worldwide.

Importing

As a result of major changes during the last two decades in the structure of the global economy, the US has largely recognized that liberal trade policies are on balance good for

domestic consumers, workers, and businesses alike. The encouragement of imports has generally led to the vitalization of economies in other countries and, in return, greater demand for US products. In addition, imported products offer US consumers a wide range of choices of products to buy, while the competition between foreign and US products helps keep domestic prices down. Because US imports have outpaced exports during the last two decades, the current US focus is on increasing exports and opening new markets abroad for US products. Nevertheless, the US remains the world's top import market.

Settlement of Import Trade Transactions

Various trade terms are available to balance the trade transaction risks for both the importer and exporter. As an importer/distributor you will wish to negotiate the most favorable terms of purchase with your overseas supplier. You will negotiate terms of purchase to ensure that you receive your import purchase in the right quantity, right quality, at the right price and on time.

At the same time you can expect your overseas supplier to negotiate terms that will minimize potential risks - particularly the risk of nonpayment. Import trade transactions can be structured in a number of ways. The structure used in a specific transaction reflects how well the participants know each other, the countries involved, and the competition in the market.

The most common terms of purchase are as follows:

1. Consignment Purchase
2. Cash-in-Advance (Pre-Payment)
3. Down Payment
4. Open Account
5. Documentary Collections
6. Letters of Credit

1. Consignment Purchase

In a consignment purchase arrangement, the importer/distributor makes payment to the overseas supplier only after sales to end user is made and payment received. Consignment purchase terms can be the most advantageous to an importer/distributor. It is also considered the most risky term for the overseas supplier.

2. Cash-in-Advance (Pre-Payment)

Under these terms of purchase, the importer must send payment to the supplier prior to shipment of goods. The importer must trust that the supplier will ship the product on time and that the goods will be as advertised. Basically, Cash-in-advance terms place all of the risk with the importer/buyer. An Importer may find his seller requiring prepayment in the following circumstances:

- (1) The Importer has not been long established.
- (2) The Importer's credit status is doubtful, unsatisfactory and/or the country political and economic risks are very high.
- (3) The product is in heavy demand and the seller does not have to accommodate an Importer's financing request in order to sell the merchandise.

There are advantages and disadvantages with Cash in Advance terms. This method of payment involves direct Buyer/Seller contact without commercial bank involvement and is therefore inexpensive. However, the Buyer faces a very high degree of payment risk while retaining little recourse against the Seller for poor quality goods or incorrect or incomplete documentation. In addition there is a possibility that an unscrupulous Seller may never deliver the goods even though the Buyer has made full prepayment. Although pre-payment terms eliminate virtually all risks to the seller these terms can place the seller at a competitive disadvantage.

3. Down Payment

The Buyer pays the Seller a portion of the cost of the goods "in advance" when the contract is signed or shortly thereafter. There are advantages and disadvantages of down payment terms. The down payment method induces the Seller to begin performance without the Buyer paying the full agreed price in advance. The disadvantage is that there is a possibility the Seller may never deliver the goods even though it has the Buyer's down payment. This option must be combined with one of the other options to cover the full cost of goods.

4. Open Account

Unsecured Open Account terms allows the importer to make payments at some specific date in the future and without the buyer issuing any negotiable instrument evidencing his legal commitment to pay at the appointed time. These terms are most

common when the importer/buyer has a strong credit history and is well-known to the seller. The buyer may also be able to demand open account sales when there are several sources from which to obtain the seller's product or when open account is the norm in the buyer's market. This mechanism offers the seller no protection in case of non-payment. However, an exporter can structure his open account sale transaction to minimize the risk of non-payment. For example, the exporter can reduce the repayment period and retain title to the goods until payment is made. Even then, it is difficult to enforce this especially if the goods have been either resold by the buyer or consumed in some other processing activity. Despite the dangers, open account terms with extended dating are becoming more common in international trade. Exporters that offer open account terms are increasingly obtaining credit insurance to mitigate the potential open account credit risks.

There are many advantages and disadvantages of open account terms. Under an open account payment method, title to the goods usually passes from the Seller to the Buyer prior to payment and subjects the Seller to risk of default by the Buyer. Furthermore, there may be a time delay in payment, depending on how quickly documents are exchanged between Seller and Buyer. While this payment term involves the fewest restrictions and the lowest cost for the Buyer, it also presents the Seller with the highest degree of payment risk and is employed only between a Buyer and a Seller who have a long-term relationship involving a great level of mutual trust.

5. Documentary Collections

Collections terms offer an important bank payment mechanism that can serve the needs of both the exporter and importer. Under this arrangement, the sale transaction is settled by the bank through an exchange of documents, thus enabling simultaneous payment and transfer of title. The importer is not obliged to pay for goods prior to shipment and the exporter retains title to the goods until the importer either pays for the value of the draft upon presentation (sight draft) or accept to pay at a later date and time (term draft). The principal obligations of parties to a documentary collection arrangement are set out in the guidelines of the "Uniform Rules for Collection" (URC) drafted by the Paris- based International Chamber of Commerce.

Role of Banks in Documentary Collections

Banks play essential roles in transactions utilizing documentary collections as follows:

Remitting Bank: This is the exporter's bank and acts as the exporter's agent in collecting payment from the importer. It basically transmits the exporter's instructions

along with the terms of the draft to the importer's bank. The bank does not assume any risks and does not undertake to pay the exporter but can influence to obtain settlement of a bill.

Collecting Bank: This is the importer's bank and takes up the role of ensuring that the buyer pays (or accept to pay) for the goods before shipping documents are released to him.

Generally, the banks in the transaction control the flow and transfer of documents and regulate the timing of the transaction. They must ensure the safety of the documents in their possession but are not responsible for their validity and accuracy.

Variations of Documentary Collections

This form of trade settlement comes in two forms - Documents against Payment and Documents against Acceptance. Each of these forms of collections may be either "clean" (financial document alone) or "documentary" (commercial documents with or without a financial document). A financial document is a check or a draft; a commercial document is a bill of lading or other shipping document. A clean collection involves dollar-denominated drafts and checks presented for collection to U.S. banks by their foreign correspondents. In a documentary collection, the exporter draws a draft or bill of exchange directly on the importer and presents this draft, with shipping documents attached, to the bank for collection.

Cash Against Documents/Sight Drafts

In a transaction on documents against payment, the exporter releases the shipping documents to the importer only on payment for the goods. In this arrangement, the exporter retains title to goods on board and may decide to refuse their discharge if payments are not received. This arrangement which demands the buyer's immediate payment of the exporter relies on a sight draft drawn on the buyer.

Document Against Acceptance/Term Drafts

An exporter may decide to release shipping documents to a buyer on acceptance of the exporter's drafts. In this case, the importer is under an obligation to pay at a future date. This method satisfies both parties since the importer is able to receive the goods before payment and the exporter has a firm assurance (but no guarantee) that payment will come at a specified future date.

Flow of Transaction in a Documentary Collections Deal

1. Exporter/drawer and Importer/drawee agree on a sales contract, including payment to be made under a Documentary Collection.
2. The Exporter ships the merchandise to the foreign buyer and receives in exchange the shipping documents.
3. Immediately thereafter, the Exporter presents the shipping documents with detailed instructions for obtaining payment to his bank (Remitting bank).
4. The Remitting bank sends the documents along with the Exporter's instructions to a designated bank in the importing country (Collecting Bank).
5. Depending on the terms of the sales contract, the Collecting Bank would release the documents to the importer only upon receipt of payment or acceptance of draft from the buyer. (The importer will then present the shipping documents to the carrier in exchange for the goods).
6. Having received payment, the collecting bank forwards proceeds to the Remitting Bank for the exporter's account.
7. Once payment is received, the Remitting bank credits the Exporter's account, less its charges.

Advantages and Disadvantages of Documentary Collection

The major advantage of a "cash against documents" payment method for the Buyer is the low cost, versus opening a Letter of Credit. The advantage for the Seller is that he can receive full payment prior to releasing control of the documents, although this is offset by the risk that the Buyer will, for some reason, reject the documents (or they will not be in order). Since the cargo would already be loaded (to generate the documents), the Seller has little recourse against the Buyer in cases of non-payment. A payment against documents arrangement involves a high level of trust between the Seller and the Buyer and should be adopted only by parties well known to each other.

Risks in Documentary Collections

For the Exporter

If it is a sight draft, the exporter will reduce the risk of non-payment but will not eliminate it totally since the importer may not be in a position to pay for the goods or

may not be able to procure sufficient foreign exchange to make the payment. In this case the exporter may be forced to either call back the goods or negotiate sale to some other interested party, which may be at a reduced rate.

In the case of term draft, the risk to the exporter is higher since the foreign buyer will take possession of the goods and may not pay at due date, forcing therefore the exporter to try and collect payment from the foreign buyer in the foreign buyer's home country.

For the Importer

The importer faces the risk of paying for goods of sub-standard quality or even with shortages. In such a circumstance, it would take some time to get refunds from the exporter. It could also happen that the exporter refuses to make refunds, leading the importer to lengthy legal proceedings.

When to use Documentary Collections?

Since Documentary Collections transactions entail some measure of trust, it advisable to use the mechanism when the following conditions apply:

1. When the exporter and importer have a well established relationship
2. When there is little or no threat of a total loss resulting from the buyer's inability or refusal to pay
3. When the foreign political and economic situation is stable
4. When a letter of credit is too expensive or not allowed

6. Letter of Credit

A letter of credit is the most widely used trade finance instrument in the world. It has been used for the last several hundred years and is considered a highly effective way for banks to transact and finance export and import trade. The letter of credit is a formal bank letter, issued for a bank's customer, which authorizes an individual or company to draw drafts on the bank under certain conditions. It is an instrument through which a bank furnishes its credit in place of its customer's credit. The bank plays an intermediary role to help complete the trade transaction. The bank deals only in documents and does not inspect the goods themselves.

Therefore a letter of credit can't prevent an importer from being taken in by an unscrupulous exporter.

The Uniform Commercial Code and the Uniform Customs and Practices for Documentary Credits published by the United States Council of the International Chamber of Commerce set forth the covenants governing the issuance and negotiation of letters of credit. All letters of credit must be issued:

- In favor of a specific beneficiary,
- for a specific amount of money,
- in a form clearly stating how payment to the beneficiary is to be made and under what conditions, and
- with a specific expiration date.
- Role of Banks in Documentary Letters of Credit
- Compared to other payment forms, the role of banks is substantial in documentary Letter of Credit transactions.
- The banks provide additional security for both parties in a trade transaction by playing the role of intermediaries. The issuing bank working for the importer and the advising bank working for the exporter.
- The banks assure the seller that he would be paid if he provides the necessary documents to the issuing bank through the advising bank.
- The banks also assure the buyer that his money would not be released unless the shipping documents evidencing proper and accurate shipment of goods are presented.

Types of Letters of Credit - 1

A letter of credit may be of two forms: Revocable or Irrevocable

Revocable L/C

This is one that permits amendments or cancellations any time by the issuing bank. This means that the exporter can't count on the terms indicated on the initial document until such a time as he is paid. This form is rarely in use in modern day trade transactions.

Irrevocable L/C

Such a letter of credit cannot be changed unless both buyer and seller agree to make changes. Usually an L/C is regarded as irrevocable unless otherwise specified. Therefore, in

effect, all the parties to the letter of credit transaction, i.e. the issuing bank, the seller and the buyer, must agree to any amendment to or cancellation of the letter of credit. Irrevocable letters of credit are attractive to both the seller and the buyer because of the high degree of involvement and commitment by the bank(s). By the 1993 revision of the UCP, credits are deemed irrevocable, unless there is an indication to the contrary.

Types of Letters of Credit - 2

A letter of credit may be of two forms: Confirmed or Unconfirmed.

Confirmed L/C

If the exporter is uncomfortable with the credit risk of the issuing bank or if the country where the issuing bank is situated is less developed or politically unstable, then as an extra measure, the exporter can request that the L/C to be confirmed. This would add further comfort to the transaction; an exporter may request that the L/C be confirmed.

This is generally by a first class international bank, typically the advising bank (now the Confirming Bank). This bank now takes the responsibility of making payments if no remittance is received from the issuing bank on due date.

Unconfirmed L/C

In contrast, an unconfirmed credit does not require the advising bank to add its own payment undertaking. It therefore leaves the liability seller with the issuing bank. The advising bank is merely as a channel of transmission of documents and payment.

Methods of Settlement

The documentary letters of credit can be opened in two ways:

- 1. Sight Letter of Credit:** A Sight Letter of Credit is a credit in which the seller obtains payment upon presentation of documents in compliance with the terms and conditions.
- 2. Time Draft or Usance Letter of Credit:** A Time Draft or Usance Letter of Credit is a credit in which the seller will be paid a fixed or determinable future time. A time Draft or usance letter of credit calls for time or usance drafts to be drawn on and accepted by the buyer, provided that documents are presented in good order. The

buyer is obligated to pay the face amount at maturity. However, the issuing bank's obligation to the seller remains in force until and unless the draft is paid.

Financing Importers through Letters of Credit

While the L/C can be used as a payment mechanism, it can also be used to provide financing to the applicant (importer). Deferred and Acceptance credits (i.e. term credits) are considered to be financing instruments for the importer/buyer. Both payment structures provide the importer/buyer the time opportunity to sell the goods and pay the amount due with the proceeds.

Under the Deferred Payment structure payment is made to the seller at a specified future date, for example 60 days after presentation of the documents or after the date of shipment (i.e. the date of the bill of lading).

Under the Acceptance structure the exporter is required to draw a draft (bill of exchange) either on the issuing or confirming bank. The draft is accepted by the bank for payment at a negotiated future fixed date. This gives the importer the potential time needed to sell the product and pay off the Acceptance at due date. For example, payment date under an acceptance credit may be at sight or after 90 days from presentation of the documents or from the shipment of goods.

Special Note on Documentary Letters of Credit

Documentary Letters of Credit hinge much on the appropriateness of documents. Banks involved in the transaction do not need to know about the physical state of the goods in question but concern themselves only with documents. If proper documents are presented, banks will make payment whether or not the actual goods shipped comply with the sales contract.

Thus, special care needs to be taken in preparation of the documents since a slight omission or discrepancy between required and actual documents may cause additional costs, delays and seizures or even total abortion of the entire deal.

(1) Documents associated with an L/C

Documents are the key issue in a letter of credit transaction. Banks deal in documents, not in goods. They decide on the basis of documents alone whether payment, negotiation, or acceptance is to be effected. A single transaction can require many different kinds of

documents. Most letter of credit transactions involve a draft, an invoice, an insurance certificate, and a bill of lading. Transactions can culminate in sight drafts or acceptances. Because letter of credit transactions can be so complicated and can involve so many parties, banks must ensure that their letters are accompanied by the proper documents, that those documents are accurate, and that all areas of the bank handle them properly.

The four primary types Documents associated with an L/C are as follows:

- Transfer documents
- Insurance documents
- Commercial documents
- Other documents

Transfer documents are issued by a transportation company when moving the merchandise from the seller to the buyer. The most common transfer document is the Bill of lading. The bill of lading is a receipt given by the freight company to the shipper. A bill of lading serves as a document of title and specifies who is to receive the merchandise at the designated port (as specified by the exporter). It can be in nonnegotiable form (straight bill of lading) or in negotiable form (order bill of lading). In a straight bill of lading, the seller (exporter) consigns the goods directly to the buyer (importer). This type of bill is usually not desirable in a letter of credit transaction, because it allows the buyer to obtain possession of the merchandise without regard to any bank agreement for repayment. A straight bill of lading may be more suitable for prepaid or open account transactions. With an order bill of lading the shipper can consign the goods to the bank, which retains title until the importer acknowledges liability to pay. This method is preferred in documentary or letter of credit transactions. The bank maintains control of the merchandise until the buyer completes all the required documentation. The bank then releases the bill of lading to the buyer, who presents it to the shipping company and gains possession of the merchandise.

Insurance documents, normally an insurance certificate, cover the merchandise being shipped against damage or loss. The terms of the merchandise contract may dictate that either the seller or the buyer obtain insurance. Open policies may cover all shipments and provide for certificates on specific shipments.

Commercial documents, principally the invoice, are the seller's description of the goods shipped and the means by which the buyer gains assurances that the goods shipped are the same as those ordered. Among the most important commercial documents are the invoice and the draft or bill of exchange. Through the invoice, the seller presents to the

buyer a statement describing what has been sold, the price, and other pertinent details. The draft supplements the invoice as the means by which the seller charges the buyer for the merchandise and demands payment from the buyer, the buyer's bank, or some other bank. Although a draft and a check are very similar, the writer of a draft demands payment from another party's account.

In a letter of credit, the draft is drawn by the seller, usually on the issuing, confirming, or paying bank, for the amount of money due under the terms of the letter of credit. In a collection, this demand for payment is drawn on the buyer. The customary parties to a draft, which is a negotiable instrument, are the drawer (usually the exporter), the drawee (the importer a bank), and the payee (usually the exporter), who is also the endorser. A draft can be "clean" (an order to pay) or "documentary" (with shipping documents attached).

A draft that is negotiable:

- Is signed by the maker or drawer
- Contains an unconditional promise to pay a certain sum of money
- Is payable on demand or at a definite time
- Is payable to order or to bearer
- Is two-name paper
- May be sold and ownership transferred by endorsement to the "holder in due course."

The holder in due course has recourse to all previous endorsers if the primary obligor (drawee) does not pay. The seller (drawer) is the secondary obligor if the endorser does not pay. The secondary obligor has an unconditional obligation to pay if the primary obligor and the endorser do not, therefore the term "two-name paper."

Other documents include certain official documents that may be required by governments in order to regulate and control the passage of goods through their borders. Governments may require inspection certificates, consular invoices, or certificates of origin. Transactions can entail notes and advances collateralized by trust receipts or warehouse receipts.

Import Trade Finance Services

Pre-Import Working Capital Program for Importers to fund the purchase of materials, services, and labor to fulfill import sales contracts. Find out more from TEFO about the Pre-Import Working Capital Program

Accounts Receivable Factoring for Importers provides for the purchase at discount of an Importer's accounts receivable representing sales to pre-approved North American Buyers. Find out more from TEFO about Accounts Receivable Factoring for Importers.

Asset Based Line of Credit for Importers provides financing of imports by leveraging a company's equity in current and fixed assets advancing funds based on a percentage of the firm's qualified receivables, inventory and other assets. Find out more from TEFO about Asset-Based Financing.

Inventory Financing for Importers provides for the financing of Importer's Inventory pre-sold to credit worthy North American Buyers. Find out more from TEFO about Inventory Financing.

Purchase Order Financing for Importers provides a solution to finance the purchase or manufacture of goods that have been pre-sold to an overseas creditworthy customer. Find out more from TEFO about Purchase Order Financing for Importers.

Purchase Order Confirmation Facility provides an overseas supplier the assurance that they will be paid for their shipment of product to an Importer prior to the importer receiving any funds from the proceeds of an Accounts Receivable finance credit facility. Find out more from TEFO about the Purchase Order Confirmation (POC) facility.

Equipment Leasing for Importers provides the professional expertise to facilitate the direct importation and lease of equipment to be acquired by North American companies. Find out more from TEFO about Import Lease Financing.

Import Letters of Credit provide importers the most widely used and accepted international trade payment mechanism and finance instrument. By structuring Letter of Credit terms to allow Deferred Payment or Trade Acceptance an L/C can be utilized to provide financing to the importer. Find out more from TEFO about Import Letter of Credit Financing.

Accounts Receivable Management Service provides Importers with on-line access to account information, A/R analysis reports, critical credit analyses, monitoring of credit limits, collection, receiving, posting, and depositing payments. Find out more from TEFO about Accounts Receivable Management Service.

Debt Collection Program for Overseas Suppliers and Importers providing professional legal collections of past due debt obligations from Buyers in North America. Find out more from TEFO about Debt Collection Program Service.

Self Assessment Questions

1. What is Export Finance?
2. What is Pre shipment Finance?
3. What is Post shipment Finance?
4. What are the external sources of funds for export trade?
5. What are the various methods of international commercial Payments?
6. Briefly discuss the criteria for Clearance of export proposals.
7. Elaborate the Fund based facilities and non fund based facilities provided by EXIM bank.
8. What is meant Forfaiting? How it helps exports?
9. Discuss the programmes for export facilitation.
10. What do you understand by ECGC?
11. Write a note on Small exporter's policy.
12. Describe standard policy.
13. What is the guarantee provided by the ECGC for the benefit of exporters?
14. Explain exchange fluctuation cover provided by ECGC.
15. Write a short note on import and import licensing.
16. Briefly discuss the most common terms of purchase.
17. Describe import trade finance services.
18. What is letter of credit? How finance importers through letters of Credit?

UNIT – 3

Unit Structure

- Lesson 3.1 - Foreign Exchange Market
- Lesson 3.2 - Hedging Techniques
- Lesson 3.3 - Foreign Exchange Management (FEMA) Act
- Lesson 3.4 - Exchange Rate Determinations And Forecasting

Lesson 3.1 - Foreign Exchange Market

Learning Objectives

Having gone through this lesson, you are able to

- Know about FOREX market
- Understand the exchange determination
- Analyse and understand spot and futures prices

Introduction

The **foreign exchange market (forex, FX, or currency market)** is a global decentralized market for the trading of currencies. The main participants in this market are the larger international banks. Financial centers around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekends. Electronic Broking Services (EBS) and Reuters 3000 extra are two main interbank FX trading platforms. The foreign exchange market determines the relative values of different currencies.

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 investment by enabling currency conversion. For example, it permits a business in the United States to import goods from the European Union member states, especially Eurozone members, and pay euros, even though its income is in United States dollars. It also supports direct speculation in the value of currencies, and the carry trade, speculation based on the interest rate differential between two currencies.^[2]

In a typical foreign exchange transaction, a party purchases some quantity of one currency by paying 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 20:15 GMT on Sunday until 22:00 GMT Friday;
- 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,^[3] the preliminary global results from the 2013 Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets Activity show that trading in foreign exchange markets averaged \$5.3 trillion per day in April 2013. This is up from \$4.0 trillion in April 2010 and \$3.3 trillion in April 2007.

FX swaps were the most actively traded instruments in April 2013, at \$2.2 trillion per day, followed by spot trading at \$2.0 trillion.

According to the Bank for International Settlements,^[4] as of April 2010, average daily turnover in global foreign exchange markets is estimated at \$3.98 trillion, a growth of approximately 20% over the \$3.21 trillion daily volume as of April 2007. Some firms specializing on foreign exchange market had put the average daily turnover in excess of US\$4 trillion.^[5]

The \$3.98 trillion break-down is as follows:

- \$1.490 trillion in spot transactions
- \$475 billion in outright forwards
- \$1.765 trillion in foreign exchange swaps
- \$43 billion currency swaps
- \$207 billion in options and other products

Market Participants

Unlike a stock market, the foreign exchange market is divided into levels of access. At the top is the interbank market, which is made up of the largest commercial banks and securities dealers. Within the interbank market, spreads, which are the difference between the bid 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 1 pip to 1–2 pips for a 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 39% of all transactions.^[60] 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”.^[65] Central banks also participate in the foreign exchange market to align currencies to their economic needs.

Commercial Companies

An important part of this 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 companies 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

National central banks play an important role in the foreign exchange markets. They try to control the money supply, inflation, and/or interest rates and often have official or unofficial target rates for their currencies. They can use their often substantial foreign exchange reserves to stabilize the market. 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, and there is no convincing evidence that they do make a profit 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 behavior of their currency. Fixing exchange rates reflects the real value of equilibrium in the market. Banks, dealers and traders use fixing rates as a trend indicator.

The mere expectation or rumor of a central bank foreign exchange intervention might be enough to stabilize a currency, but aggressive intervention might be used several times each year in countries with a dirty float currency regime. Central banks do not always achieve their objectives. The combined resources of the market can easily overwhelm any central bank.^[66] Several scenarios of this nature were seen in the 1992–93 European Exchange Rate Mechanism collapse and in more recent times in Asia.

Hedge Funds as Speculators

About 70% to 90% of the foreign exchange transactions are speculative. In other words, the person or institution that bought or sold the currency has no plan to actually take delivery of the currency in the end; rather, they were solely speculating on the

movement of that particular currency. Hedge funds have gained a reputation for aggressive currency speculation since 1996. They control billions of dollars of equity and may borrow billions more, and thus may overwhelm intervention by central banks to support almost any currency, if the economic fundamentals are in the hedge funds' favor.

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, hence, can 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 platforms, 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 in the past 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 Contract for differences 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 principal 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's bank. These companies differ from Money Transfer/Remittance Companies in that they generally offer higher-value services.

Money Transfer/Remittance Companies and Bureaux De Change

Money transfer companies/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.

Bureaux 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.

Trading Characteristics

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 EBS and Reuters, while major banks also offer trading systems. A joint venture of the Chicago Mercantile Exchange and Reuters, called FOREX - market space opened in 2007 and aspired but failed to the role of a central market clearing mechanism.

The main trading centers are New York and London, 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, excluding weekends.

Fluctuations in exchange rates are usually caused by actual monetary flows as well as by expectations of changes in monetary flows caused by changes in gross domestic product (GDP) growth, inflation (purchasing power parity theory), interest rates (interest rate parity, Domestic Fisher effect, 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.

Currencies are traded against one another in pairs. Each currency pair thus constitutes an individual trading product and is traditionally noted XXXYYY or XXX/YYY, where XXX and YYY are the ISO 4217 international three-letter code of the currencies involved. The first currency (XXX) is the base currency that is quoted relative to the second currency (YYY), called the counter currency (or quote currency).

For instance, the quotation *EURUSD (EUR/USD) 1.5465* is the price of the Euro expressed in US dollars, meaning 1 euro = 1.5465 dollars. The market convention is to quote most exchange rates against the USD with the US dollar as the base currency (e.g. USDJPY, USDCAD, USDCHF). The exceptions are the British pound (GBP), Australian dollar (AUD), the New Zealand dollar (NZD) and the euro (EUR) where the USD is the counter currency (e.g. GBPUSD, AUDUSD, NZDUSD, EURUSD).

The factors affecting XXX will affect both XXXYYY and XXXZZZ. This causes positive currency correlation between XXXYYY and XXXZZZ.

On the spot market, according to the 2013 Triennial Survey, the most heavily traded bilateral currency pairs were:

- EURUSD: 24.1%
- USDJPY: 18.3%
- GBPUSD (also called *cable*): 8.8% and

The US currency was involved in 87.0% of transactions, followed by the euro (33.4%), the yen (23.0%), and sterling (11.8%). 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. As the dollar's value has eroded during 2008, interest in using the euro as reference currency for prices in commodities (such as oil), as well as a larger component of foreign reserves by banks, has increased dramatically. Transactions in the currencies of commodity-producing countries, such as AUD, NZD, CAD, have also increased.

Determinants of Exchange Rates

Exchange Rate

The following theories explain the fluctuations in exchange rates in a floating exchange rate regime (In a fixed exchange rate regime, rates are decided by its government):

1. International parity conditions: Relative Purchasing Power Parity, interest rate parity, Domestic Fisher effect, International Fisher effect. Though to some extent the above theories provide logical explanation for the fluctuations in exchange rates, yet these theories falter as they are based on challengeable assumptions [e.g., free flow of goods, services and capital] which seldom hold true in the real world.
2. Balance of payments model: This model, however, focuses largely on tradable goods and services, ignoring the increasing role of global capital flows. It failed to provide any explanation for continuous appreciation of dollar during 1980s and most part of 1990s in face of soaring US current account deficit.

3. Asset market model: views currencies as an important asset class for constructing investment portfolios. Assets prices are influenced mostly by people's willingness to hold the existing quantities of assets, which in turn depends on their expectations on the future worth of these assets. The asset market model of exchange rate determination states that "the exchange rate between two currencies represents the price that just balances the relative supplies of, and demand for, assets denominated in those currencies."

None of the models developed so far succeed to explain exchange rates and volatility in the longer time frames. For shorter time frames (less than a few days) algorithms can be devised to predict prices. It is understood from the above models that many macroeconomic factors affect the exchange rates and in the end currency prices are a result of dual forces of demand and supply.

The world's currency markets can be viewed as a huge melting pot: in a large and ever-changing mix of current events, supply and demand factors are constantly shifting, and the price of one currency in relation to another shifts accordingly. No other market encompasses (and distills) as much of what is going on in the world at any given time as foreign exchange.^[72]

Supply and demand for any given currency, and thus its value, are not influenced by any single element, but rather by several. These elements generally fall into three categories: economic factors, political conditions and market psychology.

Economic Factors

These include: (a) economic policy, disseminated by government agencies and central banks, (b) economic conditions, generally revealed through economic reports, and other economic indicators.

- Economic policy comprises government fiscal policy (budget/spending practices) and monetary policy (the means by which a government's central bank influences the supply and "cost" of money, which is reflected by the level of interest rates).
- Government budget deficits or surpluses: The market usually reacts negatively to widening government budget deficits, and positively to narrowing budget deficits. The impact is reflected in the value of a country's currency.
- Balance of trade levels and trends: The trade flow between countries illustrates the demand for goods and services, which in turn indicates demand for a country's

currency to conduct trade. Surpluses and deficits in trade of goods and services reflect the competitiveness of a nation's economy. For example, trade deficits may have a negative impact on a nation's currency.

- Inflation levels and trends: Typically a currency will lose value if there is a high level of inflation in the country or if inflation levels are perceived to be rising. This is because inflation erodes purchasing power, thus demand, for that particular currency. However, a currency may sometimes strengthen when inflation rises because of expectations that the central bank will raise short-term interest rates to combat rising inflation.
- Economic growth and health: Reports such as GDP, employment levels, retail sales, capacity utilization and others, detail the levels of a country's economic growth and health. Generally, the more healthy and robust a country's economy, the better its currency will perform, and the more demand for it there will be.
- Productivity of an economy: Increasing productivity in an economy should positively influence the value of its currency. Its effects are more prominent if the increase is in the traded sector.

Political Conditions

Internal, regional, and international political conditions and events can have a profound effect on currency markets.

All exchange rates are susceptible to political instability and anticipations about the new ruling party. Political upheaval and instability can have a negative impact on a nation's economy. For example, destabilization of coalition governments in Pakistan and Thailand can negatively affect the value of their currencies. Similarly, in a country experiencing financial difficulties, the rise of a political faction that is perceived to be fiscally responsible can have the opposite effect. Also, events in one country in a region may spur positive/negative interest in a neighboring country and, in the process, affect its currency.

Market Psychology

Market psychology and trader perceptions influence the foreign exchange market in a variety of ways:

- Flights to quality: Unsettling international events can lead to a "flight to quality", a type of capital flight whereby investors move their assets to a perceived "safe

haven”. There will be a greater demand, thus a higher price, for currencies perceived as stronger over their relatively weaker counterparts. The U.S. dollar, Swiss franc and gold have been traditional safe havens during times of political or economic uncertainty.

- Long-term trends: Currency markets often move in visible long-term trends. Although currencies do not have an annual growing season like physical commodities, business cycles do make themselves felt. Cycle analysis looks at longer-term price trends that may rise from economic or political trends.
- “Buy the rumor, sell the fact”: This market truism can apply to many currency situations. It is the tendency for the price of a currency to reflect the impact of a particular action before it occurs and, when the anticipated event comes to pass, react in exactly the opposite direction. This may also be referred to as a market being “oversold” or “overbought”. To buy the rumor or sell the fact can also be an example of the cognitive bias known as anchoring, when investors focus too much on the relevance of outside events to currency prices.
- Economic numbers: While economic numbers can certainly reflect economic policy, some reports and numbers take on a talisman-like effect: the number it-self becomes important to market psychology and may have an immediate impact on short-term market moves. “What to watch” can change over time. In recent years, for example, money supply, employment, trade balance figures and inflation numbers have all taken turns in the spotlight.
- Technical trading considerations: As in other markets, the accumulated price movements in a currency pair such as EUR/USD can form apparent patterns that traders may attempt to use. Many traders study price charts in order to identify such patterns.

Financial Instruments

Spot

A spot transaction is a two-day delivery transaction (except in the case of trades between the US Dollar, Canadian Dollar, Turkish Lira, Euro and Russian Ruble, which settle the next business day), as opposed to the futures contracts, which are usually three months.

This trade represents a “direct exchange” between two currencies, has the shortest time frame, involves cash rather than a contract; and interest is not included in the agreed-

upon transaction. Spot trading is one of the most common types of Forex Trading. Often, a forex broker will charge a small fee to the client to roll-over the expiring transaction into a new identical transaction for a continuum of the trade. This roll-over fee is known as the “Swap” fee.

Forward

One way to deal with the foreign exchange risk is to engage in a forward transaction. In this transaction, money does not actually change hands until some agreed upon future date. A buyer and seller agree on an exchange rate for any date in the future, and the transaction occurs on that date, regardless of what the market rates are then.

The duration of the trade can be one day, a few days, months or years. Usually the date is decided by both parties. Then the forward contract is negotiated and agreed upon by both parties.

Swap

The most common type of forward transaction is the foreign exchange swap. In a swap, two parties exchange currencies for a certain length of time and agree to reverse the transaction at a later date. These are not standardized contracts and are not traded through an exchange. A deposit is often required in order to hold the position open until the transaction is completed.

Future

Futures are standardized forward contracts and are usually traded on an exchange created for this purpose. The average contract length is roughly 3 months. Futures contracts are usually inclusive of any interest amounts.

Currency futures contracts are contracts specifying a standard volume of a particular currency to be exchanged on a specific settlement date. Thus the currency futures contracts are similar to forward contracts in terms of their obligation, but differ from forward contracts in the way they are traded.

They are commonly used by MNCs to hedge their currency positions. In addition they are traded by speculators who hope to capitalize on their expectations of exchange rate movements.

Option

A foreign exchange option (commonly shortened to just FX option) is a derivative where the owner has the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date. The options market is the deepest, largest and most liquid market for options of any kind in the world.

Speculation

Controversy about currency speculators and their effect on currency devaluations and national economies recurs regularly. Nevertheless, economists including Milton Friedman have argued that speculators ultimately are a stabilizing influence on the market and perform the important function of providing a market for hedgers and transferring risk from those people who don't wish to bear it, to those who do.^[78] Other economists such as Joseph Stiglitz consider this argument to be based more on politics and a free market philosophy than on economics.

Large hedge funds and other well capitalized "position traders" are the main professional speculators. According to some economists, individual traders could act as "noise traders" and have a more destabilizing role than larger and better informed actors. Also to be considered is the rise in foreign exchange auto trading; algorithmic, or automated, trading has increased from 2% in 2004 up to 45% in 2010.

Currency speculation is considered a highly suspect activity in many countries. While investment in traditional financial instruments like bonds or stocks often is considered to contribute positively to economic growth by providing capital, currency speculation does not; according to this view, it is simply gambling that often interferes with economic policy.

For example, in 1992, currency speculation forced the Central Bank of Sweden to raise interest rates for a few days to 500% per annum, and later to devalue the krona. Former Malaysian Prime Minister Mahathir Mohamad is one well known proponent of this view. He blamed the devaluation of the Malaysian ringgit in 1997 on George Soros and other speculators.

Gregory J. Millman reports on an opposing view, comparing speculators to "vigilantes" who simply help "enforce" international agreements and anticipate the effects of basic economic "laws" in order to profit^s.

In this view, countries may develop unsustainable financial bubbles or otherwise mishandle their national economies, and foreign exchange speculators made the inevitable collapse happen sooner.

A relatively quick collapse might even be preferable to continued economic mishandling, followed by an eventual, larger, collapse. Mahathir Mohamad and other critics of speculation are viewed as trying to deflect the blame from themselves for having caused the unsustainable economic conditions.

Risk Aversion

Risk aversion is a kind of trading behavior exhibited by the foreign exchange market when a potentially adverse event happens which may affect market conditions. This behavior is caused when risk averse traders liquidate their positions in risky assets and shift the funds to less risky assets due to uncertainty.^[84]

In the context of the foreign exchange market, traders liquidate their positions in various currencies to take up positions in safe-haven currencies, such as the US Dollar. Sometimes, the choice of a safe haven currency is more of a choice based on prevailing sentiments rather than one of economic statistics. An example would be the Financial Crisis of 2008. The value of equities across the world fell while the US Dollar strengthened. This happened despite the strong focus of the crisis in the USA.

Carry Trade

Currency carry trade refers to the act of borrowing one currency that has a low interest rate in order to purchase another with a higher interest rate. A large difference in rates can be highly profitable for the trader, especially if high leverage is used. However, with all levered investments this is a double edged sword, and large exchange rate fluctuations can suddenly swing trades into huge losses.

Forex Signals

Forex trade alerts, often referred to as Forex Signals are trade strategies provided by either experienced traders or market analysts. These signals which are often charged a premium fee for can then be copied or replicated by a trader to his own live account. Forex signal products are packaged as either alerts delivered to a user's inbox or SMS, or can be installed to a trader's trading platforms.

Forward Price

The **forward price** (or sometimes forward rate) is the agreed upon price of an asset in a forward contract. Using the rational pricing assumption, for a forward contract on an underlying asset that is *tradeable*, we can express the forward price in terms of the spot price and any dividends etc. For forwards on non-tradeables, pricing the forward may be a complex task.

Forward Price Formula

If the underlying asset is tradeable and a dividend exists, the forward price is given by:

$$F = S_0 e^{(r-q)T} - \sum_{i=1}^N D_i e^{(r-q)(T-t_i)}$$

where

F is the forward price to be paid at time T

e^x is the exponential function (used for calculating continuous compounding interests)

r is the risk-free interest rate

q is the cost-of-carry

S_0 is the spot price of the asset (i.e. what it would sell for at time 0)

D_i is a dividend which is guaranteed to be paid at time t_i where $0 < t_i < T$.

Proof of the Forward Price Formula

The two questions here are what price the short position (the seller of the asset) should offer to maximize his gain, and what price the long position (the buyer of the asset) should accept to maximize his gain?

At the very least we know that both do not want to lose any money in the deal.

The short position knows as much as the long position knows: the short/long positions are both aware of any schemes that they could partake on to gain a profit given some forward price.

So of course they will have to settle on a fair price or else the transaction cannot occur.

An economic articulation would be:

(fair price + future value of asset's dividends) - spot price of asset = cost of capital

Forward price = Spot Price - cost of carry

The future value of that asset's dividends (this could also be coupons from bonds, monthly rent from a house, fruit from a crop, etc.) is calculated using the risk-free force of interest. This is because we are in a risk-free situation (the whole point of the forward contract is to get rid of risk or to at least reduce it) so why would the owner of the asset take any chances? He would reinvest at the risk-free rate (i.e. U.S. T-bills which are considered risk-free). The spot price of the asset is simply the market value at the instant in time when the forward contract is entered into. So $OUT - IN = NET\ GAIN$ and his net gain can only come from the opportunity cost of keeping the asset for that time period (he could have sold it and invested the money at the risk-free rate).

let:

K = fair price

C = cost of capital

S = spot price of asset

F = future value of asset's dividend

I = present value of F (discounted using r)

r = risk-free interest rate compounded continuously

T = length of time from when the contract was entered into

Solving for fair price and substituting mathematics we get:

$$K = C + S - F$$

where:

$$C = S(e^{rT} - 1)$$

(since $e^{rT} = 1 + j$ where j is the effective rate of interest per time period of T)

$$F = c_1 e^{r(T-t_1)} + \dots + c_n e^{r(T-t_n)}$$

where c_i is the i^{th} dividend paid at time t^i .

Doing some reduction we end up with:

$$K = (S - I)e^{rT}.$$

Notice that implicit in the above derivation is the assumption that the underlying can be traded. This assumption does not hold for certain kinds of forwards.

Forward Versus Futures Prices

There is a difference between forward and futures prices when interest rates are stochastic. This difference disappears when interest rates are deterministic.

In the language of stochastic processes, the forward price is a martingale under the forward measure, whereas the futures price is a martingale under the risk-neutral measure. The forward measure and the risk neutral measure are the same when interest rates are deterministic.

See Musiela and Rutkowski's book on Martingale Methods in Financial Markets for a continuous-time proof of this result. See van der Hoek and Elliott's book on Binomial Models in Finance for the discrete-time version of this result.

Spot Prices and Future Price Expectations

Depending on the item being traded, spot prices can indicate market expectations of future price movements in different ways. For a security or **non-perishable** commodity (e.g. silver), the spot price reflects market expectations of future price movements. In theory, the difference in spot and forward prices should be equal to the finance charges, plus any earnings due to the holder of the security, according to the cost of carry model. For example, on a share the difference in price between the spot and forward is usually accounted for almost entirely by any dividends payable in the period minus the interest payable on the purchase price. Any other cost price would yield an arbitrage opportunity and riskless profit (see rational pricing for the arbitrage mechanics).

In contrast, a **perishable** or soft commodity does not allow this arbitrage – the cost of storage is effectively higher than the expected future price of the commodity. As a result, spot prices will reflect current supply and demand, not future price movements. Spot prices can therefore be quite volatile and move independently from forward prices. According to

the unbiased forward hypothesis, the difference between these prices will equal the expected price change of the commodity over the period.

Spot Date

In finance, the spot date of a transaction is the normal settlement day when the transaction is done today. This kind of transaction is referred to as a spot transaction or simply spot.

The spot date may be different for different types of financial transactions. In the foreign exchange market, spot is normally two banking days forward for the currency pair traded. A transaction which has settlement after the spot date is called a forward or a forward contract.



Other settlement dates are also possible. Standard settlement dates are calculated from the spot date. For example, a one month foreign exchange forward settles one month after the spot date. I.e., if today is 1 February, the spot date is 3 February and the one month date is 3 March (assuming these dates are all business days). For a trade with two dates, such as a foreign exchange swap, the first date is usually taken as the spot date.

Examples

Bond

Spot rates are estimated via the bootstrapping method, which uses prices of the securities currently trading in market, that is, from the cash or coupon curve. The result is the spot curve, which exists for each of the various classes of securities.

Commodity

A simple example even if you know tomatoes are cheap in July and will be expensive in January, you can't buy them in July and take delivery in January, since they will spoil before you can take advantage of January's high prices. The July price will reflect tomato supply and demand in July. The forward price for January will reflect the market's expectations of supply and demand in January. July tomatoes are effectively a different commodity from January tomatoes (contrast contango and backwardation).

Factors that Influence Exchange Rates

Aside from factors such as interest rates and inflation, the exchange rate is one of the most important determinants of a country's relative level of economic health. Exchange rates play a vital role in a country's level of trade, which is critical to most every free market economy in the world. For this reason, exchange rates are among the most watched, analyzed and governmentally manipulated economic measures. But exchange rates matter on a smaller scale as well: they impact the real return of an investor's portfolio. Here we look at some of the major forces behind exchange rate movements.

Before we look at these forces, we should sketch out how exchange rate movements affect a nation's trading relationships with other nations. A higher currency makes a country's exports more expensive and imports cheaper in foreign markets; a lower currency makes a country's exports cheaper and its imports more expensive in foreign markets. A higher exchange rate can be expected to lower the country's balance of trade, while a lower exchange rate would increase it.

Numerous factors determine exchange rates, and all are related to the trading relationship between two countries. Remember, exchange rates are relative, and are expressed as a comparison of the currencies of two countries. The following are some of the principal determinants of the exchange rate between two countries. Note that these factors are in no particular order; like many aspects of economics, the relative importance of these factors is subject to much debate.

1. Differentials in Inflation

As a general rule, a country with a consistently lower inflation rate exhibits a rising currency value, as its purchasing power increases relative to other currencies.

During the last half of the twentieth century, the countries with low inflation included Japan, Germany and Switzerland, while the U.S. and Canada achieved low inflation only later. Those countries with higher inflation typically see depreciation in their currency in relation to the currencies of their trading partners. This is also usually accompanied by higher interest rates.

2. Differentials in Interest Rates

Interest rates, inflation and exchange rates are all highly correlated. By manipulating interest rates, central banks exert influence over both inflation and exchange rates, and

changing interest rates impact inflation and currency values. Higher interest rates offer lenders in an economy a higher return relative to other countries. Therefore, higher interest rates attract foreign capital and cause the exchange rate to rise. The impact of higher interest rates is mitigated, however, if inflation in the country is much higher than in others, or if additional factors serve to drive the currency down. The opposite relationship exists for decreasing interest rates - that is, lower interest rates tend to decrease exchange rates.

3. Current-Account Deficits

The current account is the balance of trade between a country and its trading partners, reflecting all payments between countries for goods, services, interest and dividends. A deficit in the current account shows the country is spending more on foreign trade than it is earning, and that it is borrowing capital from foreign sources to make up the deficit. In other words, the country requires more foreign currency than it receives through sales of exports, and it supplies more of its own currency than foreigners demand for its products. The excess demand for foreign currency lowers the country's exchange rate until domestic goods and services are cheap enough for foreigners, and foreign assets are too expensive to generate sales for domestic interests.

4. Public Debt

Countries will engage in large-scale deficit financing to pay for public sector projects and governmental funding. While such activity stimulates the domestic economy, nations with large public deficits and debts are less attractive to foreign investors. The reason? A large debt encourages inflation, and if inflation is high, the debt will be serviced and ultimately paid off with cheaper real dollars in the future.

In the worst case scenario, a government may print money to pay part of a large debt, but increasing the money supply inevitably causes inflation. Moreover, if a government is not able to service its deficit through domestic means (selling domestic bonds, increasing the money supply), then it must increase the supply of securities for sale to foreigners, thereby lowering their prices.

Finally, a large debt may prove worrisome to foreigners if they believe the country risks defaulting on its obligations. Foreigners will be less willing to own securities denominated in that currency if the risk of default is great. For this reason, the country's debt rating (as determined by Moody's or Standard & Poor's, for example) is a crucial determinant of its exchange rate.

5. Terms of Trade

A ratio comparing export prices to import prices, the terms of trade is related to current accounts and the balance of payments. If the price of a country's exports rises by a greater rate than that of its imports, its terms of trade have favorably improved. Increasing terms of trade shows greater demand for the country's exports. This, in turn, results in rising revenues from exports, which provides increased demand for the country's currency (and an increase in the currency's value). If the price of exports rises by a smaller rate than that of its imports, the currency's value will decrease in relation to its trading partners.

6. Political Stability and Economic Performance

Foreign investors inevitably seek out stable countries with strong economic performance in which to invest their capital. A country with such positive attributes will draw investment funds away from other countries perceived to have more political and economic risk. Political turmoil, for example, can cause a loss of confidence in a currency and a movement of capital to the currencies of more stable countries.

THE 1997 EAST ASIAN economic crisis made apparent how vulnerable currencies can be. The speculative attacks on the ringgit for example, almost devastated the economy if not for the quick and bold counter actions taken by the Malaysian government, particularly in checking the offshore ringgit transactions. It also made apparent the need for firms to manage foreign exchange risk. Many individuals, firms and businesses found themselves helpless in the wake of drastic exchange rate movements. Malaysia being among the most open countries in the world, in terms of international trade, was exposed to significant foreign exchange risk. Foreign exchange risk refers to the uncertainties faced due to fluctuating exchange rates. For example, a Malaysian trader who exports palm oil to India for future payments to be received in rupees faces the risk of rupees depreciating against the ringgit at the time the payment is made. This is because if the rupee depreciates, a smaller amount of ringgit will be received when the rupees are exchanged into ringgit. Therefore, what originally seemed a profitable venture could turn out to be a loss due to exchange rate fluctuations.

Such risks are common in international trade and finance. A significant number of international investments, trades and dealings are shelved due to the unwillingness of parties concerned to bear foreign exchange risk. Hence it is important for businesses to manage this foreign exchange risk so that they may concentrate on what they are good at and eliminate or minimize a risk that is not their trade. Unfortunately, however, in the case of most developing nations including Malaysia, tools available for managing foreign exchange

risk are minimal. Traditionally, the forward rates, currency futures and options have been used for this purpose. The futures and options markets are also known as derivative markets. However, in many nations, including Malaysia, futures and options on currencies are not available. The Malaysian Derivatives Exchange (MDEX), for example, makes available a number of derivative instruments Kuala Lumpur Composite Index Futures, Index Options, Crude Palm Oil Futures and KLIBOR (interest rate) Futures but not ringgit futures or options. Even in countries where currency derivative markets exist, however, for example the Philadelphia Stock Exchange in the United States, not all derivatives on all currencies are traded. Derivatives are available only on select major world currencies. While the existence of these markets assists in risk management, speculation and arbitrage also thrive in them. This section compares and contrasts the use of derivatives forwards, futures and options and the gold dinar for hedging foreign exchange risk. It also argues why a gold dinar system is likely to introduce efficiency into the market while reducing the cost of hedging against foreign exchange risk, compared with the derivatives.

Lesson 3.2 - Hedging Techniques

Learning Objectives

Having gone through this lesson, you may be able to:

- Understand hedging mechanism
- Know different hedging techniques
- Compare and contrast the futures and options

Introduction

A hedge is an investment position intended to offset potential losses/gains that may be incurred by a companion investment. In simple language, a hedge is used to reduce any substantial losses/gains suffered by an individual or an organization.

A hedge can be constructed from many types of financial instruments, including stocks, exchange-traded funds, insurance, forward contracts, swaps, options, many types of over-the-counter and derivative products, and futures contracts.

Public futures markets were established in the 19th century to allow transparent, standardized, and efficient hedging of agricultural commodity prices; they have since expanded to include futures contracts for hedging the values of energy, precious metals, foreign currency, and interest rate fluctuations.

Hedging means that making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

An example of a hedge would be if you owned a stock, then sold a futures contract stating that you will sell your stock at a set price, therefore avoiding market fluctuations. Investors use this strategy when they are unsure of what the market will do. A perfect hedge reduces your risk to nothing (except for the cost of the hedge).

Hedging with Forwards

Hedging refers to managing risk to an extent that it is bearable. In international trade and dealings foreign exchange plays an important role. Fluctuations in foreign exchange rates can have significant implications on business decisions and outcomes. Many international trade and business dealings are shelved or become unworthy due to significant exchange rate risk embedded in them. Historically, the foremost instrument used for managing exchange rate risk is the forward rate. Forward rates are custom agreements between two parties to fix the exchange rate for a future transaction. This simple arrangement easily eliminates exchange rate risk, however, it has some shortcomings, particularly the difficulty in getting a counter party who would agree to fix the future rate for the amount and at the time period in question. In Malaysia many businesses are not even aware that some banks do provide forward rate arrangements as a service to their customers. By entering into a forward rate agreement with a bank, the businessman simply transfers the risk to the bank, which will now have to bear this risk. Of course, the bank, in turn, may have to make some other arrangement to manage this risk. Forward contracts are somewhat less familiar, probably because no formal trading facility, building or even regulating body exists.

An Example of Hedging Using Forward Agreement

Assume that a Malaysian construction company, ABC Corporation just won a bid to build a stretch of road in India. Now is July and the contract signed for 10,000,000 rupees, would be paid for in September. This amount is consistent with ABC's minimum revenue of RM1,000,000 at the exchange rate of RM0.10 per rupee. Nonetheless, fluctuating exchange rates could end with a possible depreciation of rupees and thus render the project unworthy. ABC, therefore, enters into a forward contract with the First Bank of India to fix the exchange rate at RM0.10 per rupee. The forward contract is a legal agreement and, therefore, constitutes obligations on both sides. The First Bank may have to find a counter party for this transaction — either a party that wants to hedge against an appreciation of 10,000,000 rupees expiring at the same time or a party that wishes to speculate on an upward trend in rupees. If the bank itself plays the counter party, then the risk would be borne by the bank. The existence of speculators increases the probability of finding a counter party. By entering into a forward contract ABC is guaranteed of an exchange rate of RM0.10 per rupee in the future, irrespective of what happens to the spot rupee exchange rate. If the rupee were to actually depreciate, ABC would then be protected. However, if it were to appreciate, then ABC would have to forego this favourable movement and hence bear some implied losses. Even though a favourable movement could be lost, ABC still proceeds with the hedging since it knows that a “guaranteed” exchange rate of RM0.10 per rupee is consistent with a profitable venture.

Hedging with Futures

The futures market came into existence as an answer for the shortcomings inherent in the forward market. The futures market solves some of the shortcomings of the forward market, particularly the need and the difficulty in finding a counter party. A currency futures contract is an agreement between two parties to buy or sell a particular currency at a future date, at a particular exchange rate that is fixed or agreed upon upfront. This sounds a lot like the forward contract.

In fact, the futures contract is similar to the forward contract but is much more liquid. It is liquid because it is traded in an organized exchange — i.e. the futures market. Futures contracts are standardized contracts and thus are bought and sold just like shares in a stock market. The futures contract is also a legal contract just like the forward, however, the obligation can be ‘removed’ prior to the expiry of the contract by making an opposite transaction, i.e. if one had purchased a futures contract then one may exit by selling the same contract. When hedging with futures, if the risk is an appreciation in value, then one needs to buy futures, whereas if the risk is a depreciation then one needs to sell futures.

Consider our earlier example, instead of using forwards, ABC could have thus sold rupee futures to hedge against a rupee depreciation. Let’s assume accordingly that ABC sold rupee futures at the rate RM 0.10 per rupee. Hence the size of the contract is RM 1,000,000. Now assume that the rupee depreciates to RM 0.07 per rupee — the very thing ABC was afraid of (See Table). ABC would then close the futures contract by buying back the contract at this new rate. Note that in essence ABC bought the contract for RM0.07 and sold it for RM0.10. This gives a futures profit of RM 300,000 $[(RM0.10 - RM0.07) \times 10,000,000]$.

However, in the spot market ABC gets only RM 700,000 when it exchanges the 10,000,000 rupees at RM0.07. The total cash flow, however, is maintained at RM 1,000,000 (RM700,000 from spot and RM300,000 profit from futures). With perfect hedging the cash flow would always be RM1 million no matter what happens to the exchange rate in the spot market. One advantage of using futures for hedging is that ABC can release itself from the futures obligation by buying back the contract anytime before the expiry of the contract. To enter into a futures contract a trader, however, needs to pay a deposit (called an initial margin) first.

Then his position will be tracked on a daily basis so much so that whenever his account makes a loss for the day, the trader will receive a margin call (also known as variation margin), requiring him to pay up the losses.

Table 4: Outcome of Hedging using Currency Futures

Cash Market	Futures Market
July	July
ABC Corp. expects to have 10,000,000 rupees in September. Currently, the rupee exchange rate is RM0.10 per rupee.	ABC sells 5 September rupee futures contracts at RM0.10 (Assuming each rupee futures contract size is 2,000,000 rupees) Total underlying value of the futures: $5 \times 2 \text{ mil.} \times 0.10 = \text{RM}1,000,000$
September	September
Exchanges the 10,000,000 rupees in the spot market for RM0.07. Value in ringgit: $10,000,000 @ \text{RM}0.07 = \text{RM}700,000$ Plus futures profit: $\text{RM}700,000 + \text{RM}300,000 = \text{RM}1,000,000$	ABC buys 5 September rupee futures contracts at RM0.07 Total underlying value of the futures: $5 \times 2 \text{ mil.} \times 0.07 = \text{RM}700,000$ Futures profit: $1,000,000 - 700,000 = \text{RM}300,000$

Standardized Features of the Futures Contract and Liquidity

Unlike the forward contract, the futures contract has a number of features that have been standardized. These standard features increase the liquidity in the market, i.e. increase the number of transactions that match in terms of size and expiration. In the practical world, traders are faced with diverse conditions that need diverse actions (like the need to hedge different amounts of currency at different points of time in the future) such that matching transactions can be difficult. By standardizing the contract sizes (i.e. the amount) and the expiry dates, these different needs can be matched to some degree, even though not perfectly perhaps. Some of the standardized features include the expiry date, contract month, contract size, position limits (i.e. the number of contracts a party can buy or sell) and price limit (i.e. the maximum daily price movements allowed). Nevertheless, these standardized features introduce some hedging imperfections. In our earlier example, assuming the size of each rupee futures contract to be 2,000,000, then 5 contracts need to be sold for a contract size of 10,000,000 rupees. However, if the size of each contract is 3,000,000 for instance, then only 3 contracts can be sold, leaving 1,000,000 rupees unhedged. Therefore, with standardization, some part of the spot position can go unhedged. Some advantages and disadvantages of hedging using futures are summarized below:

Advantages of the Futures Contract

- **Liquid and central market.** Since futures contracts are traded on a central market, this increases liquidity. There are many market participants and hence one may easily buy or sell futures contracts. The problem of double coincidence of wants that could exist in the forward market is greatly reduced. A trader who has taken a position in the futures market can easily make an opposite transaction and thereby close his or her position. However, such easy exit is not a feature of the forward market.
- **Leverage.** Leverage is brought about by the futures market's margin system, where a trader takes on a larger position with only a small initial deposit. If the futures contract with a value of RM1,000,000 requires an initial margin of only RM100,000, then a one per cent change in the futures price (i.e. RM10,000) would bring about a 10 per cent change relative to the trader's initial outlay. This amplification of profits (or losses) is called leverage. Leverage allows the trader to hedge much bigger amounts with smaller outlays.
- **Positions can be easily closed out.** As mentioned earlier, positions taken in the futures market can be easily closed out by making opposite transactions. If a trader had sold 5 rupee futures contracts expiring in December, then the trader could close that position by buying 5 December rupee futures. In hedging, such closing-out of positions is done close to the expected physical spot transactions. Profits or losses from futures would offset the opposite losses or profits from the spot transaction. Nevertheless, such offsetting may not be perfect due to the imperfections brought about by the standardized features of the futures contract.
- **Convergence.** As the futures contract approaches expiration, its price and the spot price would tend to converge. On the day of expiration both prices should be equal. Convergence is brought about by the activities of arbitrageurs who would move in to profit if price disparities were to exist between the futures and the spot, i.e. buying in the cheaper market and selling in the higher priced one.

Disadvantages of the Futures Contract

- **Legal obligation.** The futures contract, just like the forward contract, is a legal obligation. Being a legal obligation it can sometimes pose problems. For example, if futures are used for hedging a project that is still in the bidding process, the futures position can turn into a speculative position in the event the bidding turns out unsuccessful.

- **Standardized features.** Since the futures contract has some of its features standardized like the contract size, expiry date, etc., perfect hedging may be impossible. Since over-hedging is also not advisable, some part of the spot transactions will, therefore, have to go unhedged.
- **Initial and daily variation margins.** This is a unique feature of the futures contract. A trader who wishes to take a position in the futures market must first pay an initial margin or deposit. This deposit will be returned when the trader closes his or her position. Also, the futures contract is marked to market, i.e. its position is tracked on a daily basis and the trader would be required to pay up variation margins in the event of daily losses. The initial and daily variation margins can pose a significant cash flow burden on traders or hedgers.
- **Forego favourable movements.** In hedging using futures, any losses or profits in the spot transaction would be offset by profits or losses from the futures transaction. Consider our earlier example where ABC sold rupee futures to protect against a rupee depreciation. However, if the rupee were to appreciate, then ABC would have to forego such favourable movements.

The above shortcomings of the futures contract, particularly it being a legal obligation, with margin requirements and the need to forego favourable movements, prompted the development and establishment of the options markets that deal in more flexible instruments, i.e. the options contracts.

Hedging using Options

A currency option may be defined as a contract between two parties — a buyer and a seller — whereby the buyer of the option has the right but not the obligation, to buy or sell a specified currency at a specified exchange rate, at or before a specified date, from the seller of the option. While the buyer of an option enjoys a right but not an obligation, the seller of the option, nevertheless, has an obligation in the event the buyer exercises the given right.

There are two types of options:

- **Call option** — gives the buyer the right to buy a specified currency at a specified exchange rate, at or before a specified date.
- **Put option** — gives the buyer the right to sell a specified currency at a specified exchange rate, at or before a specified date.

The seller of the option, of course, needs to be compensated for giving the right. The compensation is called the price or the premium of the option. The seller thus has an obligation in the event the right is exercised by the buyer.

For example, assume that a trader buys a September RM0.10 rupee call option for RM0.01. This means that the trader has the right to buy rupees for RM0.10 per rupee at any time until the contract expires in September. The trader pays a premium of RM0.01 for this right. The RM0.10 is called the strike price or the exercise price.

If the rupee appreciates over RM0.10 anytime before expiry, the trader may exercise his right and buy it for only RM0.10 per rupee. If, however, the rupee were to depreciate below RM0.10, the trader may just let the contract expire without taking any action since he is not obligated to buy it at RM0.10. In this case, if he needs physical rupee, he may just buy it in the spot market at the new lower rate.

In hedging using options, calls are used if the risk is an upward trend in price, while puts are used if the risk is a downward trend. In our ABC example, since the risk is a depreciation of rupees, ABC would need to buy put options on rupees. If rupees were to depreciate at the time ABC receives its rupee revenue, then ABC would exercise its right and thereby effectively obtain a higher exchange rate.

If, however, rupees were to appreciate instead, ABC would then just let the contract expire and exchange its rupees in the spot market at the higher exchange rate. Therefore, the options market allows traders to enjoy unlimited favourable movements while limiting losses. This feature is unique to options, unlike the forward or futures contracts where the trader has to forego favourable movements and there are also no limits to losses.

Options are particularly suited as a hedging tool for contingent cash flows, as is the case in bidding processes. When a firm bids for a project overseas, which involves foreign exchange risk, the options market allows it to quote its bid price and at the same time protect itself from the exchange rate fluctuations in the event the bid is won. In the case of hedging with forwards or futures, the firm would be automatically placed in a speculative position in the event of an unsuccessful bid, without any limit to its downside losses.

An Example of Hedging with Put Options

Consider our ABC Corp. example. Instead of already having won the contract in question, let's, however, assume that it is in the process of bidding for it — as is the common case in real life. ABC wants a minimum acceptable revenue of RM1,000,000 after hedging

costs, but ABC need to quote a bid price now. In this instance, ABC would face the exchange rate risk only upon winning the bid. Options fare better as a hedging tool here compared with forwards or futures due to the uncertainty in getting the contract. Assume that it is now July and the results of the bidding will be known only in September, and that the following September options quotes are available today:

RM0.10 call @ RM0.002

RM0.10 put @ RM0.001

Assume that the size of each rupee contract is 2,000,000 rupees. The following is how ABC could make its hedging strategy:

1. First, it needs to decide whether to buy puts or calls. Since ABC would receive rupees in the future if it won the contract, its risk is a depreciation of rupees. Therefore, it should buy puts.
2. What should the bid amount be? To answer this question we need to compute the effective exchange rate after incorporating the price of put, i.e. RM0.10 minus RM0.001 which equals RM0.099. Now the bid amount is computed as RM1,000,000 / RM0.099, which equals 10,101,010 rupees.
3. How many put contracts should it buy? To answer this, just take the bid amount and divide by the contract size, i.e. $10,101,010 / 2,000,000$ equals 5.05. Since fractions of contracts are not allowed and we don't over-hedge, 5 contracts are sufficient, with some portion going unhedged. However, if we want to guarantee a minimum revenue of RM1,000,000, we cannot tolerate any imperfections in the hedging. Therefore, in this example we should go for 6 contracts.
4. What is the cost of hedging? The cost of hedging is computed as follows: 6 contracts x 2,000,000 per contract x RM0.001 equals RM12,000. This cost of hedging is the maximum loss possible with options.

In September, ABC would have known the outcome of the bid and by then the spot rupee rate might have appreciated or depreciated. Let's look at two scenarios where the rupee appreciates to RM0.20 in one and depreciates to RM0.05 per rupee in the other. Table shows the four outcomes possible and their cash flow implications.

Table 5: Possible Cash Flow Outcomes for Hedging using Options

	Rupee Depreciates to RM0.05 per rupee	Rupee Appreciates to RM0.20 per rupee
Bid Won	<p>Exchange the 10,101,010 rupees @RM0.05 = RM505,050.50</p> <p>Plus profit from options: $6 \times 2,000,000 \times (RM0.10 - RM0.05) = RM600,000$</p> <p>Less cost of hedging = RM12,000</p> <p>Net Cash flow = RM1,093,050 (which is more than the minimum required revenue of RM1,000,000)</p>	<p>Exchange the 10,101,010 rupees @RM0.20 = RM2,020,202</p> <p>Put options not worth exercising, therefore, just let them expire.</p> <p>Less cost of hedging = RM12,000</p> <p>Net Cash flow = RM2,008,202 (In this case the option allows ABC to enjoy the favourable movement)</p>
Bid Lost	<p>In this case, the bid amount is not in consideration. However, ABC could still exercise its rights and realize a profit from the puts.</p> <p>Profit from options: $6 \times 2,000,000 \times RM0.05 = RM600,000$</p> <p>Less cost of hedging = RM12,000</p> <p>Net Cash flow = RM578,000</p>	<p>This is the worst case scenario that can happen. The bid is lost and also the put option ends up being not profitable. ABC loses the premium paid = RM12,000. This is the maximum loss possible.</p>

The above example illustrates how options can be used to guarantee a minimum cash flow on contingent claims. In the case the bid is won, a minimum cash flow of RM1,000,000 is guaranteed while allowing one to still enjoy a favourable movement if that does take place. If the bid is lost, the maximum loss possible is the premium paid.

An example for hedging with the call option is when a firm bids to buy a property (e.g. land) in another country. Say, a company bids to buy a piece of land in Indonesia to plant oil palm trees. Assume that the bidding is in Indonesian rupiahs. Here the risk would be an appreciation of the rupiah. Therefore, buying call options on the rupiah would be the suitable hedging strategy.

If one analyzes it carefully, the options market is simply an organized insurance market. One pays a premium to protect oneself from potential losses while allowing one to enjoy potential benefits. An analogy, for example, is when one buys car insurance, by paying the premium. If the car gets into an accident one gets compensated by the insurance company for the losses incurred. However, if no accident happens, one loses the premium paid. If no accident happens but the value of the car appreciates in the secondhand market, then one gets to enjoy the upward trend in price. An options market plays a similar role.

In the case of options, however, the seller of an option plays the role akin to an insurance company.

Advantages and Disadvantages of Hedging using Options

The advantages of options over forwards and futures are basically the limited downside risk and the flexibility and variety of strategies made possible. Also in options there is neither the initial margin nor the daily variation margin since the position is not marked to market. This relieves traders from potential cash flow problems.

Options are, however, more expensive because they are much more flexible compared to forwards or futures. The option price is, therefore, probably its disadvantage.

Lesson 3.3 - Foreign Exchange Management Act

Learning Objectives

After reading this lesson you are able to:

- Know about FEMA
- Understand the provisions of FEMA
- Comprehend adjudication and appeal system.

Introduction

The **Foreign Exchange Management Act (FEMA)** is a 1999 Indian law “to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India”. It was passed in the winter session of Parliament in 1999, replacing the Foreign Exchange Regulation Act (FERA).

This act seeks to make offenses related to foreign exchange civil offenses. It extends to the whole of India,^[1] replacing FERA, which had become incompatible with the pre-liberalization policies of the Government of India. It enabled a new foreign exchange management regime consistent with the emerging framework of the World Trade Organisation (WTO). It is another matter that the enactment of FEMA also brought with it the Prevention of Money Laundering Act of 2002, which came into effect from 1 July 2005.

Unlike other laws where *everything is permitted unless specifically prohibited*, under this act *everything was prohibited unless specifically permitted*. Hence the tenor and tone of the Act was very drastic. It required imprisonment even for minor offences. Under FERA *a person was presumed guilty unless he proved himself innocent*, whereas under other laws *a person is presumed innocent unless he is proven guilty*.

Definition of FEMA 2000

FEMA 2000 means Foreign exchange management Act 2000. Foreign exchange management act 2000 is very helpful law for development of foreign exchange market in

India. It was passed in 1999 and came into effect from June 1, 2000 to entire country. After this foreign exchange regulation act (FERA) 1973 was closed. FEMA was most suitable for India corporate sector instead of FERA because almost all strict regulations of FERA were removed in FEMA.

Objectives of FEMA

1. Main objective of apply FEMA is to reduce the restriction on foreign exchange. Now, any offense in foreign exchange will be civil offense not criminal offense.
2. This law's main objective is to increase the flow of foreign exchange in India. Now, under this law, you can bring foreign currency in India without any legal barrier.

Switch from FERA

FERA, in place since 1974, did not succeed in restricting activities such as the expansion of transnational corporations (TNCs). The concessions made to FERA in 1991-1993 showed that FERA was on the verge of becoming redundant. After the amendment of FERA in 1993, it was decided that the act would become the FEMA. This was done in order to relax the controls on foreign exchange in India, as a result of economic liberalization. FEMA served to make transactions for external trade (exports and imports) easier – transactions involving current account for external trade no longer required RBI's permission. The deals in Foreign Exchange were to be 'managed' instead of 'regulated'. The switch to FEMA shows the change on the part of the government in terms of foreign capital.

Need for this Management

The buying and selling of foreign currency and other debt instruments by businesses, individuals and governments happens in the foreign exchange market. Apart from being very competitive, this market is also the largest and most liquid market in the world as well as in India.^[4] It constantly undergoes changes and innovations, which can either be beneficial to a country or expose them to greater risks. The management of foreign exchange market becomes necessary in order to mitigate and avoid the risks. Central banks would work towards an orderly functioning of the transactions which can also develop their foreign exchange market.

Whether under FERA or FEMA's control, the need for the management of foreign exchange is important. It is necessary to keep adequate amount of foreign exchange from Import Substitution to Export Promotion.

Main Features

- Activities such as payments made to any person outside India or receipts from them, along with the deals in foreign exchange and foreign security is restricted. It is FEMA that gives the central government the power to impose the restrictions.
- Restrictions are imposed on people living in India who carry out transactions in foreign exchange, foreign security or who own or hold immovable property abroad.
- Without general or specific permission of the MA restricts the transactions involving foreign exchange or foreign security and payments from outside the country to India the transactions should be made only through an authorised person.
- Deals in foreign exchange under the current account by an authorised person can be restricted by the Central Government, based on public interest.
- Although selling or drawing of foreign exchange is done through an authorised person, the RBI is empowered by this Act to subject the capital account transactions to a number of restrictions.
- People living in India will be permitted to carry out transactions in foreign exchange, foreign security or to own or hold immovable property abroad if the currency, security or property was owned or acquired when he/she was living outside India, or when it was inherited by him/her from someone living outside India.
- Exporters are needed to furnish their export details to RBI. To ensure that the transactions are carried out properly, RBI may ask the exporters to comply with its necessary requirements.

Provision /Rules / Regulation of FEMA

1. Provision regarding dealing in foreign exchange:-

According to section 3 of FEMA 2000,” only authorized person under the govt. terms can deal in foreign exchange in India. “

2. Provision Regarding Holding of Foreign Exchange

According to section 4 of FEMA 2000, “All persons which are provided authority only can hold or purchase foreign exchange in India or outside India.”

3. Provision Regarding Current Account Transactions

According to section 5 of FEMA 2000,” There is no restriction regarding sale or deal foreign exchange, if it is a current account transaction.”

The following transaction are deemed current account transactions under FEMA:-

- a) Expenses in connection with foreign travel, education and medical care of parents, spouse and children (Anybody now can send the foreign currency in India for above expenses under current account)
- b) Payment due as interest on loan
- c) Payment due under short term loan for business.

4. Provision Regarding Capital Account Transactions

Under section six,” RBI will fix the limit of foreign exchange transactions relating to capital account after discussion with Indian govt.”

RBI can restrict following:-

- Transfer of foreign security by Indian resident.
- Transfer of foreign security by Indian resident which is now outside India.
- Transfer of immovable property.

5. Provision Regarding Export of Goods and Services

According to section 7 of FEMA 2000, “ It is the duty of exporter to declare the true and correct detail of goods which, he have to sell the market outside India and must send complete report to RBI. RBI can make particular requirement for any exporter. RBI can also make rules and regulations for realization of amount earned from foreign country.

6. Provision Regarding Authorised Persons

RBI can authorize anybody who can deal in money exchange or off shore transaction and foreign exchange. He has to follow the rules and guidelines of RBI. It can revoke the authorisation granted to any person at any time in public interest. If authorized person will be done contravention the rules of RBI, he will be liable to pay up to ₹ 10000 penalty and ₹ 2000 for every day during which such contravention continue.

7. Provision Regarding Contravention and Penalties: - Section 13 to 15

If anybody or person contravenes the rules and regulation of FEMA 2000 or RBI direction, he will be liable to a penalty three times of sum involved in contravention. If contravention will continue, then he will pay up to ₹ 5000 per day during the time of contravention.

8. Provision Regarding Adjudication and Appeal

According to section 18, “Central Government can appoint adjudicating authority who can give the punishment of civil imprisonment of maximum six months if case is less than one crore . If demanded value is more than one crore then punishment of imprisonment may be of three years . The person can appeal to special director against the decisions of adjudicating officer. He can also appeal in appellate tribunal and also in high court with the sixty days of communication of order

Applicability of FEMA

The foreign exchange management act 1999 was enacted to consolidated and amend the law relating to foreign exchange with the objective of facilitating external trade and for promoting the orderly development and maintenance of foreign exchange market in India. FEMA extends to the whole of India. The act also applies to all branches, offices and agencies outside India owned or controlled by a person resident in India and also to any contravention committed there under outside India by any person to whom this Act is applies.

Regulation and Management of Foreign Exchange

Dealings in Foreign Exchange

Save as otherwise provided in this Act, rules or regulations made there under, or with the general or special permission of the Reserve Bank, no person shall-

- (a) Deal in or transfer any foreign exchange or foreign security to any person not being an authorised person;
- (b) Make any payment to or for the credit of any person resident outside India in any manner;
- (c) Receive otherwise through an authorised person, any payment by order or on behalf of any person resident outside India in any manner;

Explanation

For the purpose of this clause, where any person in, or resident in, India receives any payment by order or on behalf of any person resident outside India through any other person (including an authorised person) without a corresponding inward remittance from any place outside India, then, such person shall be deemed to have received such payment otherwise than through an authorised person;

(d) 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.

For the purpose of this clause, “financial transaction” means making any payment to, or for the credit of any person, or receiving any payment for, by order or on behalf of any person, or drawing, issuing or negotiating any bill of exchange or promissory note, or transferring any security or acknowledging any debt.

Authorised Person

An “Authorized Person” under FEMA, is a person who is authorized by Reserve Bank to deal in Foreign Exchange.

For being registered as an “Authorized Person”, necessary application along with relevant documents has to be furnished to Reserve Bank.

An “Authorized Person” is also, not given a free hand to deal in foreign Exchange. He has to furnish details and information, to Reserve Bank from time to time as may be required by it.

Save as otherwise provided in this Act, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.

Current Account Transactions

The Act defines the term ‘current account transaction’ as a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction includes,

Payments due in connection with

- a. Foreign trade,
- b. Other current business
- c. Services, and
- d. Short-term banking and credit facilities in the ordinary course of business Payments due as
 - a. Interest on loans and
 - b. 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.

In the above definition, the words “without prejudice to the generality of the foregoing such transaction includes” imply that even if the transactions listed above may fit into the definition of capital account transactions, such transactions shall be treated current account transactions. For example, resident of India imports goods from outside India on a short term credit (for a period of less than 6 months), he is creating a liability outside India and thus, it can be treated a capital account transaction but, it is specifically included in the above definition as a current account transaction.

As a general rule, any person may sell or draw foreign exchange if such sale or drawal is a current account transaction. Under the Act, Central Government may, in public interest and in consultation with the Reserve Bank, impose such reasonable restrictions for current account transactions as may be prescribed. Accordingly, the Central Government has issued the Foreign Exchange Management (Current Account Transaction) Rules, 2000. It contains the list of current account transactions for which drawal of foreign exchange is:-

- Totally prohibited;
- Permitted, subject to the prior approval of concerned Ministry, Central Government;
- Permitted, subject to prior approval of the Reserve Bank of India;

No restrictions or limits are applicable for undertaking the transactions that are not covered by the above rules and the authorized dealers are free to release foreign exchange upon the satisfaction that the transactions will not involve and is not designed for the purpose of violation of the Act, or any rules, regulations made there under.

In today's changed scenario, Indian rupee has become fully convertible so far as current account transactions are concerned. This implies that foreign exchange is freely available to the residents for remittance on account of current account transactions for the various purposes like foreign travel, foreign education, and medical treatment abroad etc. The non residents are also freely allowed to remit outside India the income or capital gain generated in India. But, even today, the Indian rupee, in respect of capital account transactions, is not fully convertible.

Capital Account Transactions

Capital account transaction is defined as a transaction which:-

Alters the assets or liabilities including contingent liabilities, outside India of persons resident in India. In other words, it includes those transactions which are undertaken by a resident of India such that his/her assets or liabilities outside India are altered (either increased or decreased). For example: - (i) a resident of India acquire an immovable property outside India or acquire shares of a foreign company. This way his/her overseas assets are increased; or (ii) a resident of India borrows from a non-resident through External commercial Borrowings (ECBs). This way he/she has created a liability outside India.

Alters the assets or liabilities in India of persons resident outside the India. In other words, it includes those transactions which are undertaken by a non-resident such that his/her assets or liabilities in India are altered (either increased or decreased). For example, (i) a non-resident acquire immovable property in India or acquire shares of an Indian company or invest in a Wholly Owned Subsidiary or a Joint Venture with a resident of India. This way his/her assets in India are increased; or (ii) a non-resident borrows from Indian housing finance institute for acquiring a house in India. This way he/she has created a liability in India

The Act also contains a list of some of the most common capital account transactions:-

- Transfer or issue of any foreign security by a person resident in India;
- Transfer or issue of any security by a person resident outside India;
- Transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India;
- Any borrowing or lending in rupees in whatever form or by whatever name called;
- 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;
- Export, import or holding of currency or currency notes;
- Transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India;
- Acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India;
- Giving of a guarantee or surety in respect of any debt, obligation or other liability incurred-
 - (i) By a person resident in India and owed to a person resident outside India; or
 - (ii) By a person resident outside India.

The Act has empowered the Reserve Bank of India (RBI) to specify, in consultation with the Central Government, the permissible capital account transactions and the limits up to which foreign exchange may be drawn for these transactions. But it shall not impose any restriction on the drawal of foreign exchange for payments due on account of amortization of loans or for depreciation of direct investments in the ordinary course of business.

Accordingly, the RBI has issued notifications governing capital account transaction. The FEMA Notification No. 1/2000 dated 3-5-2000 contains the list of permissible capital account transactions as well as list of prohibited capital account transactions.

The permitted capital account transactions have been classified into two categories:-

- Capital account transactions by persons resident in India includes,
- Investment in foreign securities;
- Foreign currency loans raised in India and abroad;
- Acquisition and transfer of immovable property outside India;
- Guarantees issued in favour of a person resident outside India;
- Export, import and holding of currency or currency notes;
- Loans and overdrafts (borrowings) from a person resident outside India;
- Maintenance of foreign currency accounts in India and outside India;
- Taking out the insurance policy from an insurance company outside India;

- Remittance outside India of capital assets of a person resident in India;
- Sale and purchase of foreign exchange derivatives in India and abroad and commodity derivatives abroad.
- Capital account transactions by non- residents includes, Investment in India such as
 - (i) Issue of security by a body corporate or an entity in India and investment therein by a non-resident and
 - (ii) Investment by way of contribution to the capital of a firm or a proprietary concern or an association of persons in India;
- Acquisition and transfer of immovable property in India;
- Guarantee in favour of, or on behalf of, a person resident in India;
- Import and export of currency/currency notes into/from India;
- Deposits between a person resident in India and a person resident outside India;
- Foreign currency accounts in India of a non-resident;
- Remittance of the assets in India held by a non-resident.

There are generally two types of prohibitions on capital account transactions:-

General Prohibition

A person shall not undertake or sell or draw foreign exchange to or from an authorized person for any capital account transaction. This prohibition is subjected to the conditions specified by Reserve Bank in its circulars and notifications. For example, Reserve Bank of India has issued an AP (DIR) Circular, wherein a resident individual can draw from an authorized person foreign exchange up to US\$ 25,000 per calendar year for a capital account transaction specified in Schedule I to the Notification.

Special Prohibition

A nonresident person shall not 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 proposes to engage: - (i) in the business of chit fund, or (ii) as Nidhi Company, or (iii) In agricultural or plantation activities or (iv) in real estate business, or construction of farm houses or (v) in trading in Transferable Development Rights (TDRs).

Export of Goods and Services

(1) Every Exporter of Goods shall—

- (a) furnish to the Reserve Bank or to such other authority a declaration in such form and in such manner as may be specified, containing true and correct material particulars, including the amount representing the full export value or, if the full export value of the goods is not ascertainable at the time of export, the value which the exporter, having regard to the prevailing market conditions, expects to receive on the sale of the goods in a market outside India;
- (b) Furnish to the Reserve Bank such other information as may be required by the Reserve Bank for the purpose of ensuring the realization of the export proceeds by such exporter.

(2) The Reserve Bank may, for the purpose of ensuring that the full export value of the goods or such reduced value of the goods as the Reserve Bank determines, having regard to the prevailing market conditions, is received without any delay, direct any exporter to comply with such requirements as it deems fit.

(3) Every exporter of services shall furnish to the Reserve Bank or to such other authorities a declaration in such form and in such manner as may be specified, containing the true and correct material particulars in relation to payment for such services.

The provisions of sections 4 and 8 shall not apply to the following, namely:—

- (a) Possession of foreign currency or foreign coins by any person up to such limit as the Reserve Bank may specify;
- (b) Foreign currency account held or operated by such person or class of persons and the limit up to which the Reserve Bank may specify;
- (c) Foreign exchange acquired or received before the 8th day of July, 1947 or any income arising or accruing thereon which is held outside India by any person in pursuance of a general or special permission granted by the Reserve Bank;
- (d) Foreign exchange held by a person resident in India up to such limit as the Reserve Bank may specify, if such foreign exchange was acquired by way of gift or inheritance from a person referred to in clause (c), including any income arising there from;
- (e) Foreign exchange acquired from employment, business, trade, vocation, services, honorarium, gifts, inheritance or any other legitimate means up to such limit as the Reserve Bank may specify; and
- (f) Such other receipts in foreign exchange as the Reserve Bank may specify.

Contravention and Penalties

Penalties, any person contravening FEMA, shall be liable, upon adjudication, to a penalty up to three times the sum involved in such contravention, where such amount is quantifiable, or up to Rupees Two hundred thousand, where the amount is not quantifiable. In addition, where such contravention is a continuing one, the person will be liable to further penalty, which may extend to Rupees Five thousand

Power to Compound Contravention

15. (1) [Any contravention under section 13 may, on an application made by the person committing such contravention, be compounded within one hundred and eighty days from the date of receipt of application by the Director of Enforcement or such other officers of the Directorate of Enforcement and Officers of the Reserve Bank as may be authorized in this behalf by the Central Government in such manner as may be prescribed.
- (2) Where a contravention has been compounded under sub-section (1), no proceeding or further proceeding, as the case may be, shall be initiated or continued, as the case may be, against the person committing such contravention under that section, in respect of the contravention so compounded.

Adjudication and Appeal

Adjudicating Authority

The inquiry of any contravention of FEMA is conducted by an Adjudicating Authority appointed by the Central Government.

Appeal to Special Director (Appeals)

The special Director (Appeals) is authorized to hear the appeals arising out of in order of the Adjudicating Authority.

Appeal to Special Director (Appeals)

Appeal from an order of “Adjudicating Authority” lies before” special Director (appeal)”

- The appeal shall be made in “Form No. 1”, along with three copies of the order appealed against and the requisite fees.

- The appeal should be filed within 45 days, from the date of receipt of receipt of impugned order.
- On the date of hearing the appeal the applicant may appoint a legal practitioner or a chartered accountant to appear, plead and act on their behalf before the special Director (Appeal)
- The order of the special Director (Appeals) made at the conclusion of the proceedings shall be in writing and shall state briefly the grounds for the decision.
- Appeal to the Appellate Tribunal
- “Appellate Tribunal” is entitled to hear appeal arising out of an order from “Adjudicating Authority” and “special Director (appeal).”
- The appeal shall be made in Form No. 2, along with three copies of the impugned order and requisite fees.
- The appeal shall be made within 45 days, from the date on which copy of the impugned order is received.
- A copy of the order and appeal shall be sent to the opposite party, i.e. “Director of Enforcement,” and a date shall be fixed for hearing of the appeal.
- The appellant shall have the right to present his case / appeal through a legal practitioner or chartered Accountant.
- On the fixed date of hearing, the “Appellate Tribunal” shall pass its order in writing and the reasons therefore.
- Appeal to High Court
- An appeal from the decision of “Appellate Tribunal” lies before High Court.
- The appeal shall be filed within “60 days” from the date of communication of the decision or order of the Appellate Tribunal to him on any question of law arising from the impugned order.

Amount of Penalty

Any contravention, under FEMA, may invite the following kinds of penalties:

- If, the amount against which offence is quantities and then penalty will be “THRICE” the sum involved in contravention.
- Where the amount cannot be quantified the penalty may be imposed up to two lakhs rupees.

- If, the contravention is continuing every day, then ₹ Five Thousand for every day after the first day during which the contravention continues.

Further in addition to the penalty, any currency, security or other money or property involved in the contravention may also be confiscated.

Composition of Appellate Tribunal

20. (1) The Appellate Tribunal shall consist of a Chairperson and such number of Members as the Central Government may deem fit.
- (2) Subject to the provisions of this Act,—
- (a) The jurisdiction of the Appellate Tribunal may be exercised by Benches thereof;
 - (b) A Bench may be constituted by the Chairperson with one or more Members as the Chairperson may deem fit;
 - (c) The Benches of the Appellate Tribunal shall ordinarily sit at New Delhi and at such other places as the Central Government may, in consultation with the Chairperson, notify;
 - (d) The Central Government shall notify the areas in relation to which each Bench of the Appellate Tribunal may exercise jurisdiction.
- (3) Notwithstanding anything contained in sub-section (2), the Chairperson may transfer a Member from one Bench to another Bench.
- (4) If at any stage of the hearing of any case or matter it appears to the Chairperson or a Member that the case or matter is of such a nature that it ought to be heard by a Bench consisting of two Members, the case or matter may be transferred by the Chairperson or, as the case may be, referred to him for transfer, to such Bench as the Chairperson may deem fit.

Lesson 3.4 - Exchange Rate Determinations and Forecasting

Learning Objectives

Having gone through this lesson you are able to:

- Understand various tools for foreign exchange forecasting.
- Comprehend practical issues in fundamental forecasting.
- Understand leading indicators of currency crises

Introduction

The rupee/dollar rate is a two-way rate which means that the price of 1 dollar is quoted in terms of how much rupees it takes to buy one dollar. The value of one currency against another is based on the demand of the currency. If the demand for dollar increases, the value of dollar would appreciate. As the quotation for Rs/\$ is a two way quote, an appreciation in the value of dollar would automatically mean the depreciation in Indian rupee and vice-versa. For example if rupee would depreciate, a dollar which once cost ₹ 47 would cost say ₹ 59. So in essence the value of dollar has risen and the buying power of the rupee has gone down. Besides the primary powers of demand and supply, the rupee-dollar rates are determined by other market forces as well such as:

Market Sentiments

During turbulent markets, investors usually prefer to park their money in safe havens such as US treasuries, Swiss Franc, gold in order to avoid losses to their portfolios.

So this flight to safety would lead to foreign investors redeeming their investments from India and would naturally increase the demand for dollar vis-à-vis the Indian rupees. Remember the rupee/dollar rates during 2007 and 2008? Even today we are seeing a lot of FIIs redeeming their investments from emerging markets like India and are investing into US treasuries which are currently quoting at higher yields. This has lead to Indian rupee depreciating to ₹ 60/\$.

Speculation

When the markets are moving vertically, there's a lot of speculation about the expected changes into the currency rates due to the investments/redemptions of foreign investors. There are derivative instruments and over-the-counter currency instruments through which one can speculate/hedge the underlying currency rates. When speculators can sense improvements/deterioration of the sentiments of the markets, they too want to benefit from such rising/falling dollar and they start buying/selling dollar which would further increase the demand/supply of dollar.

RBI Intervention

When there is too much volatility in the rupee-dollar rates, the RBI prevents rates going out of control to protect the domestic economy. The RBI does this by buying dollars when the rupee appreciates too much and by selling dollars when the rupee depreciates way too much. The same was recently felt on June 12, 2013 when the rupee recovered sharply from ₹ 58.95/\$ level.

Imports and Exports

Ever thought why our Government is trying to incentivize exports and reduce imports?

There are a lot of schemes and incentives for exporters while importers are burdened by many conditions and taxes. This is to protect our economy from high rupee depreciation. Importing foreign goods requires us to make payment in dollars thus strengthening the dollar's demand and exports do the reverse. Major imports being fuel and gold; understandably even today we are a net-importing country which means that we are importing more and exporting less.

Interest Rates

The interest rates on Government bonds in emerging countries such as India attract foreign capital to India.

If the rates are high enough to cover foreign market risk and if the foreign investor/fund is comfortable with the Sovereign's fundamentals/credit ratings, money would start pouring in India and thus would provide a fillip to rupee demand.

Short-Run Forecasting Tools

Short-term changes in exchange rates are the most difficult to predict and are often determined based on bandwagon effects, overreaction to news, speculation, and technical analysis.

Trend-Following Behavior is the tendency for the market to follow a trend. In other words an increase in the exchange rate is more likely to be followed by another increase.

Investor Sentiment is based on the consensus of the market. For example if the market is bullish on the dollar, then the dollar is likely to strengthen versus other currencies.

The FX market is quite different from the world equity markets in one important aspect: transparency. In equity markets, rules ensure that volume and price data are readily available to all parties... this is *NOT* the case in FX markets. In fact large FX dealers are able to observe factors such as: shifts in risk appetite, liquidity needs, hedging demands, and institutional rebalancing.

Order Flow

There is evidence of a positive correlation between spot exchange rate movements and order flows in the inter-dealer market and with movements in customer order flows.

Three explanations for the cause of these correlations have been put forth:

- 1) *Private information* - related to the payoff from holding the currency may be contained in the order flow data. For example, future interest rates or the discount rate may be known to traders.
- 2) *Liquidity effects* – dealers charge a temporary risk premium to absorb unwanted inventory.
- 3) *Feedback trading* – the positive correlation could be related to customers buying a currency that has just appreciated (or vice versa).

Long-Run Forecasting Tools

Purchasing Power Parity (PPP) states that since the prices should be the same across countries, the exchange rate between two countries should be the ratio of the prices in each country.

$$PPP: \frac{\text{Price of a product in Country A}}{\text{Price of a product in Country B}} = \text{Spot rate (S)}$$

where, the spot rate (S) is $\frac{P^A}{P^B}$

Relative PPP states that the exchange rate will change to offset differences in national interest rates. In other words, if Country A has *higher* inflation than Country B, you can expect Country A's currency to *depreciate* versus Country B's currency.

Structural Changes

Three structural changes can affect long-term trends in exchange rates: 1) an increase in investment spending, 2) fiscal stimulus, 3) a decline in private savings.

It is the net impact of structural changes that determines if the country's currency will rise or fall.

- 1) *Investment spending* – domestic investment in a country will help to *strengthen* a country's currency. For example, the United States experienced an investment boom in the 1990s.
- 2) *Fiscal stimulus* – government investment in a country can also help strengthen a country's currency. For example, Turkey has enjoyed fiscal stimulus and government spending in recent years.
- 3) *Private savings* – the citizens of a country's tendency to save will help strengthen a country's currency. For example, Japan has had a large and persistent current-account surplus that has led to a stronger currency.

Terms of Trade

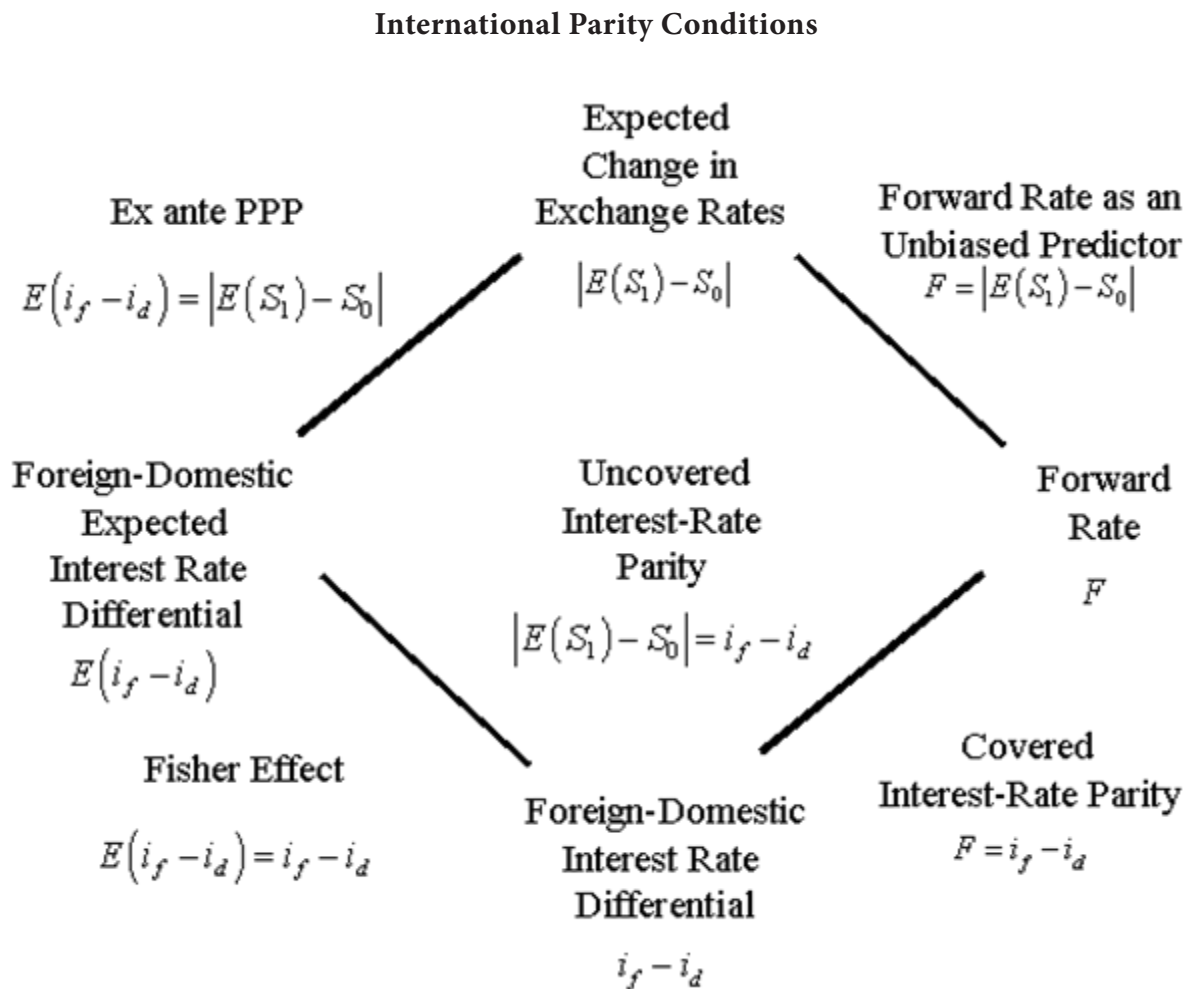
Is the idea that the price of a good that trades in international markets will have an impact of the associated country's currency. This can work in terms of both imports and exports.

For example, in countries where commodities make up a large portion of GDP, like Australia, Canada, and New Zealand, there is a strong positive relationship between the price of commodities and the strength of the associated country's currency. On the other hand, in Europe, the higher prices for oil, have led to a weaker currency.

Medium-Run Forecasting Tools

International Parity Conditions

The key international parity conditions are 1) purchasing power parity, 2) covered interest-rate parity, 3) uncovered interest-rate parity, 4) the Fisher effect, and 5) forward exchange rates.



Source: Exchange Rate Determination

- 1) **Purchasing power parity** – states that since the prices should be the same across countries, the exchange rate between two countries should be the ratio of the prices in each country.

Example: If a hamburger is \$2.54 in the United States and 3.60 real (R\$) in Brazil, then the PPP spot rate should be:

$$PPP: \frac{\text{Price of a product in Country A}}{\text{Price of a product in Country B}} = \text{Spot rate (S)}$$

$$\text{where, the spot rate (S) is } \frac{P^A}{P^B}$$

$$S = \frac{3.60R\$}{\$2.54}, \text{ which reduces to } \approx \frac{1.42R\$}{1\$}$$

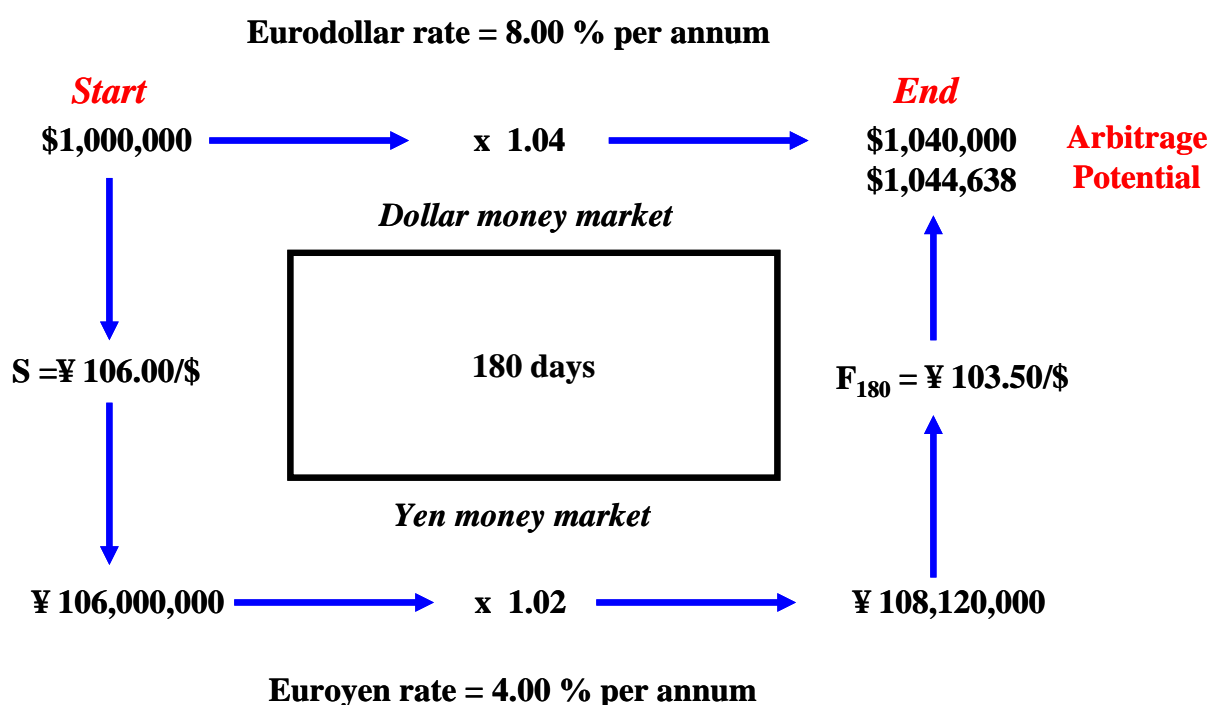
If the actual exchange rate is $S = \frac{2.19R\$}{1\$}$, then according to the PPP theory the Brazilian real is undervalued by 35%.

$$\left[PPP \text{ implied rate } \left(\frac{1.42R\$}{1\$} \right) \div \text{Actual exchange rate } \left(\frac{2.19R\$}{1\$} \right) \right] - 1 = \% \text{ over (or under)valued}$$

FYI McDonalds' Big Mac is produced locally in almost 120 countries!

- 2) **Covered interest-rate parity** –the idea that an imbalance in parity conditions can create a “risk less” opportunity for an arbitrageur.

Covered Interest Arbitrage (CIA)



Example

Step 1: Convert \$1,000,000 at the spot rate of ¥106.00/\$ to ¥106,000,000

Step 2: Invest the proceeds, (¥106,000,000), in a euroyen account for six months, earning 4% per annum, or 2% for 180 days.

Step 3: Simultaneously sell the future yen proceeds (¥108,120,000) forward for dollars at the 180-day forward rate of ¥103.50/\$. Note: at this point you have “locked in” the amount of \$1,044,638 in 180 days (or 6 months).

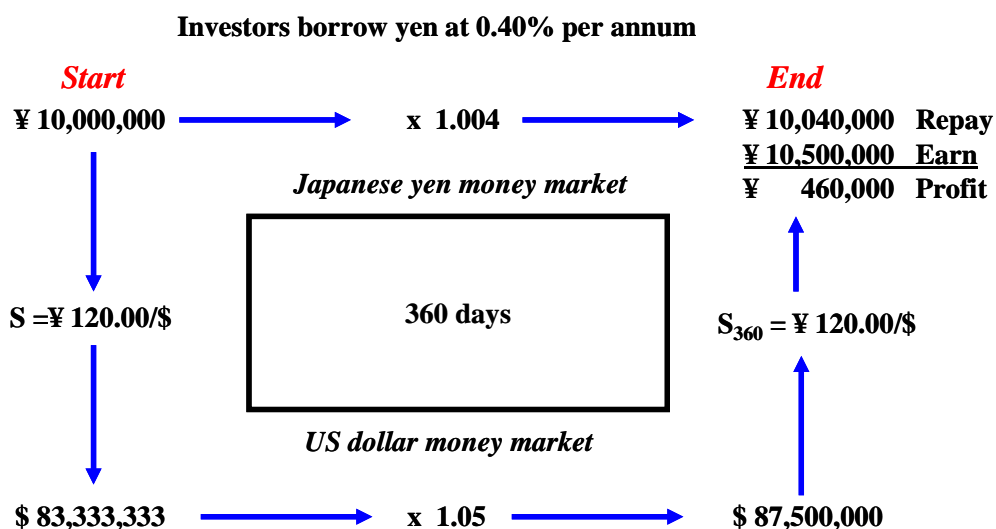
Step 4: Out of the \$1,044,638 you have to repay the loan (plus interest), this is called your opportunity cost of capital. To do this, calculate the interest rate for the period (8% per year is 4% for 180 days). So to borrow \$1,000,000 you have to pay \$40,000 in interest at the end of 6 months. Subtract the \$1,040,000 from the \$1,044,638 that you will receive from your forward contract for a “risk less” profit of \$4,638.

Notice that these activities should help the currencies return to equilibrium.

- 3) **Uncovered interest-rate parity** - Uncovered interest arbitrage is great when you are dealing with fixed exchange currencies, because the profit at the end of the period is dependant of the exchange rate (and since this is “uncovered” it is a very *risky* investment).

$$|E(S_1) - S_0| = i_f - i_d$$

Uncovered Interest Arbitrage



Note: there is a typo in the book. The correct figures are:

\$83,333.33
and
\$87,500.00

Since there are men and women making a killing in this business, the opportunities for smaller investors are almost impossible... It is these two types of arbitrage that keep exchange rates more or less in equilibrium.

- 4) **Fisher effect** - the nominal interest rate (i) in a country should be equal to the real rate of interest (r) plus expected inflation (π).

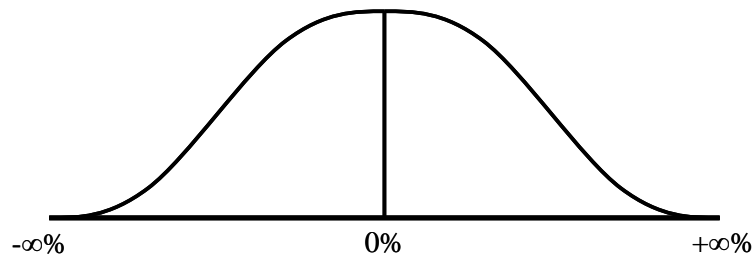
$$i = r + \pi$$

- 5) **Forward exchange rates** – an exchange rate quoted today for settlement at a future date.

Forward rates are unbiased predictors of future exchange rates. An unbiased predictor means that “on average” the estimation will be wrong on the up side or the downside with equal frequency and degree. In other words, the errors are normally distributed.

$$F_{days} = \frac{F_{days}^f}{F_{days}^d} = S \times \frac{\left[1 + \left(i^f \times \frac{days}{360} \right) \right]}{\left[1 + \left(i^d \times \frac{days}{360} \right) \right]}$$

where, the spot rate (S) is $\frac{P^f}{P^d}$ and (i) is the annual interest rate



Forecasting Exchange Rates

One of the goals of studying the behavior of exchange rates is to be able to forecast exchange rates. Chapters III and IV introduced the main theories used to explain the movement of exchange rates. These theories fail to provide a good approximation to the behavior of exchange rates. Forecasting exchange rates, therefore, seems to be a difficult task.

This chapter analyzes and evaluates the different methods used to forecast exchange rates. This chapter closes with a discussion of exchange rate volatility.

I. Forecasting Exchange Rates

International transactions are usually settled in the near future. Exchange rate forecasts are necessary to evaluate the foreign denominated cash flows involved in international transactions. Thus, exchange rate forecasting is very important to evaluate the benefits and risks attached to the international business environment.

A forecast represents an expectation about a future value or values of a variable. The expectation is constructed using an information set selected by the forecaster. Based on the information set used by the forecaster, there are two pure approaches to forecasting foreign exchange rates:

(1) The fundamental approach.

(2) The technical approach.

Fundamental Approach

The fundamental approach is based on a wide range of data regarded as fundamental economic variables that determine exchange rates. These fundamental economic variables are taken from economic models. Usually included variables are GNP, consumption, trade balance, inflation rates, interest rates, unemployment, productivity indexes, etc. In general, the fundamental forecast is based on structural (equilibrium) models. These structural models are then modified to take into account statistical characteristics of the data and the experience of the forecasters. It is a mixture of art and science.

Practitioners use structural model to generate equilibrium exchange rates. The equilibrium exchange rates can be used for projections or to generate trading signals. A trading signal can be generated every time there is a significant difference between the model-based expected or forecasted exchange rate and the exchange rate observed in the market. If there is a significant difference between the expected foreign exchange rate and the actual rate, the practitioner should decide if the difference is due to a mispricing or a heightened risk premium. If the practitioner

Fundamental Approach: Forecasting at Work

The fundamental approach starts with a model, which produces a forecasting equation. This model can be based on theory, say PPP, a combination of theories or on the ad-hoc experience of a practitioner. Based on this first step, a forecaster collects data to estimate the forecasting equation. The estimated forecasting equation will be evaluated

using different statistics or measures. If the forecaster is happy with the model, she will move to the next step, the generation of forecasts. The final step is the evaluation of the forecast.

As mentioned above, a forecast represents an expectation about a future value or values of a variable. In this chapter, we will forecast a future value of the exchange rate, S_{t+T} . The expectation is constructed using an information set selected by the forecaster. The information set should be available at time t . The notation used for forecasts of S_{t+T} is:

$$E_t [S_{t+T}],$$

where $E_t[.]$ represent an expectation taken at time t .

Each forecast has an associated forecasting error, ϵ_{t+1} . We will define the forecasting error as:

$$\epsilon_{t+1} = S_{t+1} - E_t[S_{t+1}]$$

The forecasting error will be used to judge the quality of the forecasts. A typical metric used for this purpose is the Mean Square Error or MSE. The MSE is defined as:

$$MSE = [(\epsilon_{t+1})^2 + (\epsilon_{t+2})^2 + (\epsilon_{t+3})^2 + \dots + (\epsilon_{t+Q})^2]/Q,$$

Where Q is the number of forecasts, we will say that the higher the MSE, the less accurate the forecasting model. There are two kinds of forecasts: in-sample and out-of-sample. The first type of forecasts works within the sample at hand, while the latter works outside the sample. In-sample forecasting does not attempt to forecast the future path of one or several economic variables.

In-sample forecasting uses today's information to forecast what today's spot rates should be. That is, we generate a forecast within the sample (in-sample). The fitted values estimated in a regression are in-sample forecasts. The corresponding forecast errors are called residuals or in-sample forecasting errors.

On the other hand, out-of-sample forecasting attempts to use today's information to forecast the future behavior of exchange rates. That is, we forecast the path of exchange rates outside of our sample. In general, at time t , it is very unlikely that we know the inflation rate for time $t+1$. That is, in order to generate out-of-sample forecasts, it will be necessary to make some assumptions about the future behavior of the fundamental variables.

Summary: Fundamental Forecasting Steps

- (1) Selection of Model (for example, PPP model) used to generate the forecasts.
- (2) Collection of S_t , X_t (in the case of PPP, exchange rates and CPI data needed.)
- (3) Estimation of model, if needed (regression, other methods)
- (4) Generation of forecasts based on estimated model. Assumptions about X_{t+T} may be needed.
- (5) Evaluation. Forecasts are evaluated. If forecasts are very bad, model must be changed.

Example

In-sample Forecasting Exchange Rates with PPP

Suppose you work for a U.S. firm. You are given the following quarterly CPI series in the U.S. and in the U.K. from 2008:1 to 2009:3. The exchange rate in 2008:1 is equal to 1.9754 USD/GBP. You believe that this exchange rate, 1.5262 USD/GBP, is an equilibrium rate. Your job is to generate equilibrium exchange rates using PPP. In order to do this, you do quarterly in-sample forecasts of the USD/GBP exchange rate using relative PPP. That is,

$$E_{t+1}[s_{t+1}] = s_{t+1}^F = (S_{t+1}^F / S_t) - 1 \approx I_{d,t+1} - I_{f,t+1} = I_{US,t+1} - I_{UK,t+1}.$$

The forecasted level of the exchange rate USD/GBP for next period is given by $E_t[S_{t+1}] = S_t^F$:

$$E_{t+1}[S_{t+1}] = S_{t+1}^F = S_t^F \times [1 + s_{t+1}^F].$$

Date	CPI U.S.	CPI U.K.	Inflation U.S. (I_{US})	Inflation U.K. (I_{UK})	In- Sample Forecast (S_{t+1}^F)	Actual (S_t)	Forecast Error $\epsilon_{t+1} = S_{t+1}^F - S_{t+1}$
2008.1	108.6	106.2	-	-		1.9754	-
2008.2	111.0	108.2	0.0221	0.019091	1.9813	1.9914	-0.0100
2008.3	112.3	109.3	0.0117	0.009813	1.9951	1.7705	0.2246
2008.4	109.1	108.4	-0.0285	-0.00795	1.7341	1.4378	0.2964
2009.1	108.6	106.1	-0.0046	-0.02137	1.4619	1.4381	0.0237
2009.2	109.7	106.9	0.0101	0.007279	1.4422	1.6481	-0.2059
2009.3	110.5	107.8	0.0073	0.009033	1.6452	1.5990	0.0463

Some calculations for $S_{2008:2}^F$ and $S_{2008:3}^F$:

1. Forecast $S_{2008:2}^F$.

$$\begin{aligned} I_{US,2008:2} &= (USCPI_{2008:2}/USCPI_{2008:1}) - 1 = (111.0/108.6) - 1 = 0.0221. \\ I_{UK,2008:2} &= (UKCPI_{2008:2}/UKCPI_{2008:1}) - 1 = (108.2/106.2) - 1 = 0.0191. \\ s_{2008:2}^F &= I_{US,2008:2} - I_{UK,2008:2} \\ &= 0.0221 - 0.0191 = 0.0030. \end{aligned}$$

$$\begin{aligned} S_{2008:2}^F &= S_{2008:1}^F \times [1 + s_{2008:2}^F] = 1.9754 \text{ USD/GBP} \times [1 + (0.0030)] = 1.9813 \text{ USD/GBP}. \\ \epsilon_{2008:2} &= S_{2008:2}^F - S_{2008:2} = 1.9813 - 1.9914 = -0.01. \end{aligned}$$

2. Forecast $S_{2008:3}^F$.

$$\begin{aligned} S_{2008:3}^F &= S_{2008:2}^F \times [1 + s_{2008:3}^F] = 1.9914 \text{ USD/GBP} \times [1 + (0.0019)] = 1.9951 \text{ USD/GBP}. \\ \epsilon_{2008:3} &= S_{2008:3}^F - S_{2008:3} = 1.9951 - 1.7705 = 0.2246. \end{aligned}$$

3 Evaluation of forecasts.

$$\text{MSE: } [(-0.01)^2 + (0.2246)^2 + (0.2964)^2 + \dots + (0.0463)^2]/6 = 0.0306$$

Now, you can generate trading signals. According to this PPP model, the equilibrium exchange rate in 2008:2 should be 1.9813 USD/GBP.

The market price, however, is 1.9914 USD/GBP. That is, the market is valuing the GBP higher than your fundamental model. Suppose you believe that the difference (1.9813-1.9914) is due to miss-pricing factors, then you will generate a sell GBP signal.

In general, practitioners will divide the sample in two parts: a longer sample (*estimation period*) and a shorter sample (*validation period*). The estimation period is used to select the model *and* to estimate its parameters.

Suppose we are interested in one-step-ahead forecasts. The one-step-ahead forecasts made in this period are in-sample forecasts, not “true forecasts.” These one-step-ahead forecasts are just fitted values. The corresponding forecast errors are called *residuals*.

The data in the validation period are not used during model and parameter estimation. One-step-ahead forecasts made in this period are “true forecasts,” often called *backtests*. These true forecasts and their error statistics are representative of errors that will be made in forecasting the future.

A forecaster will use the results from this validation step to decide if the selected model can be used to generate outside the sample forecasts.

Example: 2

Out-of-sample Forecasting Exchange Rates with PPP

Go back to Example V.1. Now, you want to generate out-of-sample forecasts.

You need to make some assumptions about the future behavior of the inflation rate.

(A) *Naive assumption:* $E_t[I_{t+1}] = I_{t+1}^F = I_t$.

You can generate out-of-sample forecasting by assuming that today's inflation is the best predictor for tomorrow's inflation. That is, $E_t[I_{t+1}] = I_{t+1}^F = I_t$.

This “naive” forecasting model leads us to a simplified version of the Relative PPP:

$$E_t[s_{t+1}] = s_{t+1}^F = (E_t[S_{t+1}]/S_t) - 1 \approx I_{d,t} - I_{f,t}.$$

With the above information we can predict $S_{2008:3}$:

$$s_{2008:3}^F = I_{US,2008:2} - I_{UK,2008:2} = 0.0221 - 0.0191 = 0.0030.$$

$$S_{2008:3}^F = S_{2008:2} \times [1 + s_{2008:3}^F] = 1.9914 \times [1 + (.0030)] = 1.99735$$

(B) *Autoregressive model:* $E[I_{t+1}] = \alpha_0 + \alpha_1 I_t$.

More sophisticated out-of-sample forecasts can be achieved by estimating regression models, using survey data on expectations of inflation, etc. For example, consider the following regression model:

$$I_{US,t} = \alpha_0^{US} + \alpha_1^{US} I_{US,t-1} + \epsilon_{US,t}.$$

$$I_{UK,t} = \alpha_0^{UK} + \alpha_1^{UK} I_{UK,t-1} + \epsilon_{UK,t}.$$

This autoregressive model can be estimated using historical data, say 1978:1-2008:1. Then, we have 119 quarterly inflation rates for both series. We estimate both equations.

(1) Excel output for autoregressive model for the US.

Regression Statistics

Multiple R	0.715136
R Square	0.51142
Adjusted R Square	0.507244
Standard Error	0.005517
Observations	119

ANOVA

					<i>Significance F</i>
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>F</i>
Regression	1	0.003727	0.003727	122.4694	6.48E-20
Residual	117	0.003561	3.04E-05		
Total	118	0.007288			

Standard

<i>Coefficients</i>	<i>Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>
---------------------	--------------	---------------	----------------	------------------

(2) Excel output for autoregressive model for the UK.

SUMMARY OUTPUT					
<i>Regression Statistics</i>					
Multiple R	0.092703				
R Square	0.018594				
Adjusted R Square	-0.0087				
Standard Error	0.051729				
Observations	112				
ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	2	0.002528	0.00126	0.47242	0.624762
Residual	109	0.291666	0.00268		
Total	111	0.294195			
<i>Standard</i>					
	<i>Coefficients</i>	<i>Error</i>	<i>t Stat</i>	<i>P-value</i>	
Intercept	0.006934	0.005175	1.3399	0.18028	
(IMYR – IUSD)t	0.215927	0.105824	2.04044	0.04131	
(yMYR – yUSD)t	0.091592	0.051676	1.77243	0.07633	

First, you evaluate the regression by looking at the t-statistics and the R^2 . The t-statistic is used to test the null hypothesis that a coefficient is equal to zero. The R^2 measures how much of the variability of the dependent variables is explained by the variability of the

independent variables. That is, the R^2 measures the explanatory power of our regression model. Both R^2 coefficients are far from zero, relatively high for the U.S. inflation rate (51%). All coefficients have a t-stats higher than 1.96. That is, you will say that they are significant at the 5% level –i.e., with p-values smaller than .05. That is, all the coefficients are statistically different from zero.

Second, you use the regression to forecast inflation rates. Then, you will use these inflation rate forecasts to forecast the exchange rate. That is,

$$I_{US,2008:3}^F = .00292 + .7001 \times (.0221) = .01839$$

$$I_{UK,2008:3}^F = .00713 + .4144 \times (.0191) = .01505$$

$$s_{2008:3}^F = I_{US,2008:3}^F - I_{UK,2008:3}^F = .01839 - .01505 = .00334.$$

$$S_{2008:3}^F = 1.9914 \text{ USD/GBP} \times [1 + (.00334)] = 1.99802 \text{ USD/GBP}.$$

That is, you predict, over the next quarter, an appreciation of the GBP. You can use this information to manage currency risk at your firm.

For example, if, during the next quarter, the U.S. firm you work for expects to have GBP outflows, you can advise management to hedge. ¶

Example: 3

Out-of-sample Forecasting Exchange Rates with a Structural Ad-hoc Model

Suppose a Malaysian firm is interested in forecasting the MYR/USD exchange rate. This Malaysian firm is an importer of U.S. goods. A consultant believes that monthly changes in the MYR/USD exchange rate are driven by the following econometric model (MYR = Malaysian Ringitt)

$$s_{MYR/USD,t} = a_0 + a_1 INF_t + a_2 INC_t + \varepsilon_t, \quad (V.1)$$

Where, INF_t represents the inflation rate differential between Malaysia and the U.S., and INC_t represents the income growth rates differential between Malaysia and the U.S.

The spot rate this month is $S_t = 3.1021$ MYR/USD. Suppose equation (V.1) is estimated using 10 years of monthly data with ordinary least squares (OLS). We have the following excel output:

SUMMARY OUTPUT					
<i>Regression Statistics</i>					
Multiple R	0.092703				
R Square	0.018594				
Adjusted R Square	-0.0087				
Standard Error	0.051729				
Observations	112				
ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	2	0.002528	0.00126	0.47242	0.624762
Residual	109	0.291666	0.00268		
Total	111	0.294195			
<i>Standard</i>					
	<i>Coefficients</i>	<i>Error</i>	<i>t Stat</i>	<i>P-value</i>	
Intercept	0.006934	0.005175	1.3399	0.18028	
(IMYR – IUSD)t	0.215927	0.105824	2.04044	0.04131	
(yMYR – yUSD)t	0.091592	0.051676	1.77243	0.07633	

That is, the coefficient estimates are: $a_0 = 0.00693$, $a_1 = 0.21593$, and $a_2 = 0.09159$.
That is, the output from your OLS regression is:

$$E[\text{IMYR} - \text{IUSD}] = 0.00693 + 0.21593 \text{ INF}_t + 0.09159 \text{ INC}_t, \quad R^2 = .0186.$$

(1.34)
(2.04)
(1.77)

Let's evaluate our ad-hoc model. The t-statistics (in parenthesis) for the two variables are all bigger than 1.65. Therefore, all the explanatory variables are statistically significant at the 10% level. This regression has an R^2 equal to .0186. That is, INF and INC explain less than two percent of the variability of changes in the MYR/USD exchange rate. This is not very high, but the t-stats give some hope for the model. The t-statistics (in parenthesis) for the two variables are all bigger than 1.65. Therefore, all the explanatory variables are statistically significant at the 10% level. The Malaysian firm decides to use this model to generate out-of-sample forecasts.

Suppose the Malaysian firm has forecasts for next month for INF_t and INC_t : 3% and 2%, respectively. Then,

$$s_{MYR/USD, t+one-month}^F = 0.0069 + 0.21593 \times (0.03) + .09159 \times (0.02) = .0152.$$

The MYR is predicted to depreciate 1.52% against the USD next month. The spot rate this month is $S_t = 3.1021$ MYR/USD, then, for next month, we predict:

$$S_{t+1}^F = 3.1021 \text{ MYR/USD} (1.0152) = 3.1493 \text{ MYR/USD}.$$

Based on these results, the Malaysian firm, which imports goods from the U.S., decides to hedge its next month USD anticipated outflows.

Some Practical Issues in Fundamental Forecasting

There are several practical issues associated with any fundamental analysis forecasting, such as the forecasting model of equation (V.1):

- (1) Correct specification. That is, are we using the “right model?” (In econometrics jargon, “correct specification.”)
- (2) Estimation of the model. This is not a trivial issue. For example, in equation (V.1) we need to estimate the model to get a_0 , a_1 , and a_2 . Bad estimates of a_0 , a_1 , and a_2 will produce a bad forecast for $s_{MYR/USD, t+one-month}^F$. This issue sometimes is related to (1).
- (3) Contemporaneous variables. In a model like equation (V.1), some of the explanatory variables are contemporaneous. We also need a model to forecast the contemporaneous variables. For example, in the equation (V.1) we need a model to forecast INT_t and INC_t . In econometrics jargon, this is called simultaneous equations models.

Technical Approach

The *technical approach* (TA) focuses on a smaller subset of the available data. In general, it is based on price information.

The analysis is “technical” in the sense that it does not rely on a fundamental analysis of the underlying economic determinants of exchange rates or asset prices, but only on extrapolations of past price trends. Technical analysis looks for the repetition of specific price patterns. Technical analysis is an art, not a science.

Computer models attempt to detect both major trends and critical, or turning, points. These turning points are used to generate trading signals: buy or sell signals.

The most popular TA models are simple and rely on moving averages (MA), filters, or momentum indicators.

Technical Analysis Models

MA Models

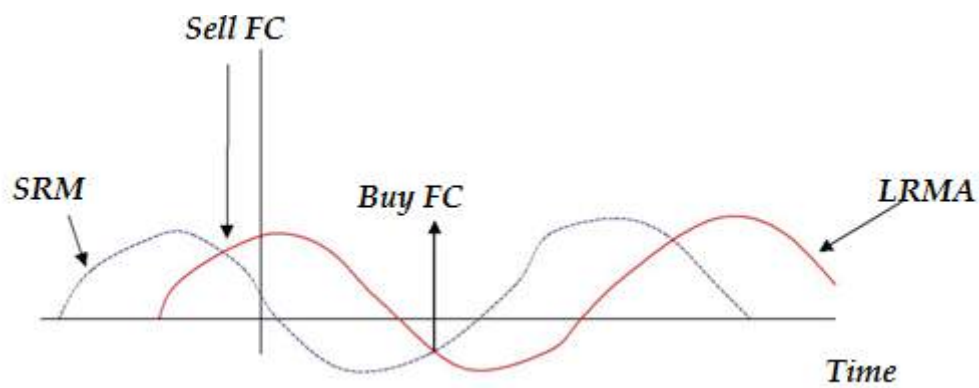
The goal of a MA model is to smooth erratic daily swings of asset prices in order to signal major trends. A MA is simply an average of past prices. We will use the simple moving average (SMA).

An SMA is the unweighted mean of the previous Q data points: $SMA = (S_t + S_{t-1} + S_{t-2} + \dots + S_{t-(Q-1)})/Q$

If we include the most recent past prices, then we calculate a short-run MA (SRMA). If we include a longer series of past prices, then we calculate a long-term MA (LRMA).

The *double MA system* uses two moving averages: a LRMA and a SRMA. A LRMA will always lag a SRMA because it gives a smaller weight to recent movements of exchange rates.

In MA models, buy and sell signals are usually triggered when a SRMA of past rates crosses a LRMA. For example, if a currency is moving downward, its SRMA will be below its LRMA. When it starts rising again, it soon crosses its LRMA, generating a buy foreign currency signal.



Buy FC signal: When SRMA crosses LRMA from below.

Sell FC signal: When SRMA crosses LRMA from above.

Example V.5

Generating trading signals for the (USD/GBP) using the Double MA model. We generate a SRMA using 30 days of information (red line)

We generate a LRMA using 150 days of information (green line).

Every time there is a crossing, the double MA model generates a trading signal.



The double MA model generates many trading signals, as indicated by the crossings between the SRMA (red line) and the LRMA (green line). For example, there is a sell GBP signal in late 2007. By April 2009, the model generates a buy GBP signal.

Filter Models

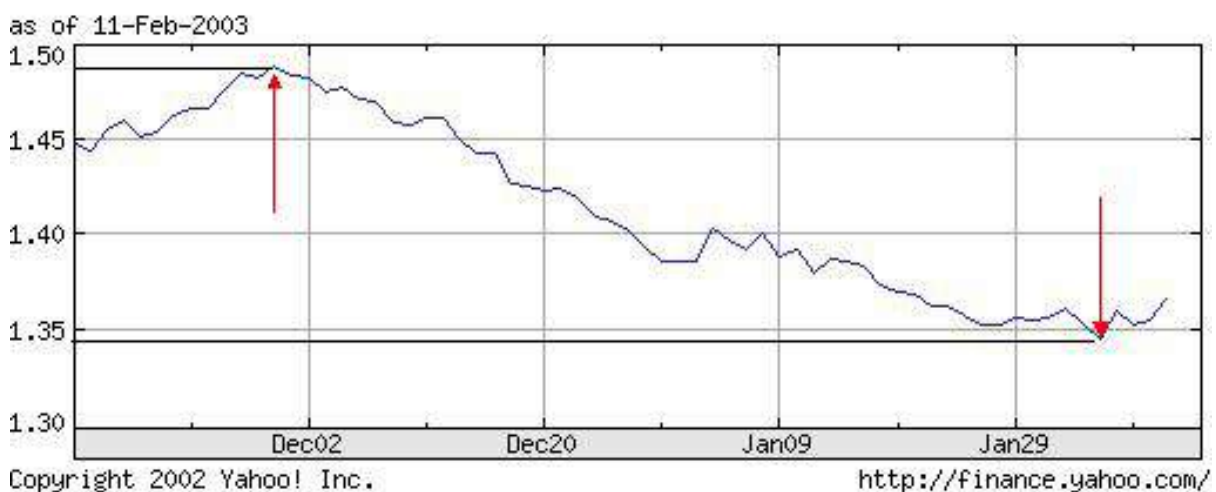
This is probably the most popular TA model. It is based on the finding that asset prices show significant small autocorrelations. If price increases tend to be followed by increases and price decreases tend to be followed by decreases, trading signals can be used to profit from this autocorrelation. The key of the system relies on determining when exchange rates start to show significant changes, as opposed to irrelevant noisy changes. Filter methods generate buy signals when an exchange rate rises X percent (the filter) above its most recent trough, and sell signals when it falls X percent below the previous peak. Again, the idea is to smooth (filter) daily fluctuations in order to detect lasting trends. The filter size, X, is typically between 0.5% and 2.0%.

Example V.6

Determination of Trading signals with a filter model.

Let the filter, X, be 1% $\Rightarrow X = 1\%$.

First, we need to determine a peak or a trough. Then, we generate trading signals.



Peak = 1.486 CHF/USD ($X = \text{CHF } .01486$) \rightarrow When S_t crosses 1.47114 CHF/USD, Sell USD

Trough = 1.349 CHF/USD ($X = \text{CHF } .01349$) \rightarrow When S_t crosses 1.36249 CHF/USD, Buy USD.

Note that there is a trade-off between the size of the filter and transaction costs. Low filter values, say 0.5%, generate more trades than a large filter, say 2%. Thus, low filters are more expensive than large filters. Large filters, however, can miss the beginning of trends and then be less profitable.

Momentum Models

Momentum models determine the strength of an asset by examining the change in velocity of the movements of asset prices. If an asset price climbs at increasing speed, a buy signal is issued.

These models monitor the derivative (slope) of a time series graph. Signals are generated when the slope varies significantly. There is a great deal of discretionary judgement in these models. Signals are sensitive to alterations in the filters used, the period length used to compute MA models and the method used to compute rates of change in momentum.

Basic Forecasting Models

Forecasting from Econometric Models

The econometric approach to forecasting consists first of formulating an econometric model that relates a dependent variable to a number of independent variables that are expected to affect it. The model is then estimated and used to obtain conditional or unconditional forecasts of the dependent variable. The models are generally formulated using economic theory and the statistical properties of the variables included in the model.

Example A.V.1

In Example V.3, a company believes that monthly changes in the MYR/USD exchange rate are related to the interest rates differential between Malaysia and the U.S. (INT_t) and income growth rates differential (INC_t) between Malaysia and the U.S. That is, the econometric model is given by:

$$sMYR/USD, t, one-month = a_0 + \delta INT_t + \mu INC_t + \varepsilon_t \quad (A.1)$$

Where ε_t is a prediction error assumed to follow a normal distribution with zero mean and constant variance, σ^2 .

The IFE predicts that INT_t should have a positive coefficient. That is, if Malayan interest rates increase relative to U.S. interest rates, then the MYR should depreciate with respect to the USD (i.e., δ should be positive). Similarly, the Asset Approach predicts that INC_t should have a negative coefficient. That is, if income grows in Malaysia at a faster rate than in the U.S., the MYR should appreciate with respect to the USD (i.e., μ should be negative).

Several economic series seem to show seasonal effects. For example, many researchers have found a Monday effect in the U.S. stock market. Since these seasonal effects are predictable, many forecasters include seasonal variables in an econometric model like equation (A.1).

Example A.V.2

In Example A.V.1 a forecaster might like to introduce monthly seasonal variables to predict the monthly change in the MYR/USD. In this case, equation (A.1) would include eleven monthly dummy variables.

$$s_{MYR/USD,t,one-month} = a_0 + \delta INT_t + \mu INC_t + \tau_{Jan} D_{Jan} + \dots + \tau_{Nov} D_{Nov} + \epsilon_t$$

where

$$D_i = \begin{cases} 1 & \text{if } t=i, \quad i = \text{Jan}, \dots, \text{Nov.} \\ 0 & \text{otherwise.} \end{cases}$$

Forecasting from Time Series Models

Econometric models are generally based on some underlying economic model. A popular alternative to econometric models, especially for short-run forecasting is known as time series models. These models typically relate a dependent variable to its past and to random errors that may be serially correlated.

Time series models are generally not based on any underlying economic behavior.

A powerful time series model is the ARMA (Autoregressive Moving Average) process. The basic idea is that the series s_t at time t is affected by past values of s_t in a predictable manner. A general ARMA(p,q) can be written as:

$$s_t = \alpha_0 + \alpha_1 s_{t-1} + \dots + \alpha_p s_{t-q} + \beta_1 \varepsilon_{t-1} + \dots + \beta_p \varepsilon_{t-q} + \varepsilon_t, \quad (\text{A.2})$$

where ε_t is the prediction error at time t assumed to have a constant variance σ^2 . The terms with the α 's coefficients are the moving average terms. The terms with the β 's coefficients are the moving average terms.

In order for the ARMA model in (A.2) to have nice properties -i.e., to be stationary-, we need to check that the roots of the polynomial

$$1 - (\alpha_1 z + \alpha_2 z^2 + \dots + \alpha_p z^p) = 0$$

lie outside the unit circle. In general, this requires that $|\alpha_1| < 1$.

The prediction error, ε_t , is just the difference between the realization of s_t and the prediction of s_t using the ARMA(p,q) model.

Example A.V.3

Suppose we estimate equation (A.2) and we obtain

$$s_t^p = a_0 + a_1 s_{t-1} + \dots + a_p s_{t-q} + b_1 \varepsilon_{t-1} + \dots + b_p \varepsilon_{t-q},$$

Where s_t^p is the predicted change in s_t , the a_i 's are the estimated α_i 's coefficients, and the b_i 's are the estimated β_i 's coefficients. Then, $\varepsilon_t = s_t - s_t^p$.

Note: Suppose that s_t represents changes in the MYR/USD exchange rate. According to (A.2), the past p changes in the MYR/USD exchange rate affect today's change in the MYR/USD exchange rate. Also, the past q prediction errors affect today's change in the MYR/USD exchange rate.

The key component of the ARMA model is to determine q and p . Several statistical packages provide identification tools to determine q and p .

Many forecasters prefer to work with simpler AR(p) models. In this case, to determine p , a simple rule of thumb can be followed: start with an AR(1) model and add terms until the added terms are not statistically significant.

Forecasting Using a Combination of Methods

Many forecasters use a combination of the methods described in A.I and A.II. The dependent variable might depend on theoretical grounds on a set of independent variables. On empirical grounds it has been found that the dependent variable shows a high degree of autocorrelation. Although this autocorrelation is not present in the economic model, an economist might combine an economic model with an ARMA model to produce a better forecast.

Example

Suppose a forecaster believes that changes in the monthly MYR/USD exchange rate are determined by the IFE. She also has found that an ARMA (1,1) helps to predict future changes in exchange rates. She decides to use the following forecasting model:

$$s_{\text{MYR/USD},t,\text{one-month}} = \alpha_0 + \delta_{\text{INT}t} + \alpha_1 s_{t-1} + \beta_1 \varepsilon_{t-1} + \varepsilon_t$$

where ε_t is a prediction error with a constant variance, σ^2 .

A Stationarity and Trends in Macroeconomic and Financial Data

In the previous sections, we have implicitly assumed that the dependent variable and independent variables are stationary. Roughly speaking, stationarity implies that the unconditional moments of a time series are independent of time. That is, they are constant.

Example A.V.5

The process for Y_t is said to be *weakly stationary* if:

$$\begin{aligned} E[Y_t] &= \mu && \text{for all } t \\ E[(Y_t - \mu)(Y_{t-j} - \mu)] &= \sigma^2 && \text{for } j = 0 \\ &= 0 && \text{for } j \geq 0. \end{aligned}$$

The assumption of stationarity might not be appropriate for many of the economic and financial series used in practice. Several economic and financial series show clear trends: GDP, Consumption, CPI prices, stock prices, exchange rates, etc. For example, in Figure V.2, the CHF/USD shows a clear, predictable positive trend. This trend should be incorporated into any forecasting model.

There are two ways to achieve stationarity for these non-stationary series. The idea is to incorporate this trend in the model: (1) a deterministic time trend and (2) stochastic trend. The first model, also referred as *trend-stationary*, includes a deterministic time trend. The second model, also referred as a *unit root process*, uses first differences instead of levels.

Example

Suppose y_t is a non-stationary series.

(A) Trend-stationary process. $y_t = \alpha + \delta t + \varepsilon_t$,

where ε_t is a stationary error.

(B) Unit Root process. $y_t - y_{t-1} = \alpha + \varepsilon_t$,

where ε_t is a stationary error. This simple process is called a random walk with drift α .

We should note that this unit root process can be written in an AR(1) form:

$$y_t = \alpha_1 y_{t-1} + \alpha + \varepsilon_t,$$

where $\alpha_1=1$.

Both processes have different implications. If the series y_t follows a trend-stationary process, a shock has a temporary effect on the series, and the series eventually catches up with its trend. On the other hand, if y_t follows a unit root process, a shock might have permanent consequences for the level of future y_t 's.

There are several tests to check if a series has a unit root. These tests usually find a unit root on all major macroeconomic data. Of particular interest to us, exchange rates, GNP, money supply, and price levels have unit roots. Therefore, it is highly advisable to estimate models for these series in first differences.

It is common to take logs of the data before using it (see the Appendix of the Review Chapter). For small changes, the first difference of the log of a variable is approximately the same as the percentage change in the variable:

$$\log(y_t) - \log(y_{t-1}) = \log(y_t/y_{t-1}) = \log[1 + (y_t - y_{t-1})/y_{t-1}] \approx (y_t - y_{t-1})/y_{t-1},$$

Where we have used the fact that for z close to zero, $\log(1+z) \approx z$. It is usually convenient to multiply $\log(y_t)$ by 100. Thus, the changes are measured in units of percentage change.

We should notice, however, that several economists claim that unit root tests are not very revealing. These economists claim that in finite samples -like the ones available to us- it is very difficult to distinguish between models with a unit root -i.e., $\alpha_1=1$ - and stationary models with α_1 very close to 1.

Interesting Readings

Appendix V is based on **Introductory Econometrics with Applications**, by Ramu Ramanathan, published by Harcourt Brace Jovanovich.

Appendix V-B: Taylor Rules

According to the Taylor rule, the CB raises the target for the short-term interest rate, i_t , if:

- (1) Inflation, I_t , raises above its desired level
- (2) Output, y_t , is above “potential” output

The target level of inflation is positive (deflation is thought to be worse than positive inflation for the economy). The target level of the output deviation is 0, since output cannot permanently exceed “potential output.”

John Taylor (1993) assumed the following reaction function by the CB:

$$i_t = I_t + \varphi (I_t - I_t^*) + \gamma y\text{-gap}_t + r^* \quad (\text{Equation BC.1})$$

where $y\text{-gap}_t$ is the output gap –a percent deviation of actual real GDP from an estimate of its potential level-, and r^* is the equilibrium level or the real interest rate, which Taylor assumes equal to 2%. The coefficients φ and γ are weights, which can be estimated (though, Taylor assumes them equal to .5).

Let I_t^* and r^* in equation BC.1 be combined into one constant term, $\mu = r^* - \varphi I_t^*$. Then,

$$i_t = \mu + \lambda I_t + \gamma y\text{-gap}_t,$$

where $\lambda = 1 + \varphi$.

For many countries, whose CB monitors S_t closely; the Taylor rule is expanded to include the real exchange rate, R_t :

$$i_t = \mu + \lambda I_t + \gamma y\text{-gap}_t + \delta R_t$$

Estimating this equation for the US and a foreign country can give us a forecast for the interest rate differential, which can be used to forecast exchange rates.

Exercises

1. Go back to Example V.2.
 - i. Take the autoregressive forecasting model, estimated above. What is $S^F_{1997:4}$?
 - ii. Calculate the same forecast using the “naive” model.
 - iii. Compare both forecasts with the in-sample PPP forecast.
2. You work for a Tunisian investment bank. You have available the following quarterly interest rate series in the U.S., i_{USD} , and in Tunisia, i_{TND} , from 1998:4 to 1999:3 (TND=Tunisian Dinar). The TND/USD in 1998:4 is equal to 1.1646. Your job is to do quarterly out-of-sample forecasts of TND/USD exchange rate for the period 1999:2-1999:3, using the linear approximation to the International Fisher Effect (IFE).

Date	→	U.S.	Quarterly Forecast
1998:4	.0590	.0621	1.1646
1999:1	.0593	.0635	
1999:2	.0595	.0680	
1999:3	.0599	.0714	

- i. Generate one-step-ahead forecasts –that is, as new information arrives, a new next period forecast is generated- for the period 1999:1-1999:4.
- ii. Your firm uses the following forecasting regression model to forecast interest rates. Use a regression analysis.

$$i_{USD,t} = .0075 + .93 i_{USD,t-1} + \varepsilon_t, \quad i_{TND,t} = .0060 + .97 i_{TND,t-1} + \varepsilon_t.$$

Generate out-of-sample forecasts for the period 1999:1-1999:4.

3. Given that firms cannot forecast exchange rates, should they worry about currency risk?
4. J. Cruyff, a Dutch designer company, wants estimate the monthly volatility of the weekly EUR/USD exchange rate. They use the following AR (1)-GARCH(1,1) model:

$$s_t = [\log(S_t) - \log(S_{t-1})] \times 100 = a_0 + a_1 s_{t-1} + e_{Ft}, \quad e_{Ft} | \Psi_{t-1} \sim N(0, \sigma_t^2).$$

$$\sigma_t^2 = \alpha_0 + \alpha_1 e_{t-1}^2 + \beta_1 \sigma_{t-1}^2 + \delta e_{t-1}^2 D_t,$$

where D_t is the following dummy variable:

$$D_t = 0 \text{ if } e_{t-1} \geq 0$$

$$D_t = 1 \text{ if } e_{t-1} < 0.$$

This GARCH model is an asymmetric model. Negative shocks increase the variance more than positive shocks. The persistence parameter should be redefined. That is, $\lambda = [\alpha_1 + \beta_1 + (1/2)\delta]$.

Using data from January 1974 till August 1997, the «quants» at J. Cruyff estimated the model for s_t :

$$s_t = 0.178 + 0.064 s_{t-1},$$

(0.90) (1.51)

$$\sigma_t^2 = 0.222 + 0.035 e_{t-1}^2 + 0.860 \sigma_{t-1}^2 + 0.123 e_{t-1}^2 D_t.$$

(2.09) (2.48) (12.44) (0.04)

- (a) Find λ and calculate the unconditional variance, σ^2 . Is it well defined?
 - (b) Given that $e_{\text{Aug } 97} = -1.073$, and $\sigma_{\text{Aug } 97}^2 = 7.436$, forecast the variance for September 1997.
 - (c) Forecast the variance for August 1998.
5. You want to calculate the VAR of a position in EUR. The value of your position is USD 50 million. You estimated the volatility of changes in the USD/EUR exchange rates as 22%. The time interval is seven days. You use a 99% confidence interval to calculate.

Law of One Price

From Wikipedia, the free encyclopedia

Jump to: navigation, search

The **law of one price (LOP)** is an economic concept which posits that “a good must sell for the same price in all locations” The law of one price constitutes the basis of the theory of purchasing power parity and is derived from the no arbitrage assumption.

Intuition

The intuition behind the law of one price is based on the assumption that differences between prices are eliminated by market participants taking advantage of arbitrage opportunities: Assume different prices for a single identical good in two locations, no transport costs and no economic barriers between both locations. The arbitrage mechanism can now be performed by both the supply and/or the demand site:

All sellers have an incentive to sell their goods in the higher-priced location, driving up supply in that location and reducing supply in the lower-priced location. If demand remains constant, the higher supply will force prices to decrease in the higher-priced location, while the lowered supply in the alternative location will drive up prices there.

Conversely, if all consumers move to the lower-priced location in order to buy the good at the lower price, demand will increase in the lower-priced location and - assuming constant supply in both locations - prices will increase, whereas the decreased demand in the higher-priced location leads the prices to decrease there. Both scenarios result in a single, equal price per homogeneous good in all locations. In efficient markets the convergence on one price is instant. (*For further discussion, please refer to rational pricing*).

Example: Financial Markets

Commodities can be traded on financial markets, where there will be a single offer price (asking price), and bid price. Although there is a small spread between these two values the **law of one price** applies (to each). No trader will sell the commodity at a lower price than the market maker's bid-level or buy at a higher price than the market maker's offer-level. In either case moving away from the prevailing price would either leave no takers, or be charity.

In the derivatives market the law applies to financial instruments which appear different, but which resolve to the same set of cash flows; see rational pricing. Thus:

"A security must have a single price, no matter how that security is created. For example, if an option can be created using two different sets of underlying securities, then the total price for each would be the same or else an arbitrage opportunity would exist." A similar argument can be used by considering arrow securities as alluded to by Arrow and Debreu (1944).

Where the law does not apply

See also: Purchasing power parity Difficulties

- The law does not apply *inter temporally*, so prices for the same item can be different at different times in one market. The application of the law to financial markets in the example above is obscured by the fact that the market maker's prices are continually moving in liquid markets. However, at the *moment* each trade is executed, the law is in force (it would normally be against exchange rules to break it).
- The law also need not apply if buyers have less than perfect information about where to find the lowest price. In this case, sellers face a tradeoff between the frequency and the profitability of their sales. That is, firms may be indifferent between posting a high price (thus selling infrequently, because most consumers will search for a lower one) and a low price (at which they will sell more often, but earn less profit per sale).
- The Balassa-Samuelson effect argues that the law of one price is not applicable to all goods internationally, because some goods are not tradable. It argues that the consumption may be cheaper in some countries than others, because non tradable (especially land and labor) are cheaper in less developed countries. This can make a typical consumption basket cheaper in a less developed country, even if some goods in that basket have their prices equalized by international trade.

Apparent Violations

- A well-known example of an apparent violation of the law was Royal Dutch/Shell shares. After merging in 1907, holders of Royal Dutch Petroleum (traded in Amsterdam) and Shell Transport shares (traded in London) were entitled to 60% and 40% respectively of all future profits. Royal Dutch shares should therefore automatically have been priced at 50% more than Shell shares. However, they diverged from this by up to 15%.^[4] This discrepancy disappeared with their final merger in 2005.

Purchasing Power Parity

GDP per capita by countries in 2013, calculated using PPP exchange rates.

In economics, **purchasing power parity (PPP)** is a component of some economic theories and is a technique used to determine the relative value of different currencies.

Theories that invoke purchasing power parity assume that in some circumstances (for example, as a long-run tendency) it would cost exactly the same number of, say, US dollars to buy euros and then to use the proceeds to buy a market basket of goods as it would cost to use those dollars directly in purchasing the market basket of goods.

The concept of purchasing power parity allows one to estimate what the exchange rate between two currencies would have to be in order for the exchange to be on par with the purchasing power of the two countries' currencies.

Using that PPP rate for hypothetical currency conversions, a given amount of one currency thus has the same purchasing power whether used directly to purchase a market basket of goods or used to convert at the PPP rate to the other currency and then purchase the market basket using that currency. Observed deviations of the exchange rate from purchasing power parity are measured by deviations of the real exchange rate from its PPP value of 1.

PPP exchange rates help to avoid misleading international comparisons that can arise with the use of market exchange rates. For example, suppose that two countries produce the same physical amounts of goods as each other in each of two different years.

Since market exchange rates fluctuate substantially, when the GDP of one country measured in its own currency is converted to the other country's currency using market exchange rates, one country might be inferred to have higher real GDP than the other country in one year but lower in the other; both of these inferences would fail to reflect the reality of their relative levels of production. But if one country's GDP is converted into the other country's currency using PPP exchange rates instead of observed market exchange rates, the false inference will not occur.

Concept

The idea originated with the School of Salamanca in the 16th century and was developed in its modern form by Gustav Cassel in 1918. The concept is based on the law of one price, where in the absence of transaction costs and official trade barriers, identical goods will have the same price in different markets when the prices are expressed in the same currency.

Another interpretation is that the difference in the rate of change in prices at home and abroad—the difference in the inflation rates—is equal to the percentage depreciation or appreciation of the exchange rate.

Deviations from parity imply differences in purchasing power of a “basket of goods” across countries, which means that for the purposes of many international comparisons, countries’ GDPs or other national income statistics need to be “PPP-adjusted” and converted into common units. The best-known purchasing power adjustment is the Geary–Khamis dollar (the “international dollar”).

The real exchange rate is then equal to the nominal exchange rate, adjusted for differences in price levels. If purchasing power parity held exactly, then the real exchange rate would always equal one. However, in practice the real exchange rates exhibit both short run and long run deviations from this value, for example due to reasons illuminated in the Balassa–Samuelson theorem.

There can be marked differences between purchasing power adjusted incomes and those converted via market exchange rates. For example, the World Bank’s *World Development Indicators 2005* estimated that in 2003, one Geary-Khamis dollar was equivalent to about 1.8 Chinese yuan by purchasing power parity —considerably different from the nominal exchange rate. This discrepancy has large implications; for instance, when converted via the nominal exchange rates GDP per capita in India is about US\$1,704 while on a PPP basis it is about US\$3,608. At the other extreme, Denmark’s nominal GDP per capita is around US\$62,100, but its PPP figure is US\$37,304.

Functions

The purchasing power parity exchange rate serves two main functions. PPP exchange rates can be useful for making comparisons between countries because they stay fairly constant from day to day or week to week and only change modestly, if at all, from year to year. Second, over a period of years, exchange rates do tend to move in the general direction of the PPP exchange rate and there is some value to knowing in which direction the exchange rate is more likely to shift over the long run.

Among other uses, PPP rates facilitate international comparisons of income, as market exchange rates are often volatile, are affected by political and financial factors that do not lead to immediate changes in income and tend to systematically understate the standard of living in poor countries, due to the Balassa–Samuelson effect.

Measurement

The PPP exchange-rate calculation is controversial because of the difficulties of finding comparable baskets of goods to compare purchasing power across countries.

Estimation of purchasing power parity is complicated by the fact that countries do not simply differ in a uniform price level; rather, the difference in food prices may be greater than the difference in housing prices, while also less than the difference in entertainment prices. People in different countries typically consume different baskets of goods. It is necessary to compare the cost of baskets of goods and services using a price index. This is a difficult task because purchasing patterns and even the goods available to purchase differ across countries.

Thus, it is necessary to make adjustments for differences in the quality of goods and services. Furthermore, the basket of goods representative of one economy will vary from that of another: Americans eat more bread; Chinese more rice. Hence a PPP calculated using the US consumption as a base will differ from that calculated using China as a base. Additional statistical difficulties arise with multilateral comparisons when (as is usually the case) more than two countries are to be compared.

Various ways of averaging bilateral PPPs can provide a more stable multilateral comparison, but at the cost of distorting bilateral ones. These are all general issues of indexing; as with other price indices there is no way to reduce complexity to a single number that is equally satisfying for all purposes. Nevertheless, PPPs are typically robust in the face of the many problems that arise in using market exchange rates to make comparisons.

For example, in 2005 the price of a gallon of gasoline in Saudi Arabia was USD 0.91, and in Norway the price was USD 6.27. The significant differences in price wouldn't contribute to accuracy in a PPP analysis, despite all of the variables that contribute to the significant differences in price. More comparisons have to be made and used as variables in the overall formulation of the PPP.

When PPP comparisons are to be made over some interval of time, proper account needs to be made of inflationary effects.

Law of One Price

Although it may seem as if PPPs and the law of one price are the same, there is a difference: the law of one price applies to individual commodities whereas PPP applies to the general price level. If the law of one price is true for all commodities then PPP is also therefore true; however, when discussing the validity of PPP, some argue that the law of one price does not need to be true exactly for PPP to be valid. If the law of one price is not true for a certain commodity, the price levels will not differ enough from the level predicted by PPP.^[4]

The purchasing power parity theory states that the exchange rate between one currency and another currency is in equilibrium when their domestic purchasing powers at that rate of exchange are equivalent.

Big Mac Index

Big Mac hamburgers, like this one from Japan, are similar worldwide.

An example of one measure of the law of one price, which underlies purchasing power parity, is the Big Mac Index, popularized by the Economist, which compares the prices of a Big Mac burger in McDonald's restaurants in different countries.

The Big Mac Index is presumably useful because although it is based on a single consumer product that may not be typical, it is a relatively standardized product that includes input costs from a wide range of sectors in the local economy, such as agricultural commodities (beef, bread, lettuce, cheese), labor (blue and white collar), advertising, rent and real estate costs, transportation, etc.

In theory, the law of one price would hold that if, to take an example, the Canadian dollar were to be significantly overvalued relative to the U.S. dollar according to the Big Mac Index, that gap should be unsustainable because Canadians would import their Big Macs from or travel to the U.S. to consume them, thus putting upward demand pressure on the U.S. dollar by virtue of Canadians buying the U.S. dollars needed to purchase the U.S.-made Big Macs and simultaneously placing downward supply pressure on the Canadian dollar by virtue of Canadians selling their currency in order to buy those same U.S. dollars.

The alternative to this exchange rate adjustment would be an adjustment in prices, with Canadian McDonald's stores compelled to lower prices to remain competitive.

Either way, the valuation difference should be reduced assuming perfect competition and a perfectly tradable good. In practice, of course, the Big Mac is not a perfectly tradable good and there may also be capital flows that sustain relative demand for the Canadian dollar. The difference in price may have its origins in a variety of factors besides direct input costs such as government regulations and product differentiation.^[4]

In some emerging economies, western fast food represents an expensive niche product price well above the price of traditional staples—i.e. the Big Mac is not a mainstream 'cheap' meal as it is in the West, but a luxury import. This relates back to the idea of product differentiation: the fact that few substitutes for the Big Mac are available confers market

power on McDonald's. Additionally, with countries like Argentina that have abundant beef resources, consumer prices in general may not be as cheap as implied by the price of a Big Mac.

The following table, based on data from *The Economist's* January 2013 calculations, shows the under (–) and over (+) valuation of the local currency against the U.S. dollar in %, according to the Big Mac index. To take an example calculation, the local price of a Big Mac in Hong Kong when converted to U.S. dollars at the market exchange rate was \$2.19, or 50% of the local price for a Big Mac in the U.S. of \$4.37. Hence the Hong Kong dollar was deemed to be 50% undervalued relative to the U.S. dollar on a PPP basis.

Measurement Issues

In addition to methodological issues presented by the selection of a basket of goods, PPP estimates can also vary based on the statistical capacity of participating countries. The International Comparison Program, which PPP estimates are based on, requires the disaggregation of national accounts into production, expenditure or (in some cases) income, and not all participating countries routinely disaggregate their data into such categories.

Some aspects of PPP comparison are theoretically impossible or unclear. For example, there is no basis for comparison between the Ethiopian laborer who lives on teff with the Thai laborer who lives on rice, because teff is not commercially available in Thailand and rice is not in Ethiopia, so the price of rice in Ethiopia or teff in Thailand cannot be determined. As a general rule, the more similar the price structures between countries, the more valid the PPP comparison.

PPP levels will also vary based on the formula used to calculate price matrices. Different possible formulas include GEKS-Fisher, Geary-Khamis, IDB, and the superlative method. Each has advantages and disadvantages.

Linking regions presents another methodological difficulty. In the 2005 ICP round, regions were compared by using a list of some 1,000 identical items for which a price could be found for 18 countries, selected so that at least two countries would be in each region. While this was superior to earlier “bridging” methods, which do not fully take into account differing quality between goods, it may serve to overstate the PPP basis of poorer countries, because the price indexing on which PPP is based will assign to poorer countries the greater weight of goods consumed in greater shares in richer countries.

Need for Adjustments to GDP

The exchange rate reflects transaction values for traded goods *between* countries in contrast to non-traded goods, that is, goods produced for home-country use. Also, currencies are traded for purposes other than trade in goods and services, *e.g.*, to buy capital assets whose prices vary more than those of physical goods. Also, different interest rates, speculation, hedging or interventions by central banks can influence the foreign-exchange market.

The PPP method is used as an alternative to correct for possible statistical bias. The Penn World Table is a widely cited source of PPP adjustments, and the so-called Penn effect reflects such a systematic bias in using exchange rates to outputs among countries.

For example, if the value of the Mexican peso falls by half compared to the US dollar, the Mexican Gross Domestic Product measured in dollars will also halve. However, this exchange rate results from international trade and financial markets. It does not necessarily mean that Mexicans are poorer by a half; if incomes and prices measured in pesos stay the same, they will be no worse off assuming that imported goods are not essential to the quality of life of individuals. Measuring income in different countries using PPP exchange rates helps to avoid this problem.

PPP exchange rates are especially useful when official exchange rates are artificially manipulated by governments. Countries with strong government control of the economy sometimes enforce official exchange rates that make their own currency artificially strong. By contrast, the currency's black market exchange rate is artificially weak. In such cases, a PPP exchange rate is likely the most realistic basis for economic comparison.

Updating PPP rates for GDP

Since global PPP estimates —such as those provided by the ICP— are not calculated annually, but for a single year, PPP exchange rates for years other than the benchmark year need to be updated. This is done using the country's GDP deflator. To calculate a country's PPP exchange rate in Geary–Khamis dollars for a particular year, the calculation proceeds in the following manner:

$$\text{PPPrate}_{X,i} = \frac{\text{PPPrate}_{X,b} \cdot \frac{\text{GDPdef}_{X,i}}{\text{GDPdef}_{X,b}}}{\text{PPPrate}_{U,b} \cdot \frac{\text{GDPdef}_{U,i}}{\text{GDPdef}_{U,b}}}$$

Where $PPP_{X,i}$ is the PPP exchange rate of country X for year i, $PPP_{X,b}$ is the PPP exchange rate of country X for the benchmark year, $PPP_{U,b}$ is the PPP exchange rate of the United States (US) for the benchmark year (equal to 1), $GDP_{X,i}$ is the GDP deflator of country X for year i, $GDP_{X,b}$ is the GDP deflator of country X for the benchmark year, $GDP_{U,i}$ is the GDP deflator of the US for year i, and $GDP_{U,b}$ is the GDP deflator of the US for the benchmark year.

Difficulties

There are a number of reasons that different measures do not perfectly reflect standards of living.

Range and Quality of Goods

The goods that the currency has the “power” to purchase are a basket of goods of different types:

1. Local, non-tradable goods and services (like electric power) that are produced and sold domestically.
2. Tradable goods such as non-perishable commodities that can be sold on the international market (like diamonds).

The more that a product falls into category 1, the more that its price will be from the currency exchange rate, moving towards the PPP exchange rate. Conversely, category 2 products tend to trade close to the currency exchange rate. (See also Penn effect).

More processed and expensive products are likely to be tradable, falling into the second category, and drifting from the PPP exchange rate to the currency exchange rate. Even if the PPP “value” of the Ethiopian currency is three times stronger than the currency exchange rate, it won’t buy three times as much of internationally traded goods like steel, cars and microchips, but non-traded goods like housing, services (“haircuts”), and domestically produced crops. The relative price differential between tradables and non-tradables from high-income to low-income countries is a consequence of the Balassa–Samuelson effect and gives a big cost advantage to labour intensive production of tradable goods in low income countries (like Ethiopia), as against high income countries (like Switzerland).

The corporate cost advantage is nothing more sophisticated than access to cheaper workers, but because the pay of those workers goes farther in low-income countries than high, the relative pay differentials (inter-country) can be sustained for longer than would be

the case otherwise. (This is another way of saying that the wage rate is based on average local productivity and that this is below the per capita productivity that factories selling tradable goods to international markets can achieve.) An equivalent cost benefit comes from non-traded goods that can be sourced locally (nearer the PPP-exchange rate than the nominal exchange rate in which receipts are paid). These act as a cheaper factor of production than is available to factories in richer countries.

The Bhagwati–Kravis–Lipsey view provides a somewhat different explanation from the Balassa–Samuelson theory. This view states that price levels for non-tradable are lower in poorer countries because of differences in endowment of labor and capital, not because of lower levels of productivity. Poor countries have more labor relative to capital, so marginal productivity of labor is greater in rich countries than in poor countries. Non tradable tend to be labor-intensive; therefore, because labor is less expensive in poor countries and is used mostly for non tradable, non tradable are cheaper in poor countries. Wages are high in rich countries, so non tradable are relatively more expensive.^[4]

PPP calculations tend to over emphasis the primary sectoral contribution and under emphasis the industrial and service sectoral contributions to the economy of a nation.

Trade Barriers and non Tradable

The law of one price, the underlying mechanism behind PPP, is weakened by transport costs and governmental trade restrictions, which make it expensive to move goods between markets located in different countries. Transport costs sever the link between exchange rates and the prices of goods implied by the law of one price. As transport costs increase, the larger the range of exchange rate fluctuations. The same is true for official trade restrictions because the customs fees affect importers' profits in the same way as shipping fees. According to Krugman and Obstfeld, "Either type of trade impediment weakens the basis of PPP by allowing the purchasing power of a given currency to differ more widely from country to country."^[4] They cite the example that a dollar in London should purchase the same goods as a dollar in Chicago, which is certainly not the case.

Non tradable are primarily services and the output of the construction industry. Non tradable also lead to deviations in PPP because the prices of non tradable are not linked internationally. The prices are determined by domestic supply and demand, and shifts in those curves lead to changes in the market basket of some goods relative to the foreign price of the same basket. If the prices of non tradable rise, the purchasing power of any given currency will fall in that country.

Departures from Free Competition

Linkages between national price levels are also weakened when trade barriers and imperfectly competitive market structures occur together. Pricing to market occurs when a firm sells the same product for different prices in different markets. This is a reflection of inter-country differences in conditions on both the demand side (*e.g.*, virtually no demand for pork or alcohol in Islamic states) and the supply side (*e.g.*, whether the existing market for a prospective entrant's product features few suppliers or instead is already near-saturated).

According to Krugman and Obstfeld, this occurrence of product differentiation and segmented markets results in violations of the law of one price and absolute PPP. Over time, shifts in market structure and demand will occur, which may invalidate relative PPP

Differences in Price Level Measurement

Measurements of price levels differ from country to country. Inflation data from different countries are based on different commodity baskets; therefore, exchange rate changes do not offset official measures of inflation differences. Because it makes predictions about price changes rather than price levels, relative PPP is still a useful concept. However, change in the relative prices of basket components can cause relative PPP to fail tests that are based on official price indexes.

Global Poverty Line

The global poverty line is a worldwide count of people who live below an international poverty line, referred to as the dollar-a-day line. This line represents an average of the national poverty lines of the world's poorest countries, expressed in international dollars. These national poverty lines are converted to international currency and the global line is converted back to local currency using the PPP exchange rates from the ICP.

Interest rate Parity

Interest rate parity is a no-arbitrage condition representing an equilibrium state under which investors will be indifferent to interest rates available on bank deposits in two countries. The fact that this condition does not always hold allows for potential opportunities to earn riskless profits from covered interest arbitrage. Two assumptions central to interest rate parity are capital mobility and perfect substitutability of domestic and foreign assets. Given foreign exchange market equilibrium, the interest rate parity condition implies that the expected return on domestic assets will equal the exchange rate-adjusted expected

return on foreign currency assets. Investors cannot then earn arbitrage profits by borrowing in a country with a lower interest rate, exchanging for foreign currency, and investing in a foreign country with a higher interest rate, due to gains or losses from exchanging back to their domestic currency at maturity. Interest rate parity takes on two distinctive forms: *uncovered interest rate parity* refers to the parity condition in which exposure to foreign exchange risk (unanticipated changes in exchange rates) is uninhibited, whereas *covered interest rate parity* refers to the condition in which a forward contract has been used to *cover* (eliminate exposure to) exchange rate risk. Each form of the parity condition demonstrates a unique relationship with implications for the forecasting of future exchange rates: the forward exchange rate and the future spot exchange rate.

Economists have found empirical evidence that covered interest rate parity generally holds, though not with precision due to the effects of various risks, costs, taxation, and ultimate differences in liquidity. When both covered and uncovered interest rate parity hold, they expose a relationship suggesting that the forward rate is an unbiased predictor of the future spot rate.

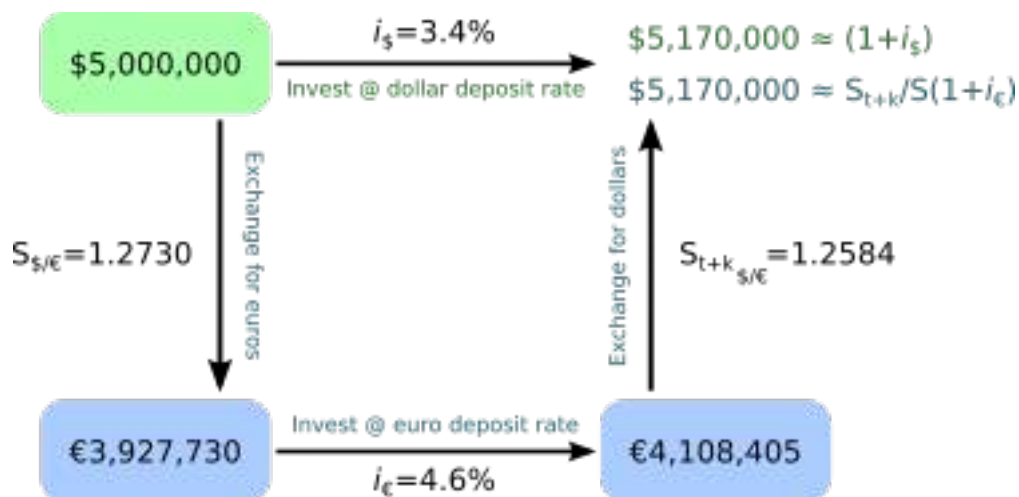
This relationship can be employed to test whether uncovered interest rate parity holds, for which economists have found, mixed results. When uncovered interest rate parity and purchasing power parity hold together, they illuminate a relationship named *real interest rate parity*, which suggests that expected real interest rates represent expected adjustments in the real exchange rate. This relationship generally holds strongly over longer terms and among emerging market countries.

Assumptions

Interest rate parity rests on certain assumptions, the first being that capital is mobile - investors can readily exchange domestic assets for foreign assets. The second assumption is that assets have perfect substitutability, following from their similarities in riskiness and liquidity. Given capital mobility and perfect substitutability, investors would be expected to hold those assets offering greater returns, be they domestic or foreign assets.

However, both domestic and foreign assets are held by investors. Therefore, it must be true that no difference can exist between the returns on domestic assets and the returns on foreign assets. That is not to say that domestic investors and foreign investors will earn equivalent returns, but that a single investor on any given side would expect to earn equivalent returns from either investment decision.

Uncovered Interest Rate Parity



A visual representation of uncovered interest rate parity holding in the foreign exchange market, such that the returns from investing domestically are equal to the returns from investing abroad.

When the no-arbitrage condition is satisfied *without* the use of a forward contract to hedge against exposure to exchange rate risk, interest rate parity is said to be *uncovered*. Risk-neutral investors will be indifferent among the available interest rates in two countries because the exchange rate between those countries is expected to adjust such that the dollar return on dollar deposits is equal to the dollar return on foreign deposits, thereby eliminating the potential for uncovered interest arbitrage profits. Uncovered interest rate parity helps explain the determination of the spot exchange rate. The following equation represents uncovered interest rate parity.

$$(1 + i_{\$}) = \frac{E_t(S_{t+k})}{S_t}(1 + i_{\text{€}})$$

where

$E_t(S_{t+k})$ is the expected future spot exchange rate at time $t + k$

k is the number of periods into the future from time t

S_t is the current spot exchange rate at time t

$i_{\$}$ is the interest rate in the US

$i_{\text{€}}$ is the interest rate in a foreign country or currency area (for this example, following a US perspective, it is the interest rate available in the Eurozone)

The dollar return on dollar deposits, $1 + i_{\$}$, is shown to be equal to the dollar return on euro deposits,

$$\frac{E_t(S_{t+k})}{S_t}(1 + i_c)$$

Approximation

Uncovered interest rate parity asserts that an investor with dollar deposits will earn the interest rate available on dollar deposits, while an investor holding euro deposits will earn the interest rate available in the euro-zone, but also a potential gain or loss on euros depending on the rate of appreciation or depreciation of the euro against the dollar. Economists have extrapolated a useful approximation of uncovered interest rate parity that follows intuitively from these assumptions.

If uncovered interest rate parity holds, such that an investor is indifferent between dollar versus euro deposits, then any excess return on euro deposits must be offset by some expected loss from depreciation of the euro against the dollar. Conversely, some shortfall in return on euro deposits must be offset by some expected gain from appreciation of the euro against the dollar. The following equation represents the uncovered interest rate parity approximation.^[1]

$$i_{\$} = i_c + \frac{\Delta E_t(S_{t+k})}{S_t}$$

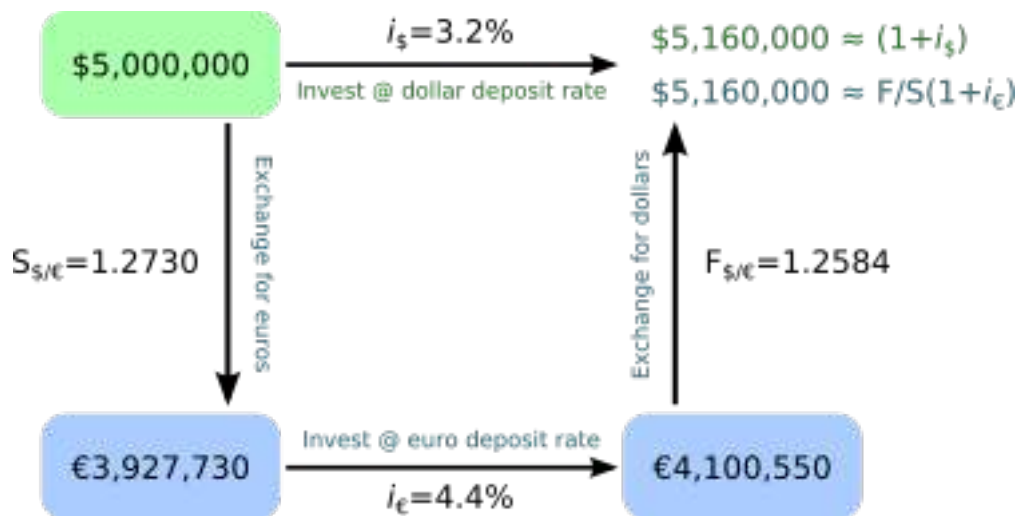
where

$\Delta E_t(S_{t+k})$ is the change in the expected future spot exchange rate

$\Delta E_t(S_{t+k})/S_t$ is the expected rate of depreciation of the dollar

A more universal way of stating the approximation is “the home interest rate equals the foreign interest rate plus the expected rate of depreciation of the home currency.”^[1]

Covered Interest Rate Parity



A visual representation of covered interest rate parity holding in the foreign exchange market such that the returns from investing domestically are equal to the returns from investing abroad.

When the no-arbitrage condition is satisfied with the use of a forward contract to hedge against exposure to exchange rate risk, interest rate parity is said to be *covered*. Investors will still be indifferent among the available interest rates in two countries because the forward exchange rate sustains equilibrium such that the dollar return on dollar deposits is equal to the dollar return on foreign deposit, thereby eliminating the potential for covered interest arbitrage profits. Furthermore, covered interest rate parity helps explain the determination of the forward exchange rate. The following equation represents covered interest rate parity.

$$(1 + i_{\$}) = \frac{F_t}{S_t}(1 + i_c)$$

where

F_t is the forward exchange rate at time t

The dollar return on dollar deposits, $1 + i_{\$}$, is shown to be equal to the dollar return on euro deposits,

$$\frac{F_t}{S_t}(1 + i_c).$$

Empirical Evidence

Covered interest rate parity (CIRP) is found to hold when there is open capital mobility and limited capital controls, and this finding is confirmed for all currencies freely traded in the present-day. One such example is when the United Kingdom and Germany abolished capital controls between 1979 and 1981. Maurice Obstfeld and Alan Taylor calculated hypothetical profits as implied by the expression of a potential inequality in the CIRP equation (meaning a difference in returns on domestic versus foreign assets) during the 1960s and 1970s, which would have constituted arbitrage opportunities if not for the prevalence of capital controls.

However, given financial liberalization and resulting capital mobility, arbitrage temporarily became possible until equilibrium was restored. Since the abolition of capital controls in the United Kingdom and Germany, potential arbitrage profits have been near zero. Factoring in transaction costs arising from fees and other regulations, arbitrage opportunities are fleeting or nonexistent when such costs exceed deviations from parity. While CIRP generally holds, it does not hold with precision due to the presence of transaction costs, political risks and tax implications for interest earnings versus gains from foreign exchange, and differences in the liquidity of domestic versus foreign assets. Researchers found evidence that significant deviations from CIRP during the onset of the global financial crisis in 2007 and 2008 were driven by concerns over risk posed by counter parties to banks and financial institutions in Europe and the US in the foreign exchange swap market. The European Central Bank's efforts to provide US dollar liquidity in the foreign exchange swap market, along with similar efforts by the Federal Reserve, had a moderating impact on CIRP deviations between the dollar and the euro. Such a scenario was found to be reminiscent of deviations from CIRP during the 1990s driven by struggling Japanese banks which looked toward foreign exchange swap markets to try and acquire dollars to bolster their creditworthiness.

When both covered and uncovered interest rate parity (UIRP) hold, such a condition sheds light on a noteworthy relationship between the forward and expected future spot exchange rates, as demonstrated below.

$$UIRP : (1 + i_{\$}) = \frac{E_t(S_{t+k})}{S_t}(1 + i_c)$$

$$CIRP : (1 + i_{\$}) = \frac{F_t}{S_t}(1 + i_c)$$

Dividing the equation for UIRP by the equation for CIRP yields the following equation:

$$1 = \frac{E_t(S_{t+k})}{F_t}$$

which can be rewritten as:

$$F_t = E_t(S_{t+k})$$

This equation represents the unbiasedness hypothesis, which states that the forward exchange rate is an unbiased predictor of the future spot exchange rate. Given strong evidence that CIRP holds, the forward rate unbiasedness hypothesis can serve as a test to determine whether UIRP holds (in order for the forward rate and spot rate to be equal, both CIRP and UIRP conditions must hold). Evidence for the validity and accuracy of the unbiasedness hypothesis, particularly evidence for co integration between the forward rate and future spot rate, is mixed as researchers have published numerous papers demonstrating both empirical support and empirical failure of the hypothesis.

UIRP is found to have some empirical support in tests for correlation between expected rates of currency depreciation and the forward premium or discount. Evidence suggests that whether UIRP holds depends on the currency examined, and deviations from UIRP have been found to be less substantial when examining longer time horizons. Some studies of monetary policy have offered explanations for why UIRP fails empirically. Researchers demonstrated that if a central bank manages interest rate spreads in strong response to the previous period's spreads, that interest rate spreads had negative coefficients in regression tests of UIRP. Another study which setup a model wherein the central bank's monetary policy responds to exogenous shocks, that the central bank's smoothing of interest rates can explain empirical failures of UIRP. A study of central bank interventions on the US dollar and Deutsche mark found only limited evidence of any substantial effect on deviations from UIRP. UIRP has been found to hold over very small spans of time (covering only a number of hours) with a high frequency of bilateral exchange rate data. Tests of UIRP for economies experiencing institutional regime changes, using monthly exchange rate data for the US dollar versus the Deutsche mark and the Spanish peseta versus the British pound, have found some evidence that UIRP held when US and German regime changes were volatile, and held between Spain and the United Kingdom particularly after Spain joined the European Union in 1986 and began liberalizing capital mobility.

Real Interest Rate Parity

When both UIRP (particularly in its approximation form) and purchasing power parity (PPP) hold, the two parity conditions together reveal a relationship among expected real interest rates, wherein changes in expected real interest rates reflect expected changes in the real exchange rate. This condition is known as *real interest rate parity* (RIRP) and is related to the international Fisher effect. The following equations demonstrate how to derive the RIRP equation.

$$UIRP : \Delta E_t(S_{t+k}) = E_t(S_{t+k}) - S_t = i_{\$} - i_c$$

$$PPP : \Delta E_t(S_{t+k}) = \Delta E_t(p^{\$}_{t+k}) - \Delta E_t(p^c_{t+k})$$

Where P represents inflation.

If the above conditions hold, then they can be combined and rearranged as the following:

$$RIRP : i_{\$} - \Delta E_t(p^{\$}_{t+k}) = i_c - \Delta E_t(p^c_{t+k})$$

RIRP rests on several assumptions, including efficient markets, no country risk premia, and zero change in the expected real exchange rate. The parity condition suggests that real interest rates will equalize between countries and that capital mobility will result in capital flows that eliminate opportunities for arbitrage. There exists strong evidence that RIRP holds tightly among emerging markets in Asia and also Japan. The half-life period of deviations from RIRP have been examined by researchers and found to be roughly six or seven months, but between two and three months for certain countries. Such variation in the half-lives of deviations may be reflective of differences in the degree of financial integration among the country groups analyzed. RIRP does not hold over short time horizons, but empirical evidence has demonstrated that it generally holds well across long time horizons of five to ten years.

Self Assessment Questions

1. Give a short note on Foreign market participants.
2. Describe the determinants of exchange rates.
3. Discuss the Financial Instruments used in market.
4. What are the factors influence the exchange rate? Discuss.
5. Briefly explain the method of Hedging with Forwards

6. How to hedge with futures? Discuss.
7. Discuss the advantage and disadvantages of the hedging with forward contracts and futures contracts.
8. Discuss option contracts. How to hedge with options contract?
9. What is the objective of FEMA?
10. Give detailed note the FERA and FEMA.
11. What are the main features of FEMA?
12. Explain the Provisions of FEMA
13. Discuss on the adjudication and appeal procedures under FEMA
14. Explain the Short run foreign exchange rate forecasting tools.
15. Compare and contrast Long-term and medium term foreign exchange rate forecasting tools
16. Write a note on banking crises and currency crises.
17. Discuss the basic forecasting models.

UNIT - IV

Unit Structure

Lesson 4.1 - Export Trade Documentation: Financial and Commercial

Lesson 4.2 - Transport and Office Documents

Lesson 4.1 - Export Trade Documentation: Financial and Commercial

Learning Objectives

Having gone through this lesson, you are able to

- Understand the export documentation procedures
- Know the various commercial documents
- Comprehend documents related to goods

Introduction

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 (and should) be duplicated precisely from one document to the next.

Fortunately, there are software products that capture the primary details of the shipment and insert them into the necessary documents without flaw. This Fast Fact will describe many of the documents your business will need in order to export successfully.

This lesson explains documents used in export documents are authenticated records certifying that the goods are exported in general export documents are classified as commercial documents and regulatory documents. Commercial documents are those

by customs of trade, are required for effecting physical transfer of goods and their title from the exporter to the importer and the realization of export sale proceeds. Regulatory documents are those which have been proscribed by different government department/bodies in compliance of the requirements of various rules and regulations under relevant laws. Governing, export trade such as, export inspection, foreign exchange regulations, export trade control customs etc.

Commercial Documents Are Listed Below

1. Proforma invoice
2. Commercial invoice
3. Packing list
4. Shipping instructions
5. Intimation for inspection
6. Certificate of inspection/Quality control
7. Insurance declaration
8. Certificate of insurance
9. Shipping order
10. Mate receipt
11. Bill of loading /combined transport document
12. Application for certificate of origin
13. Certificate of origin
14. Bill of exchange
15. Shipment advice
16. Letter to the bank for collection/negotiation of documents.

Regulatory Documents Are Listed Below:

- | | |
|---------------------------------|-----------------------|
| 1. Gate Pass-1/Gate Pass-II | Prescribed by Central |
| 2. AR4/AR4A Form | Excise Authorities |
| ➤ For export of goods ex-bond | Cusomes Authorities |
| ➤ For export of Duty Free Goods | |
| ➤ For export of Dutiable goods | |
| ➤ For export of Goods under | |
| ➤ Claim for Duty Drawback | |

- | | |
|--|-----------------------------|
| 4. Export Application. Dock Challan/
Port Trust Copy of Shipping Bill | Prescribed by
Port Trust |
| 5. Receipt for payment of port charges | |
| 6. Vehicle Ticket | |
| 7. Exchange Control Declaration/
GR/PP Forms | Prescribed by RBI |
| 8. Freight Payment Certificate | |
| 9. Insurance Premium | |
| 10. Payment Certificate | |

Out of 16 commercial documents, exporters have to send as many as eight documents are known as principal export documents.

Commercial invoice packing list, bill of lading/combined transport document, certificate of inspection, quality control. Insurance policy, certificate of origin, bill of exchange and shipment advice are called principle export documents. The remaining eight documents are known as auxiliary documents.

Classification of Documents

The export related documents can be classified into the following four heads for easy understanding

- I. Documents related to Goods,
- II. Documents related to Transport,
- III. Documents related to Payments,
- IV. Documents related to Inspection,
- V. Documents related to Exchange Control, and
- VI. Documents relating to Excisable Goods.

I. Documents Related to Goods

1. Proforma Invoice
2. Commercial Invoice
3. Packing List
4. Certificate of Origin

5. Consular Invoice
6. GSP Certificate.

II. Documents Related to Transport

1. Shipping Order
2. Mate's Receipt
3. Bill of Lading
4. Airway Bill
5. Shipping Bill
6. Marine Insurance policy
7. Post Parcel Receipt
8. Port Trust Document

III. Documents Related to Payment

1. Letter of Credit
2. Bill of Exchange
3. Bank Certificate of Payment.

IV. Documents Related to Inspection

1. Certificate of Inspection

V. Documents Related Of Exchange Control

1. Guaranteed |Remittance (GR) Form
2. Post Parcel (PP) Form
3. Value Payable/Cast on-Delivery (VP/COD) Form

Vi. Documents Relating to Excisable Goods

1. AR4 Form
2. Form C

Documents Related to Goods

Export documents related goods are explained below.

1. Proforma Invoice

It is a provisional invoice. The primary purpose of the proforma invoice is to state the terms and conditions and other subject matter relating to export to export to the importer. The information contained in the proforma invoice is as the same commercial invoice and document format is also the same. The proforma invoice sent by the exporter is used by the importer

- (i) To get import license,
- (ii) To open letter of credit and
- (iii) To arrange for loan in foreign exchange.

2. Commercial Invoice

The commercial Invoice described the entire details of goods involved in export transaction. It is an important export document. it serves as a bill for goods exported. Import duty in the importers country is calculated on the basis of commercial invoice. It is the evidence of contract of sale. The commercial invoice should be given prescribed format. It should correspond with the specifications relating to goods given in the letter of credit.

Contents of Commercial Invoice

Commercial invoice contains the following information related to goods.

- i. Name and address of the exporter and importer,
- ii. Invoice number
- iii. Reference number of exporter and exporter,
- iv. Terms of delivery of goods and payment for export,
- v. Name of the ship/aircraft.
- vi. Port of loading and port of discharge,
- vii. Detailed description of goods,
- viii. Details of packing, number of packages, types and specified markings on the packages,
- ix. Quantity of goods, unit price of goods and total price,
- x. Details of freight and insurance.

3. Packing List

Export packs the export cargo according to the instruction of the importer. Packing of note reveals the contents of single pack. One packing note is prepared for one pack. In there are so many pack, consolidated statement of packing notes is to be prepared. Packing list shows the contents of the whole consignment of export. Exporter should submit packing list to the customs authorities and insurance company in order to fulfill the documentary obligation for export.

4. Certificate of Origin

Certificate of Origin is generally issued by the Chamber of Commerce. Export Promotion Council and other export related institutions which are authorised by the government of India are also issuing certificate of origin.

Contents of Certificate of Origin

- i. Description of goods-quantity and value,
- ii. Number of packages and markings packages –wise,
- iii. Declaration by the exporter,
- iv. Certificate by the issuing authority.

In foreign trade, certain specified countries provide concession in import duty to goods being exported from a particular country. This concession is given under generalized system preferences. A proof is required to the countries providing concession that the goods are manufactured in that particular country. Certificate of origin serves as a proof in this regard

5. Consular Invoice

In foreign trade, some importing countries may insist and require consular invoiced in addition to commercial invoices. The format of the consular invoice is to be received from the office of the respective consulate of the importing country functioning in the exporter's country. After getting the format, exporters should complete the form by providing necessary information about the exportable goods. The consular invoice should be signed and authenticated by the consulate of the importing country functioning in the exporter's country. Exporter has to pay a nominal fee to the local consulate for issuing and certifying the consular invoice.

6. GSP Certificate

GSP certificate is used by the developing country to get duty concession from the developed countries. Concession refers that the developed countries will reduce import duty when they import goods from the specified developing countries. Developing countries are encouraged to export to developed countries and developed countries levy concessional import duty under generalized system of preferences (GSP) scheme of the United Nations Conference of Trade and Development (UNCTAD). India is also one of the countries getting concessions under GSP.

GSP certificate is required to avail this type of concession. Export promotion councils and directorate General of Foreign trade are authorised by the government to issue GSP certificate to the exporters. Central silk board, coin board, all India handicraft board, textiles committed and jute commissioner are also authorised to issue GSP certificate to the exporters coming under their direction and control.

Export Documentation

Essential data elements must be uniform on all documents:

- Name & Address of Seller / Shipper
- Name & Address of Buyer / Consignee
- Origin Point & Destination Point
- Port of Load / Unload
- Description of the Goods
- Number of Pieces, Cartons, Crates
- Net weight, Gross Weight, Volume
- Invoice & Purchase Order Numbers

Material Handling

Packing List: A packing list is prepared by the shipper and is a detailed breakdown of the items within a shipment. It may also include any “special marks” for identification. For example, the customer may want “ABC XX” in blue letters on the side of the packaging. For insurance claims and tracking purposes, it helps to describe what is in each “package”. The packing list should also reference the customer’s purchase order number and destination.

Often, a packing list is taped to palletized cargo or on the main carton/box of a shipment so that the importer's customs agency or any transportation handlers can have easy access to it to know what the goods are and their destination. The quantity and items listed on the commercial invoice must match with the packing list, but not necessarily match the proforma invoice. Some companies prepare a packing list that is identical to the commercial invoice, minus the prices and other monetary details.

Dock (or Warehouse) Receipt: The dock or warehouse receipt is issued by a warehouse supervisor or port officer and certifies that the goods have been received by the shipping company. This document is used to transfer accountability when goods are moved by the domestic carrier to the port of embarkation and left with the international carrier. At this time, the carrier's Bill of Lading is also signed by both parties and copies are issued accordingly.

Bills of Lading (B/L)

A Bill of Lading is issued by the carrier to the shipper for receipt of the goods, and is a contract between the owner of the goods and the carrier to deliver the goods. Sometimes the B/L acts as title to the goods so an "Original" B/L is issued- usually a set of three. Whoever presents one of those Original, Negotiable B/L can take possession of the goods. A B/L can be either negotiable or non-negotiable.

Non-negotiable (or "straight") B/L: Indicates that the shipper will deliver the goods to the buyer and that title of the goods has not been transferred to the shipper (i.e., the buyer or seller "owns" the goods while they are being shipped). This type of B/L is often used when payment for the goods has already been made in advance.

Negotiable (or "shipper's order") B/L: Serves as a title document to the goods, issued "to the order of" a party, usually the shipper, whose endorsement is required to effect its negotiation. It can also be issued "to the order of" the buyer's bank as part of a documentary credit/letter of credit stipulation so that when the buyer's bank receives the Original B/L, they can endorse it over to the buyer at the time of payment for the buyer to clear the goods at customs. Sometimes the negotiable B/L may be consigned "To Order" without reference to a company. A negotiable B/L can be bought or traded while the goods are in transit, whereas a "Straight" B/L is non-negotiable and is consigned to the buyer.

The B/L is frequently electronically manifested by the shipping line company using the data sent by the shipper or its agent. Bills of Lading also include a "notify party" (usually the buyer or their agent) so that when the vessel arrives at the port of destination, the carrier

can notify the party that the goods are available, are in need of customs clearing, or are ready for pick up. Usually the importer can pick up the goods after customs clearance and duties are paid. “Freight Collect” means the consignee pays the freight charges as well. “Freight Prepaid” means the shipper pays the freight charges, but not customs clearance unless the terms are “delivered duty paid”. If Certificate of Insurance: This document indicates the type and amount of insurance in force on a particular shipment for loss or damage while in transit. It is sometimes referred to as Marine insurance, but may cover the entire voyage.

Certificate of Inspection: Some customers will require a “pre-shipment inspection” to satisfy their own requirements or local regulations, according to an industry, government, or carrier specification. Neutral organizations specialize in these types of certifications, whereby an inspector checks the goods in question prior to shipment. Sometimes an inspector can look at a sample, but other times inspection must occur when the goods are packaged to issue a certificate.

Certificate of Free Sale: This form may be required by the importing country to ensure that the goods offered for entry comply with domestic requirements for sale in the U.S. It is often required for agricultural, medicinal, or cosmetic products and can be issued by the VEDP or U.S. FDA.

Certificate of Authentication (Apostille): An original document that has been notarized may require “authentication” by the Secretary of the Commonwealth. An Apostille certificate will be issued according to the country (language) of destination, confirming the status of the notary who has witnessed the original document. Phytosanitary Certificate: Primarily a document required to import goods into the U.S., confirming compliance with phytosanitary safety regarding agricultural and animal health standards.

Special Documents

Declaration of Dangerous Goods (DGD): A DGD declares the nature, quantity, and quantity of hazardous materials and reports the proper classification for each item.

ATA Carnet

A Carnet, sometimes referred to as a “merchandise passport”, is used for shipping goods to countries on a temporary, duty-free basis only. For a fee, this passport allows a company to ship needed materials to foreign trade shows or conduct repairs overseas. Within a year, the materials must return to the U.S. in order to avoid a hefty fine.

Documentary Letters of Credit (L/C): A letter of credit is a document issued by a bank committing to pay the seller/exporter a stated amount of money on behalf of the buyer/importer as long as the specific terms and conditions are met. Of all shipping documents, errors or making changes to the L/C are the most costly and time consuming because of the risk of payment in error. Knowledge of the proper forms required, along with uniformity and document control, will help exporters prevent errors in shipping documentation, save processing time, create good file management, improve customer service, and of course, avoid costly fines.

Lesson 4.2 - Transport and Office Documents

Learning Objectives

After reading this lesson you are able to:

- Understand shipping documentation
- Comprehend Bills of lading
- Discuss marine insurance policy
- Understand documents related payments and inspection.

Documents Related to Transport

Documents related to transport of export goods are explained below:

Shipping Documentation

Shipping documents are the key to international trade, and have been used for thousands of years. Documents outline the sale, shipment, and responsibilities of each party so that the full transaction is understood and complete without delay or additional costs. Documents also ensure compliance with applicable regulations.

Using an experienced Freight Forwarder will help you to avoid problems and secure your relationship with your customers. Consider providing your Forwarder with a suitable “letter of authorization” to act as your agent on overseas documentation matters.

Although not a required or standardized document, preparing a thorough and well organized “Shipper’s Letter of Instructions” (SLI) is a good practice for your company to establish. You can give your Forwarder limited authorization and initial instructions with an SLI as soon as the shipment details emerge, which allows time to prepare documents, make arrangements, and ask questions. Although a Freight Forwarder is not absolutely required for a successful export shipment, a licensed Customs House Broker is required to clear goods imported into any country, including the United States.

Below are some factors to consider when determining which documents are needed for a particular shipment:-

- Country of origin and destination, as well as transshipment
- Mode of transportation — truck, rail, ocean, air, pipeline
- Commodity — agriculture, livestock, safety/security, end-use, intangible- software, service
- Size — value, volume, weight, dimensions
- Parties to the transaction — shipper, consignee, agents, brokers, banks
- Based on these factors, many of the following documents may be required for an international shipment. These documents can be prepared by the exporter and then processed or forwarded by a Freight Forwarder.
- Invoices — Commercial, Pro-forma, Consular
- Packing Lists — Dock, or Warehouse, Receipt
- Bills of Lading (B/L) — Ocean B/L, or Motor/Truck or Air Bill, or Way Bill
- Electronic Export Information (formerly the Shipper's Export Declaration, or SED) is not an actual document but still a very important part of the export process
- Certificates of Origin (C/O), sometimes country-specific — NAFTA C/O, Israel C/O
- Declaration of Dangerous Goods (DGD) — Hazmat, placards
- Certificates — Insurance, Free Sale, Inspection, Phytosanitary, Authentication (Apostille)
- Miscellaneous: Letters of Credit, ATA Carnet, Duty Drawback

1. Shipping Order

Exporter should apply to a shipping company in order to reserve the required space for shipment of export cargo. After getting and scrutinizing the application, shipping company will send shipping order to the exporter confirming the space arranged in the ship for shipment. Shipping order shows ship details, route, approximate dates on which the ship will reach various ports, freight details and other relevant terms and conditions of shipping service.

2. Mate's Receipt

Captain of the ship will issue Mate's receipt after the goods are loaded on the board of the ship. It is prime facie evidence shows that the goods are loaded on the board of the

ship. Master of captain of the ship will inspect the goods and packaging, when the goods are in the process of loading over the board of the ship. Any discrepancy of defective is noticed in the goods or packaging, a note about the specified discrepancy of defective is made on the Mate's receipt

3. Bill of Lading

Bill of Lading is issued by the shipping company after the goods are loaded on the board of the ship. Master of captain of the ship will inspect the goods are loaded on the hoard of the ship. it is prepared based in the Mate's receipt issued by the master of captain of the ship . Bill of Lading is an acknowledgement of goods loaded on the board of the ship. It is an undertaking of the shipping company to deliver the goods in the condition in which it is received and to execute the terms and conditions of carriage agreed between exporter and Shipping Company. Hill of Lading is a document of title to goods. Delivery of goods can be made by the person in whose favour the bill of lading is endorsed. As per the requirement of the exporter, Bill of Lading is also made available to exporter. Exporter can use any one of the original copies of bill of lading for negotiation with the bank. Bill of lading can be made transferable by endorsing in favour of a specified person or to his order. Bill of Lading may be endorsed in blank.

Contents of Bill of Lading

- i. Name and other details of rthe ship and shipping company
- ii. name of the port of loading
- iii. name and address of the exporter
- iv. name and address of the importer (in certain cases this column may be either blank or in favour of a specified person or his order).
- v. name and address of the person to be notified when the goods reach the port of destination
- vi. details of name of the port of discharge and delivery
- vii. details of freight paid or payable (to pay to collected)
- viii. Description of goods
- ix. number of packages, kind of packages and marks and numbers on packages.
- x. remarks about condition of goods, if any.

Type of Bill Lading

- i. Claused bill of Lading
- ii. Clear bill of lading
- iii. Through bill of lading
- iv. Direct bill of lading
- v. Transshipment bill of lading
- vi. Freight paid bill of lading
- vii. Freight collect bill of lading
- viii. Shipped bill of lading
- ix. Received for shipment of lading
- x. Stale bill of lading.

If the captain or master of the ship find, while inspecting the goods, that the goods are in damaged condition or packages are damaged, the captain will make a note in bill of lading about the damage of goods or packages. This bill of lading is known as claused bill of lading or dirty bill of lading.

While inspecting the goods, if the goods and packages are found in good condition a clear bill of lading will be issued by the captain of the ship. Sometimes contract of carriage of goods between exporters and carrier may cover transport by land on other sea carriers in addition to the main carriage of goods by sea. In order to cover the all stages of journey, a through bill of lading is issued. Direct bill of lading is issued when the same vessel carried the goods from the port of shipment to port of destination transshipment bill of lading is issued when the goods are transshipped from one ship to another ship for a part of the journey.

The second ship will carry the cargo for the remaining journey, and deliver the goods in the port of discharge freight collect bill of lading is issued when the imported in supposed to pay freight. Shipped bill of lading means that shipping company has received goods on board of the ship received for shipment bill of lading means that the goods are under the custody of the shipping company. It means that the goods are received for shipment. Generally, bill of lading should reach the importer before the goods reach the port of discharge (import Port).they only importer can take necessary steps to take delivery of goods. If the bill of lading is delayed to reach the importer, he cannot take the delivery of goods in time. He has to incur extra cost of demurrage. This type of bill of lading known as stale bill of lading.

4. Airway Bill

It is issued by the airline company. Within the goods are transported by air, the airline company will issue airway bill to the exporters. Airway bill is an evidence of contract of carriage. It is not document of title to goods, whereas bill of lading is a document of title of goods. Under airway bill the goods are delivered to the party mentioned by the exporter.

5. Shipping Bill

Shipping bill is an important document used in export transactions. It is an important document required by the customs authorities for certification of export transaction. It is used for claiming duty drawback and other export incentives. Shipping bill is classified into three types. They are

- (i) Drawback shipping bill,
- (ii) Dutiable shipping bill and
- (iii) Duty free shipping bill.

This classification is based on the type of goods exported i.e., drawback goods, dutiable goods and duty free goods.

Drawback shipping bill is used for drawback goods. Exporters can claim duty drawback on such goods. Dutiable shipping bill is used for dutiable goods and exporter should pay duty. Duty-free shipping bill is used for duty free goods. Exporter need not pay duty for such goods. Drawback shipping bill is Green colour for sea transport and for air transport. Duty free shipping bill is White color for sea transport and Pink color for air transport. In the electronic data interchange system color of the shipping bill is not given importance and purpose is given due importance.

Contents of Shipping Bill given below

- i. Name, address and IEA number of exporter and name and address of the consignee
- ii. Name of the ship
- iii. Name of the shipping agent
- iv. Description, quantity and value of goods
- v. Type of cargo (bulk, liquid)
- vi. Number of packages, details of markings and numbers on packages, container numbers.

- vii. Port of loading and port of discharge
- viii. Country of destination
- ix. Nature of export continent
- x. Customs house agent LIA Number
- xi. Invoice number and date
- xii. AR4/AR4A number and date

Shipping bill is prepared in five copies. The five copies are

- (i) Customs and statistical copy,
- (ii) Port trust copy,
- (iii) Drawback copy,
- (iv) Export promotion copy and
- (v) Exporter's copy.

Marine Insurance Policy

Marine insurance is contract between policy holder (exporter) and insurance component. The insurance company will issue marine insurance policy to the exporter. Marine insurance policy in a basic document related to transport of exportable goods is indemnified the risks to the goods when the goods are transported by sea. Marine insurance policy is taken to cover the risk related to goods from the exporter's warehouse to importer's warehouse if the export contract is on CIF (cost, Insurance and Freight) term, exporter has to take necessary steps to take marine insurance policy and pay premium for the policy. Marine insurance policy is freely transferable by endorsement and delivery.

Contents for Marine Insurance Policy

- i. Name and address of the insurance company
- ii. Name and address of the insured (name of the exporter in whose favour the insurance is effected)
- iii. Marine insurance policy certificate number and date of issue.
- iv. Name of vessel (ship)
- v. Port of loading and poet of discharge
- vi. Description of goods, number and kind of packages and marks and number on packages

- vii. Insured value, period of insurance and terms of insurance
- viii. Clauses of insurance (risk or risks insured against)

Post Parcel Receipt

Post Parcel Receipt is issued by the postal authorities when the goods are exported through post. It is an evidence of receipt of goods for export and it is not a document of title to goods. The goods are delivered to the consignee mentioned by the exporter. The terms of payment such as documents against payment and document against acceptance can be used while exporting goods through post also. In export through post, goods are consigned in the name of the concerned banks. Prior permission should be obtained from the concerned banks in this regard.

Port Trust Document

Ports design their documents (forms) for exporter's use to pay port charges. The documents are used by the port authorities to record the details of transactions relating to shipment of goods in their ports. The port trust documents are designed by the ports based on the information required to them about export transaction. Information regarding cargo handled and port charges received are also recorded in the port trust documents. These documents are used by the ports for their internal management. Export application dock challan and port trust copy of shipping bill are different names of the port trust documents used in different ports in our country.

Document Related to Payment

Documents related to export payment are explained below:

1. Letter of Credit

Letter of Credit is one of the most important documents used in the export trade. It is defined as "a promise by the overseas importer through his banker where letter of credit is opened by him, to the exporter through his banker (known as negotiating banker) to pay the proceeds on the receipt of documents certifying the shipment of goods". It is defined by the Jacob Cherian in his book, Export Marketing as "a written undertaking issued by the buyer's bank agreeing to pay a certain sum of money within a stipulated period against a specified set of documents." Letter of credit is classified into various types. They are irrevocable and revocable letter of credit, with or without Recourse letter of credit, confirmed and unconfirmed letter of Credit.

Bill of Exchange

It is a negotiable instrument and can be transferred to another person. It may be either sight bill or time (usance) bill. Sight bill is paid immediately on the presentation of documents to the importer. Time bill or usance bill is paid on a fixed date mentioned in the bill (usually after 30, 60, or 90 days) after presentation of documents to the importer.

When a draft is drawn on a foreign bank, it is named as foreign draft or bill of exchange. It is a method of collection export payment from the importer through bank. Bill of exchange is defined as “an unconditional order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay or demand or on a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer”.

3. Bank Certificate of Payment

This is a certificate issued by the negotiating bank (exporter's bank) stating that the export payment is received from the importer as per the exchange control regulations of the government of India.

Document Relating to Inspection

Documents relating to inspection of export goods are explained below:

1. Certificate of Inspection

Exporters should obtain inspection certificate from the export promotion Agency as per the export (quality control and inspection) Act, 1962 and it is obligatory also to the exporters. Exporter should apply to the export inspection agency in the prescribed format for export cargo inspection. After inspection, export inspection agency will issue verification of inspection. Exporter should submit this document to the customs authorities to obtain their approval for shipment of export cargo. Exporter should attach the following documents with his application for inspection to the export inspection agency:

1. Copy of the commercial invoice
2. Draft/cheque for the fee payable for inspection
3. Copy of the export contract and
4. Declaration of the importer's technical specifications of quality and /or a sample approved by the importer in support of the declaration of specifications.

Documents Related to Exchange Control

Documents related to exchange control for export goods are explained below;

Exporters should observe exchange control regulations in getting export payment from foreign countries. Exporters should take steps to get export payment from foreign countries. Exporters should take steps to get export payment within 180 days from the date of shipment.

Otherwise, notice will be served to the exporters and necessary action will be taken against the exporter. Exporter should give valid reasons and justification from the delay in getting export payment. In the recent EXIM Policy (2002) exporters are permitted 360 days from the date of shipment to get export payment from foreign countries. Exporters should take steps to get export payment within 360 days from the date of shipment

1. Guaranteed Remittance Form (GR)

Exporters are directed by the RBI to declare in time the amount of foreign exchange they receive in every export consignment. The declaration of exporter should be made in a prescribed form. This form is known as GR-I form. This form is prepared in triplicate. Exporter submits the original GR-1 Form to the customs authorities at the time of shipment.

Duplicate and triplicate copies of GR-1 form are submitted by exporter to the bank (authorized dealer in foreign exchange) helping in collection of export payment and export payment is routed through this bank. After the export payment is received from the importer, the bank will send duplicate copy of GR-1 form to the RBI certifying for the export money received.

Contents of GR-1 Form

- Name, address and code number of exporter
- Name and address of the consignee
- Name of the negotiation bank (bank through which payment is to be received)
- Name of the ship/airline
- Date of shipment, port of shipment and country of destination
- Nature of export contract (FOB, CIF, C&F)
- Describing of goods, quantity of goods, export value, customs assessable value/

2. Post Parcel (PP) Form

If the export is made through post parcel, exporter should declare the details of export in post parcel form. Exporter should submit this form to the bank (authorized foreign exchange dealer) for counter signature.

The bank will counter sign and return the original copy of the pp form to exporter. the counter signed pp form is submitted to the post office with the parcel (export goods for export. bank retains the duplicate copy of the pp form., exporter will submit relevant export documents within 21 days from the date post parcel to the bank for negotiation and collection. the duplicate pp form will be referred by the bank for documents negotiation and collection of behalf of the exporter.

3. Value Payable. Cash-On –Deliver (VP/COD) Form

Exporter should declare export details in VP/COD form in the export is made through post parcel and payment arrangement is made through postal channels value payable on cash on delivery basis. This form is to be submitted to the post parcel (export goods) for export.

Documents Relating to Excisable Goods

Documents relating to excisable goods are explained below

1 AR4 form

AR4 form is used to claim rebate on excise duty. Exporter should submit this AR4 form to the central excise officials before removal of excisable goods from the factory for export. Exporter should submit this AR4 form to customs authorities as the token of shipment. After shipment, the customs authorities will certify, by endorsement in AR4 form that the goods have been shipped. Exporter can claim rebate or excise duty on the basis of endorsement made by the customs authorities.

Form C

Form C is used to apply for rebate on excise duty for export goods other than vegetables, non essential oils and tea exported by sea. This form is also submitted to central excise officials for necessary action and getting rebate on excise duty. The documentary procedure of AR4 form is applied for form C for claiming rebate on excise duty.

Aligned Documentation System

Mahajan, in his book export documentation has defined aligned documentation system as “a method of creating information on a set of standardized forms printed on paper of the same size and in such a way that items of identical information occupy the same position of each form.” Aligned documentation system is based on the UN Layout key. It helps to prove and effective alternative to the repetitive and unproductive method of preparation of export documents. Aligned documentation system organized export documents in such a way to facilitate the present day requirements of trade and transport this system simplifies and standardized document. The objectives of aligned documentation system are (i) to simplify, rationalize and priorities information required by various commercial interests and government agencies and align in a standardized format and (ii) to achieve economy of time and effort involved in the present method of export documentation.

In the export trade, the organizations such as, Federation of Indian Export Organization, Federation of Indian Chamber of Commerce and Industry, Associated Chamber of Commerce, Federation of Freight Forwarders Associations of India, Shippers’ Association, Export Inspection Agencies, Port Trusts, Shipping Corporation of India, General insurance Corporation, Export Credit and Guarantee Corporation, Collectors of Custom Reserve Bank of India and export companies are involved. 16 to 25 export documents are prepared to fulfill the requirements of the above organizations in export trade. Most of the information available in these documents are the same and repetitive.

Further the export documents are in different size, shape and layout. So it becomes necessary to simplify and standardized all export documents and number of export documents should be reduced as much as possible. The Aligned Documentation System insist to prepare export documents on a uniform and standardized A4 size paper. It is planned to prepare only two master documents (One for commercial documentation purpose and another for regulatory documentation purpose) to fulfill all the documentary requirements of export and instead of preparing 16 to 25 export documents.

The Aligned Documentation System helps to prepare export documents with increased speed, convenience, economy and accuracy. The recently developed electronic data interchange (EDI) will contribute to simplify the export documents and fulfill the objectives of aligned documentation system. All major ports functioning in India are directed to implement electronic data interchange in their export documentary procedures and creating records relating to shipment and other export related activities.

Shipping Terms

Selected shipping terms are given below.

Anchor

A heavy iron implement usually in the form of a hook, lowered by means of chains from the ship on to the bottom of the sea to keep the ship safe from moving

Berth

- 1) A loading or discharging anchorage allowing a ship to go to alongside.
- 2) This may also apply to cabin I ship.

Breakwater

Strong structure material to break the force of sea waves a breakwater is constructed outside an open harbor to protect it from waves, and it possible for ship to berth also a part of protection on the weather deck of ship to stop the waves over riding the deck.

Bunker

Fuel or coal utilized by engines of a ship

Cargo

The general meaning of various merchandise transported on a ship or airplane or by land vehicles. Cargo is accepted on production of a bill of lading as from of contract of affreightment showing the full details of the cargo carried, including freight charges involved.

Charter

- 1) The chartering or hiring of a ship. A ship which is hired out is said to be on charter and the time during which a ship is hired out is known as period of the charter.
- 2) Short term for charter party

Charter Party

Documents containing all the terms and conditions of the contract between a ship owner and charter, and signed by both parties and their agents, for the hire of a ship or the space in a ship. Most charter parties are standard forms with printed clauses and spaces or boxes in which details relating to the individual charter, such as freight, lay time, demurrage, the ship's construction, speed and consumption are inserted. The printed document may be varied and/or added to by agreement of the two parties sometimes spelled charter party or charter party.

Container

Box designed to enable goods to be sent from door-to-door without the contents being handled. There are several standard sizes used worldwide such that the same container may be transferred from one mode of transport to other modes in the course of a single voyage.

Indeed, specially designed road and rail vehicles and special ships are frequently used to carry containers. The most common sizes of containers are the 20 footer, which measure about 20 feet long by 8 feet wide by 8 feet 6 inches high and the 40 footer, measuring about 40 feet long and having the same width and height as the 20 footer. Typically made of steel, there are containers of several types whose use depends principally on the nature of the cargo, for example dry bulk, liquid or perishable cargoes.

Container Foreign Station

Place where consignments are grouped together and packed into a shipping container, or where such consignments are unpacked.

Dock

Enclosed basin surrounded by quays equipped with cargo handling equipment used for loading and discharging ships. A dock is not a pier or wharf (q.v) each of which has its own specific meaning. It would be appropriate, however, to say that a vessel docked at a pier.

Draught (or Draft)

Depth to which a ship is immersed in the water, this depth varies according to the design of the ship and will be greater or lesser depending not only on the weight of the ship

and everything on board, such as cargo, ballast, fuel and spares, but also on the destiny of the water in which the ship is lying. A ship's draught is determined by reading her draught marks, a scale marked on the ship's stem and stern.

Feeder

Wooden boxes open at the bottom, which is built under the hatchway of a ship when grains in bulk are to be carried. The grain is loaded into the cargo compartment filling the feeder which feeds the hold with grain as the cargo settles during the voyage, in order to prevent it from shifting.

Forwarding Agents

Persons engaged in taking care of cargo or personal effect to be dispatched from one place to another by sea, land or air, similar to freight forwards.

Free Alongside Ship or Free Alongside Berth

Buyer is to pay all the expenses from the time shipment up to the time of destination. there include the loading and loading expenses, freight and all other charges involved in the process of its transportation route.

Self Assessment Questions

1. What is letter of credit? Explain its importance in export.
2. What are documents related to export payments?
3. What is GR form?
4. What do you understand by AR-4 form?
5. What is aligned documentation system?
6. Explain bill of lading?
7. What are shipping terms? explain
8. What are various types of shipping bills?
9. What is Mate's bill?
10. What is aligned documentation system?
11. Explain Charter party agreement.

UNIT - V

Lesson 5.1 - Export Promotion Schemes

Learning Objectives

Having gone through this lesson you are able to:

- Understand various provisions of export promotion schemes
- Understand various supporting institutions of export promotion schemes
- Discuss promotional measures.
- Comprehend various financial and fiscal incentives to exports in India.

Introduction

The Export Promotion Schemes can be categorized as,-

- Duty exemption scheme which permit duty free import of inputs required for export production viz., Advance Authorisation and Duty Free import Authorisation (DFIA);
- Duty remission scheme which enable post-export replenishment of / remission of duty paid on inputs viz., Duty Entitlement Pass Book Scheme;
- Reward schemes which entitle exporters to duty credit scripts subject to various specific conditions like Served from India Scheme (SFIS), Vishesh Krishi Gram Udyog Yojana (VKGUY), Focus Market Scheme (FMS), Focus Product Scheme (FPS) and Status Holder Incentive Scheme
- Export Promotion Capital Goods (EPCG) Scheme which permits an exporter to import Capital Goods at concessional / Nil duty against an export obligation to be fulfilled in specified time.

Advance Authorisation Scheme

The Advance Authorisations are issued to allow duty free import of inputs, which are physically incorporated in the export product (after making normal allowance for wastage). In addition, fuel, oil, energy catalysts, etc., which are consumed in the course of their use to obtain the export product are also allowed under the scheme. The raw materials/inputs are allowed duty free as per the quantity specified in the Standard

Input-Output Norms (SION) notified by the DGFT or as per self-declared norms of the exporter in terms of Para 4.7 of Handbook of Procedures (HBP) Vol.1. The Advance

Authorisations are not issued for some specified items like vegetable oils, cereals, spices, honey etc.. The Advance Authorisation holder is required to fulfill the export obligation (EO) by exporting a specified quantity/value of the resultant product.

The Advance Authorisations are issued both for physical exports as well as deemed exports. These are also issued on the basis of annual requirements of the exporter, which enables him to plan his manufacturing / export programme on a long term basis.

The Advance Authorisations are issued on pre-export or post export basis in accordance with the FTP and procedures in force on the date of issue of Authorisation.

The Advance Authorisations are issued either to a manufacturer exporter or merchant exporter tied to a supporting manufacturer(s). They can also be issued to sub-contractors in respect of supplies of goods to specified projects provided the name of such sub-contractor appears in the main contract.

The Advance Authorisation Schemes (normal Advance Authorization, Advance Authorisation for Annual Requirement have been operationalized through the Notifications No. 96/2009-Cus. And No. 99/2009-Cus both dated 11.9.2009 with minor variations in the conditions. The Advance Authorisation for Deemed Exports Scheme has also been operationalized by a Customs Notification No. 112/2009-Cus. dated 29.09.2009).

The Advance authorisations are issued with a minimum of 15% value addition with effect from the current FTP, 2009-14. The value addition for gems and jewellery and for specified goods is specified as per Appendix-11B and para 4A2.1 of HBP Vol.1.

In case of Authorisation for Tea, the minimum value addition is 50% as per para 4.1.6 of FTP (RE-2010). Higher value additions are prescribed for exports for which payments are

not received in freely convertible currency. The Advance Authorisations and/or materials, imported there under are not transferable even after completion of export obligation.

The imports/exports against Advance Authorisations and their utilization require proper monitoring as the goods are imported duty free against a liability to export. For this, the Advance Authorisation holder is required to maintain a proper record of his imports and exports and to pay the duties in case he is unable to fulfill his export obligation, the

Advance Authorisation holder is required to indicate the Advance Authorization No. / date on the body of the Shipping Bill/Invoice (in case of deemed exports). After fulfillment of specified export obligation, the Advance Authorisation holder is required to submit relevant export documents along with Advance Authorisation to the DGFT authorities for obtaining Export Obligation Discharge Certificate (EODC).

After obtaining EODC, the Advance Authorisation Authorization holder produces the same before the Customs for the purpose of obtaining redemption of bond/Bank Guarantee filed by him. The concerned Commissioners of Customs and Central Excise are also required to effectively monitor the compliance with provisions of Customs Notifications. The Commissioners of Customs have also been advised to put in place an institutional mechanism whereby they meet the RLA at least once every quarter to pursue issues relating to EO fulfillment status so that the action is taken against defaulters.

In the event of failure to fulfill the EO, the Advance Authorisation holder becomes liable to pay the differential Customs duties with interest as notified on such duties. The Advance Authorization holder is required to file a bond with 100% Bank Guarantee for the duty difference at the time of import of duty free inputs. Certain categories of exporters, however, have been exempted from filing Bank Guarantees subject to certain conditions.

The Advance Authorisations normally have a validity period for fulfillment of Export

Obligation (EO) of 36 months from the date of issue with certain exceptions as per para 4.22 of HBP Vol.1. The relevant DGFT authority who issues the Authorisation is competent to grant revalidation or grant extension of EO period beyond the prescribed period.

No All Industry Rate (AIR) of Duty Drawback is admissible to an Advance Authorisation holder. However, the Advance Authorisation holder is entitled to claim Brand Rate of Duty Drawback in respect of inputs which are not imported against the

Advance Authorisation and on which Customs/Excise duties have been paid. Every advance Authorisation holder is required to maintain a true and proper account of consumption and utilisation of duty free imported/domestically procured goods for a minimum period of 3 years as per para 4.30 of HBP Vol.1.

Duty Free Import Authorisation (DFIA)

The Duty Free Import Authorisation (DFIA) scheme introduced in 2006 is similar to Advance Authorisation scheme in most aspects **except** with a minimum value addition requirement of 20%. Once export obligation is completed, transferability of authorisation/material imported against the authorisation is permitted. However, once the transferability has been endorsed, the inputs can be imported/domestically sourced only on payment of Additional Customs duty/Central Excise duty. The DFIA Authorisations are issued only for products for which SION have been notified. This scheme is operationalized through a Notification No.40/2006-Cus., dated 1-5-2006. The DFIA Scheme in the present FTP (2009-14) was operationalized by the Customs Notification No.98/2009-Cus. dt.11.09.2009.

The monitoring of export obligation is an essential ingredient of the DFIA scheme. Thus, the Commissioners of Customs have been advised to put in place an institutional mechanism whereby they meet the RLA at least once every quarter to pursue issues relating to EO fulfilment status so that the concerted action is taken against defaulters.

Further, there is a requirement that in case the facility of rebate under Rules 18 or 19(2) of the Central Excise Rules, 2002 or CENVAT facility under the Cenvat Rules, 2004 has been availed, then the duty free imported goods have to be used in the manufacture of the dutiable goods.

Reward Scheme – Served From India Scheme

Served from India Scheme (SFIS) incentivizes exports of specified goods/exports to certain countries. The objective of SFIS is to “accelerate growth in export of services so as to create a powerful and unique ‘Served from India’ brand, instantly recognized and respected world over.” SFIS is operationalised vide Notification No.91/2009-Cus., dated 11-9-2009.

All Indian service providers, who have free foreign exchange earning of at least ₹ 10/- lakhs in preceding financial year/current financial year are eligible for SFIS. For individuals, the limit of minimum free foreign exchange earnings is ₹ 5/- lakhs. Under this scheme, duty credit scrip @10% of free foreign exchange earnings are given to the exporter.

The duty credit scrip can be used for import of any capital goods including spares, office equipment and professional equipment, office furniture and consumables that are otherwise freely importable and/or restricted under ITC (HS). Imports have to relate to any service sector business of applicant. While import of vehicles per se is not permitted, vehicles in the nature of professional equipments to the service provider like Air Fire Fighting and Rescue Vehicles (AFFRVS), Heavy Duty Modular Trailer Combination etc. are permitted. In case of hotels, clubs having residential facility of minimum 30 rooms, golf resorts and stand-alone restaurants having catering facilities, duty credit scrip can also be used to import consumables including food items and alcoholic beverages.

The entitlement/goods (imported/procured) are subject to Actual User condition i.e. non-transferable (except within Group Company and managed hotels). The duty credit scrip is permitted to be utilized for procurement from domestic sources, in terms of Notification No. 34/2006-CE, dated 14-6-2006.

Reward scheme – Vishesh Krishi and Gram Udyog Yojana (VKGUY) or Special Agriculture and Village Industry Scheme

The objective of VKGUY is to promote exports of specified agricultural products, and Gram Udyog products, forest based products. The scheme is operationalized vide Notification No.94/2009-Cus., and No.95/2009-Cus., both dated 11-9-2009.

Duty credit scrips are granted @5% of FOB value of exports in free foreign exchange. This rate is reduced to 3% in cases where exporter has also availed benefits of

- (i) Drawback at rates higher than 1%; and/or
- (ii) Specific DEPB rate i.e. other than Miscellaneous Category – Sr. Nos. 22D & 22C of Product Group 90 of the DEPB Schedule; and/or
- (iii) Advance Authorization or Duty Free Import Authorization import for inputs other than catalysts, consumables and packing materials.

Some specified flowers, fruits, vegetables and other products, are entitled to an additional duty credit scrip equivalent to 2% of FOB value of exports (over and above the 5% or 3% VKGUY reduced rate entitlement).

The Status Holders, as defined in para 3.10.2 of the FTP exporting specified agricultural products are entitled to Agri. Infrastructure Incentive Scrip (AIIS) equal to 10% of FOB value of agricultural exports (including VKGUY benefits).

The following capital goods / equipments are permitted for import against AIIS: Cold storage units including Controlled Atmosphere (CA) and Modified Atmosphere (MA) stores; Pre-cooling units and Mother Storage units for Onions, etc.

- AI. Pack Houses (including facilities for handling, grading, sorting and packaging etc.);
- BI. Reefer Van/containers; and
- IV. Other capital goods/equipments as may be notified in Appendix 37F.

The goods imported against AIIS are subject to actual user condition and hence non-transferable. However, the scrips issued under AIIS are freely transferable amongst Status Holders as well as to units (not including developers) in Food Parks for import of Cold Chain equipment.

Reward Scheme - Focus Market Scheme (FMS)

The objective of this scheme is to offset high freight cost and other externalities to select international markets with a view to enhance India's export competitiveness in these countries. The scheme is operationalized vide Notification No.94/2009-Cus., and No.95/2009-Cus., both dated 11-9-2009.

The exporters of all products to countries, as notified in Appendix 37C of HBP Vol.1, are entitled for Duty Credit Scrip equivalent to 3% of FOB value of exports in free foreign exchange.

In the annual supplement to the Foreign Trade Policy, announced by DGFT on 13.10.2011, a new scheme – “Special Focus Market Scheme (SFMS)” has been introduced. Under this scheme exports to 41 countries would be incentivized with additional 1% duty credit for exports made with effect from 01.04.2011. This duty credit is over and above the duty credit granted under FMS i.e. if an item covered under FMS is exported to the countries listed under SFMS then the total duty credit would be @4%.

In terms of Notification No. 93/2009-Cus., dated 11-9-2009 the following categories of export products/sectors are ineligible for Duty Credit Scrip, under FMS:

- (a) Supplies made to SEZ units;
- (b) Service exports;
- (c) Diamonds and other precious, semi precious stones, gold, silver, platinum and other precious metals in any form, including plain and studded jewellery;

- (d) Ores and concentrates, of all types and in all forms;
- (e) Cereals, of all types;
- (f) Sugar, of all types and in all forms;
- (g) Crude/petroleum oil and crude/petroleum based products covered under ITC HS codes 2709 to 2715, of all types and in all forms; and
- (h) Milk and milk products covered under ITC HS codes 0401 to 0406, 19011001, 19011010, 2105 and 3501.

Reward Scheme - Focus Product Scheme (FPS)

The objective of this scheme is to incentives export of specified products notified in Appendix 37D of HBP Vol.1 to all countries (including SEZ units). The exporters are entitled for Duty Credit Scrip @ 2% of FOB value of exports in free foreign exchange.

However, Special Focus Product(s) /sector (s), covered under Tables of Appendix 37D, are eligible for Duty Credit Scrip equivalent to 5% of FOB value of exports in free foreign exchange.

Further, Focus Product(s)/sector(s) notified under Table of Appendix 37D of the HBP Vol.1 are granted additional Duty Credit Scrip equivalent to 2% of FOB value of exports in free foreign exchange over and above the existing rate for that product/sector from the admissible date of export /period specified in the public notice issued to notify the product/sector. This scheme is operationalized vide Notification No.92/2009-Cus., dated 11-9-2009.

In the annual supplement to the Foreign Trade Policy, announced by DGFT on 13.10.2011, a new scheme – “Special Bonus Benefit Scheme” has been introduced. Under this scheme 50 products of engineering, pharmaceutical and chemical sectors have been granted duty credit @ 1% of the value. This scheme will be available on exports made on or after 01.10.2011 and would automatically sunset on 31.03.2012.

The list of products at 6- digit / 8-digit levels has been given in the newly created Table in the appendix 37 D of the FPS scheme. For this para 3.15.2 of the FTP 2009-14 has been amended by Notification No.79 (RE-2010)/2009-14 dated 13.10.2011.

Reward Scheme - Market Linked Focus Products Scrip (MLFPS)

The export of products/sectors of high export intensity/employment potential (which are not covered under present Focus Product Scheme List) are incentivized at 2% of

FOB value of exports in free foreign exchange under Focus Product Scheme when exported to the Linked Markets (countries), which are not covered in the present FMS list.

Reward Scheme - Status Holders Incentive Scrip (SHIS)

The Status Holders of specified sectors are provided with an extra scrip called the SHIS @ 1% of the of FOB value of exports of these sectors made during 2009-10, 2010-11 and 2011-12 **and 2012-13**. The objective of the scheme is to promote investment in upgradation of technology of some specified sectors. This scheme is operationalized vide Notification No.104/2009-Cus., dated 14-9-2009.

The SHIS is not issued to the exporters in a particular year if they have in that year availed the benefits of Technology Upgradation Fund Scheme (TUFS) or/and have got zero percent EPCG Authorisation.

The SHIS is issued with actual user condition and may be used for imports of capital goods (as defined in FTP) relating to certain specified sectors.

Expired/abolished Export Promotion Schemes whose Scrips / Certificates are still in use

There are some Export Promotion Schemes that have expired and no longer in vogue, but imports against scrips issued to beneficiaries of these schemes are continuing and hence their monitoring becomes important.

Duty Free Credit Entitlement (DFCE) Scheme

This scheme for status holders was announced on 31-3-2003 whereby the status holders having incremental growth of more than 25% in FOB value of exports subject to a minimum export turnover of ₹ 25 crores, were entitled to duty credit at 10% of the incremental growth in exports. The duty credit scrip / the goods imported against it are governed by the Actual User condition. This scheme was replaced by the Target Plus Scheme on 1-9-2004.

Target Plus Scheme (TPS)

This scheme was introduced for the Star Export Houses w.e.f. 1-9-2004 whereby the exporters were entitled to rewards in the form of duty free credit based on incremental export performance. Initially, the entitlement was 5% to 15% of the incremental growth in exports, but later w.e.f. 1-4-2005; it was reduced to 5%. The duty credit scrip/the goods

imported against it are governed by the actual user condition and can be used for import of any inputs, capital goods including spares, office equipment, professional equipment and office furniture. The scheme ended on 1-4-2006. The Customs Notification Number was 32/2005-Cus.dated 08.04.2005.

Duty Free Replenishment Certificate (DFRC) scheme

This scheme permitted duty free import (exemption from only Basic Customs duty) of inputs which were used in the manufacture of export product on post-export basis as replenishment. The DFRC authorisations were issued with a minimum value addition of 25% and only in respect of export products covered under the SION notified by DGFT. The DFRC authorisation and /or material(s) imported against it are freely transferable. The scheme ended on 1-5-2006.

Duty Entitlement Pass Book (DEPB) Scheme

- a. DEPB scheme which was in operation since 1-4-1997 has come to an end on 30.09.2011. This was an export promotion scheme that envisages grant of DEPB Credit Entitlement to an exporter at the time of export at an ad-valorem rate notified by DGFT, in relation to FOB value of the export product. The DGFT had notified DEPB rates for nearly 2700 export products, which are based on the computation of basic Customs duty suffered by the exporters on the inputs listed in the SION applicable to the export product. The crucial feature of the DEPB scheme was that all the inputs listed in the SION are deemed to have been imported and to have suffered Customs duties. The

DEPB Scheme was operationalised vide Notification No.97/2009-Cus., dated 11-9-2009.

- b. The normal validity period of a DEPB scrip is 12 months.
- c. The DEPB scrip and/or the items imported against it are freely transferable. Import against DEPB scrips is allowed at the port specified in the DEPB which is the port from where exports have been made. Imports from a port other than the port of export are also allowed under Telegraphic Release Advice (TRA) facility as per the terms and conditions of the notification issued by Department of Revenue.
- d. No Duty Drawback is allowed on exports made under DEPB scheme.

However, in cases where CVD is paid in cash on imported inputs, or where indigenous duty paid inputs, not specified in SION, are used in the manufacture of export product,

Brand Rate of Duty Drawback is admissible provided CENVAT credit in respect of such duty incidence is not availed.

Special Provisions

The following exports categories /sectors are ineligible for Duty Credit Scrip entitlement under VKGUY, FMS, FPS (including MLFPS) and Status Holders Incentive Scrip schemes:

- (a) EOUs / EHTPs / BTPs who are availing direct tax benefits / exemption;
- (b) Export of imported goods covered under Para 2.35 of FTP;
- (c) Exports through transshipment, meaning thereby that exports originating in third country but transshipped through India;
- (d) Deemed Exports;
- (e) Exports made by SEZ units or SEZ products exported through DTA units; and
- (f) Items, which are restricted or prohibited for export under Schedule-2 of Export Policy in ITC (HS).

For computation of Duty Credit Scrip Benefits, FOB Value of Exports (in free foreign exchange) shall include up to 12.5% Foreign Agency Commission. Duty Credit Scrip and items imported against it are freely transferable.

However, Duty Credit Scrip issued under DFCE scheme, TPS, SFIS and SHIS are not freely transferable. Capital goods provided same is freely importable and / or restricted under ITC (HS). Duty Credit Scrips can also be utilized for payment of duty against imports under EPCG scheme provided the item is importable against the scrip.

Additional customs duty/excise duty paid in cash or through debit under Duty Credit scrip can be adjusted as CENVAT Credit or Duty Drawback, except under SFIS. Utilization of Duty Credit Scrip for imports from a port other than port of registration is allowed under Telegraphic Release Advice (TRA).

The benefit of only one Reward scheme can be claimed against a shipment. The exporter has to declare his intention to claim the benefit of the reward schemes, in case of duty free shipment, at the time of export. Utilization of Duty Credit Scrip is permitted for payment of duty in case of import of capital goods under lease financing.

Transfer of export performance from one to another is not permitted. However, for VKGUY, FMS and FPS (including MLFPS), benefits can be claimed either by the supporting manufacturer (along with disclaimer from the company / firm who has realized the foreign exchange directly from overseas) or by the company / firm who has realized the foreign exchange directly from overseas.

Duty Credit Scrips can also be used / debited towards payment of Customs Duties in case of EO defaults under Authorizations issued under Chapters 4 and 5 of the Foreign Trade Policy. However, penalty / interest shall be required to be paid in cash.

Export Promotion Capital Goods (EPCG) Scheme

Under EPCG scheme, import of capital goods which are required for the manufacture of resultant export product specified in the EPCG Authorization is permitted at nil/ concessional rate of Customs duty. This Scheme enables upgradation of technology of the indigenous industry. For this purpose EPCG Authorizations are issued by RA (Regional Authority) of DGFT on the basis of nexus certificate issued by an independent chartered engineer.

At present the EPCG Authorization holder is permitted to import capital goods at 0% or 3% Customs duty. Under the 0% duty EPCG scheme the Authorization holder is required to undertake export obligation (EO) equivalent to 6 times of the duty saved amount on the capital goods imported within a period of 6 years reckoned from the date of issue of Authorization. Under the 3% duty EPCG scheme, the Authorization holder has to fulfill EO equivalent to 8 times of the duty saved amount on the capital goods imported in 8 years.

EO under the scheme is to be over and above the average level of exports achieved by the authorization holder in the preceding three licensing years for the same and similar products.

EPCG Authorizations are issued to manufacturer exporters and merchant exporter with or without supporting manufacturer, and service providers. EPCG scheme is also available to a service provider who is designated/ certified as a Common Service Provider (CSP) by the DGFT or State Industrial Infrastructural Corporation in a Town of Export Excellence. EPCG authorization issued to a CSP gives details of the users and the quantum of EO which each user has to fulfill. The CSP as well as the specific users are under an obligation to fulfill the export obligation under the scheme.

The EPCG Authorization specifies the value/quantity of resultant export product to be exported against it. In the case of manufacturer/merchant/service exporters, such EO is required to be fulfilled by exporting goods manufactured or capable of being manufactured or services rendered by the use of capital goods imported under the scheme. Up to 50% of the EO may also be fulfilled by export of other goods manufactured or service(s) provided by the importer or his group company or managed hotel, which has the EPCG Authorization, subject to the condition that in such cases, additional EO imposed shall be over and above the average exports achieved by the importer or his group company or managed hotel in preceding three years for both the original and the substitute product(s)/service(s). In order to ensure fulfillment of specified EO as also to secure interest of revenue, the EPCG Authorization holder is required to file bond with or without bank guarantee with the Customs prior to commencement of import of capital goods. Bank guarantee equal to 100% of the differential duty in case of merchant exporters and 25% in case of manufacturer exporters is required to be submitted except in case of a few exempted categories.

EPCG Authorization can also be obtained for annual requirement with a specific duty saved amount and corresponding EO. It indicates the export products through which EO shall be fulfilled.

Capital goods imported under EPCG scheme are subject to actual user condition and the goods imported cannot be transferred/sold till the fulfillment of EO. In order to ensure that the capital goods imported under EPCG scheme are utilized in the manufacture of resultant export product, after importation/clearance of capital goods from Customs, the Authorization holder is required to produce certificate from the jurisdictional Central Excise Authority or Chartered Engineer confirming installation of such capital goods in the declared premises. A period of 6 months is allowed for the purpose of installation of capital goods and commencement of production. This period may be extended by the Assistant/Deputy Commissioner of Customs.

The normal validity period of zero duty EPCG Authorization is 9 months and that of 3% EPCG Authorization is 24 months. RA concerned may revalidate authorization for six months at a time and maximum up to 12 months from the date of expiry of validity. In order to ensure proper account of fulfilment of EO, the EPCG Authorization holder is required to indicate the EPCG Authorization No./date on the body of the Shipping Bill/ invoice (in case of deemed exports). After fulfilment of specified EO, the Authorization holder submits relevant export documents along with EPCG

Authorization to the DGFT authorities for the purpose of obtaining EO discharge certificate. After obtaining EO discharge certificate from DGFT, the Authorization holder

produces the same before Customs for the purpose of obtaining redemption of bond/BG filed by him. In order to ensure that the Authorization holder maintains a specified level of EO throughout the EO period of 6/8 years, in addition to average EO, block wise EO is also specified.

The Licensing Authority or RA can grant extension of block-wise period for any block(s) or overall period of fulfilment of EO up to a period of two years on payment of composition fee equal to 2% of proportionate duty saved amount on unfulfilled EO for each year of extension. The RA grant further extension in the overall period of EO up to a period of further two years if the authorization holder pays 50% of differential duty on the unfulfilled portion of EO and agrees to fulfill other conditions as may be specified by the RA for this purpose. However, for zero duty EPCG scheme only one extension of two years in EO period shall be available subject to conditions mentioned above.

Exports in discharge of EO under the EPCG scheme are entitled to duty neutralization schemes like Drawback, Advance Authorization, DFIA etc. as well as benefits of reward schemes such as FPS, FMS, and VKGUY etc. in accordance with the terms and conditions of those scheme(s). However, benefits of TUFS and SHIS will not be available in the year in which the zero duty authorisation has been issued.

Since this scheme permits import of capital goods at nil/concessional Customs duties subject to conditions specified in the Customs notifications, monitoring of fulfilment of EO is essential, the Customs are directed to put in place a mechanism to effectively monitor all imports under the EPCG scheme and take action to recover the Customs duty in case of default.

Further, they should maintain close liaison with the Regional Licensing Authority (RLA) of the DGFT. The Commissioners of Customs have also been advised to put in place an institutional mechanism whereby they meet the RLA at least once every quarter to pursue issues relating to EO fulfilment status so that the concerted action is taken against defaulters.

General Provisions of Export Promotion Schemes

Imports and exports under the Export Promotion schemes are restricted to limited ports, airports, ICDs and LCSs, as specified in the respective Customs duty exemption notifications. However, the Commissioners of Customs are empowered to permit export/import under these schemes from any other place which has not been notified, on case to case basis by making suitable arrangements at such places.

Facility of executing Common bond by Authorization Holders for specified export promotion schemes [Advance Authorization / Duty Free Import Authorization (DFIA) / Export Promotion Capital Goods (EPCG)] has been extended by Circular No.11(A)/ 2011-Cus. dated 25-2-2011.

Re-credit of duty credit scrips, in respect of re-export of goods imported using reward/DEPB scrips, which was earlier permitted when imported goods were found defective/unfit for use, has been extended to re-export for any other reason, subject to fulfilment of specified conditions w.e.f. 14.01.2011.

Clearance of goods from Custom Bonded warehouses utilizing duty credit scrips of SFIS, VKGUY, FMS.FPS, SFIS has been allowed under the same procedure as prescribed for DEPB scrips.

Supporting Institutions

To achieve the target of 1 percent share in the world merchandise trade by 2007 (EXIM Policy, 2002-07, government of India) to enhance foreign exchange earnings by promoting exports and to promote hassle free export activity the government of India has been eyeing upon the emerging concepts viz. Export Oriented Units, Electronic Hardware Technology Park (EHTP), software Technology Parks (STPs), Export Processing Zones (EPZs) and more specifically on Special Economic Zones (SEZs). The dazzling achievements of Singapore, the Shenzhen of China and Nantex of Taiwan, which have been a lure for Indian industry and planners for decade is now materializing as the industry wants the same success story to be repeated in India like China. The first part of the chapter discusses all like this.

Also, when thinking of achieving the export targets India can't ignore to think about small and medium scale exporters. The intuitional support for small exporters is discussed in next part of this chapter tries to hold the right pulse of India's International trade. Final section of this chapter deals with the infrastructural support – roads, ports, railway as infrastructure bottlenecks are posting a major challenge to India's ambitious export plan.

Export Oriented Units (EOUS), Units in Export Processing Zones (EPZS), Electronic Hardware Technology Parks (EHTPS), Software Technology Parks (STPS)

Eligibility, Export & Import

Units undertaking to the export their entire production of goods and services may be set up under the Export Oriented Units (EOU) Scheme, EPZ Scheme, EHTP or STP

Scheme such units may engaged in manufacturing, providing services, repair, remaking, reconditioning, re-engineering including making of gold/silver/platinum and articles thereof, agriculture including agro-processing, aquaculture, bio-technology, horticulture, viticulture, sericulture, pisciculture, poultry and granites and may export all products except restricted items of exports in ITC (HS). Units for generation / distribution of power may also set up in EPZs; however, no trading unit shall be permitted.

An EOU/EPZ/EHTP/STP unit may export goods and services (Including by products, rejects, wastes scarp) and may import without payment of duty on all types of goods (Including Capital Goods and second hand capital goods).

Net Foreign Exchange Earnings as a Percentage of Exports, Letter of Intent and Legal Undertaking

The minimum Net Foreign Exchange earnings as a percentage of Exports (NFEP) and the minimum Export Performance (EP) shall be as specified in annexure 8.1 items of manufacture for export specified in the letter of permission (LOP) Letter of Intent (LOI) alone shall be taken into account for calculation of NFEP and EP.

On approval, a Letter of Permission (LOP)/ Letter of Intent (LOI) shall be issued by the Development Commissioner to EOU/EPZ/EHTP/STP Unit. The LOP / LOI shall have an initial validity of 3 years. Its validity may be extended by another 3 years, beyond initial validity, by the competent authority. However, proposal approved prior to 01/04/2002 shall be considered on case to case basis by the Board of Approval.

LOP/LOI issued to EOU/EPZ/EHTP/STP units by the concerned authority would be constructed as a license for all purposes, including for procurement of raw-materials and consumables either directly or through designated state trading enterprise.

The unit shall execute a legal undertaking with the Development Commissioner concerned and in the event of failure to fulfill the performance; it would be liable to penalty in terms of legal undertakings or under any other law from the time being in force.

Application and Approvals

Only project having an investment of not less than ₹ 50 lakhs and above in building, plant & Machinery shall be considered for establishment under EOU scheme. (This shall however, not apply to existing units and units in EPZ/EHTP/STP/Agriculture/Floriculture/Aquaculture/Animal Husbandry/ information technology, handicrafts, services and such

other sectors as may be decided by the BOA). Applications for setting up of EOU/EPZ/EHTP/STP units, satisfying the conditions mentioned in the paragraph 6.7 of the Handbook (Vol.1) may be approved by the concerned Development Commissioner within 15 days.

In other cases, approval may be granted by the Board of Approval (BOA) set up for this purpose. Proposals requiring industrial license may be considered by the board of approval on a case to case basis.

Entitlements

- An EOU/EPZ/EHTP/STP unit may export goods manufactured by it through a merchant exporter / status holder recognized under the EXIM policy or any other EOU/EPZ/EHTP/STP /SEZ.
- Supplies from the (Domestic Tariff Area) DTA to EOU/EPZ/EHTP/STP units will be regarded as “deemed exports” and the DTA supplier shall be eligible for the relevant entitlements (under paragraph 8.3 of Exim policy, 2002-07).
- The EOU/EPZ/EHTP/STP units shall be entitled for the following:
 - i. Reimbursement central sales tax
 - ii. Exemption from the payment of central excise duty on all goods as per entitlement.
 - iii. Reimbursement of central Excise duty paid on bulk tea procured from licensed auction centers by Development Commissioner of concerned zone so long as levy on bulk tea in this regard is in force.
 - iv. Reimbursement of duty paid on fuels procured from domestic oil companies, be the Development Commissioner of the concerned zone as per the rate of drawback notified by the DGFT from time to time.
 - v. EOU/EPZ, gem and jewellery units shall be entitled for participation in exhibitions abroad with the permission of Development Commissioner, export branded jewellery (For display / sale in the permitted shops abroad and export through showrooms abroad and duty free shops)
- No license are required for import / Domestic procurement
- Such units can repatriate their profits freely without any dividend balancing requirement.
- Such unit has freedom to sub-contract part of the production and production process in the domestic area.

- EOU/EPZ/EHTP/STP units can be clear goods upto 50 percent of the value of export in the domestic area on the concessional duty. Also such units are exempted from industrial licensing for manufacture of items reserved for small scale industry sector.
- Supplier of cut and polished diamonds, precious and semi-precious stones, synthetic stones and processed pearls from DTA to EOU/EPZ units shall be eligible for grant of Replenishment licenses at rates and for the items mentioned in Handbook (Vol. 1).
- Rejects (Waste) may be sold in the DTA on payment of duties as applicable. Sale of rejects upto 5% of FOP value of exports shall not be subject to achievement of NFEP.

Bonding and De Bonding

The initial bonding period for units under the EOU/EHTP/STP schemes shall be 5 years, which may be extended by the Development Commission concerned for a period of 5 years at a time. Subject to the approval of the Development Commissioner, EOU/ EPZ/ EHTP/ STP units may be de bonded such de bonding shall be subject to payment of duties of customs and excise and the industrial policy in force at the time of de bonding.

Confederation of 100 Percent Export Units (CEU) and EPCES CEU

Confederation of 100 percent export units (CEU), non-profit registered society, was established in 1982 specifically to service the promotional needs of 100% EOU. CEU is the apex industry organization with exclusive focus on export promotion. Its chief activities includes:

- i. Convening meetings, conferences, seminars workshops and round table conference to promote export production and to serve business interests.
- ii. Maintaining overseas liaison with international and UN agencies like ITC, GATT, UNCTAD, ESCAP, UNIDO, IMF, World Bank, ADB and ILO and establishing rapport with overseas chamber of commerce, trade associations, etc.
- iii. Sponsoring special projects related to the promotion of 100% EOU and EPZ units.

EPCES

The newly set-up export promotion council for 100%EOUs and SEZs (EPCES) have grown into a proper council. The body now has a corpus of nearly ₹ 1 crore built from the contribution of 1500 top exporters drawn from all major export groups. EPCES is the

commerce ministry instrument to promote the 23 SEZs in various stages of implementation (Hardware and software technology parks are not the part of council even as they are based on the pattern of EOU and SEZ scheme)

Special Economic Zones

An Introduction

The Desi favour of fancying the new and pilling on en bloc is now happening to Special Economic Zones (SEZs) which in any case has been a concept long in coming to give strong fillip to the industrialization efforts of the country. How far the dreams of India could materialize depends very much on the success of emerging zones and intuitions’.

The International Confederation of Free Trade Unions (ICFTU) defines EPZs/SEZs as: “a clearly demarcated industrial zone, which constitutes a free trade enclave industrial zone, which constitutes a free trade enclave outside a country’s normal customs and trading system where foreign enterprises where produce principally for export benefit from certain tax and financial incentives.

India’s EXIM Policy Defines SEZ as:

“Special Economic Zones is a specifically delineated duty free enclave and shall be deemed to be foreign territory for the purpose of trade operations and duties and tariffs”.

Goods going to the SEZ area from DTA shall be treated as deemed exports and goods comings from the SEZ area into DTA shall be treated as if the goods are being imported. SEZ units may be set up for manufacture of goods and rendering of services, production, processing, assembling, trading, repair, remaking, reconditioning, and re-engineering including making of gold / silver / platinum jewellery and articles thereof or in connection therewith.

Origin

The drawn of the new millennium saw the birth of SEZs which take on from all the previous concepts for individual development through encouragement to high tech. industry and foreign investment.

The then union commerce and industry minister Mr.Murosoli Maran while announcing the new EXIM policy on 31st March, 2000 came up with a new concept of

establishment of Special Economic Zone by merging the concept of free trade zones and Export Processing Zones. Thus in 2000, with a view to provide an internationally competitive and hassle free environment for export production SEZ schemes was introduced.

The Exim policy provides for setting up of SEZs in the public, private, joint sector or by state governments. It was also envisaged that some of the existing EPZs would be converted into SEZ. Accordingly, the EPZs at Kandla and Surat (Gujarat), Santa Cruz (Maharashtra) and Cochin (Kerala) were converted into SEZs. SEZs is under administrative control of the Development of Commissioner.

Objectives

- To enhance foreign exchange earnings by promoting exports
- To attract Foreign Direct Investment and induce technology transfers
- To generate employment opportunities and assist in income generation
- To develop and foster internationally competitive and hassle free environment for exports
- To attract investment in export production and to boost exports.

Functional and Approved SEZs so far

At present 8 Special Economic Zones are operational in India of which 4 were EPZs, which were converted to SEZ as per the Exim policy. They are:

- i. Kandla SEZ, in Gandhidham, Gujarat (Multi-Product SEZ, Spread over 700 acres of land area).
- ii. SEEPZ SEZ, in Mumbai, Maharashtra (For Electronic and gems and Jewellery Spread over 93 acres of land area)
- iii. Cochin SEZ, in Cochin, Kerala (Multi – Product SEZ Covering 103 acres)
- iv. Surat SEZ is a private Sector developed multi-Product SEZ covering 103 acres of land area and other four are: Madras SEZs, Vishakapatnam SEZ, Falta SEZ and Noida.

The Government also have approved 27 other SEZs. Some of green field SEZs approved by Government includes – Positra SEZ (Gujarat), Nanguneri SEZ (Tamil Nadu), Bhadohi SEZ (UP), Dronagiri SEZ (Maharashtra), Kakinado SEZ (Hyderabad), Paradeep and Gopalpur SEZ (Orissa), Kupli SEZ (Kolkata) and Indore SEZ (MP).

The new SEZs are integrated townships comprising of a SEZ Developer, who is usually a finance rich multinational infrastructure development company. As per the notification which came into effect from 15 August, 2003, the SEZ is divided into processing area for exports by approved SEZ unit, and the non-processing area under the developer who provides utility services to the processing area. The SEZ unit as well as the developer enjoy the privileges of duty free and control free export and import. The key decision like division of the zone into processing and non-processing areas lies with customs commissioner.

Important Incentives for SEZ Units

- The Government of India has exempted SEZ Units from import duties and income tax to promote exports. Units in SEZs are eligible for an income tax break on export profits for 20 years, with deduction equivalent to 100% of exports for the first five years. SEZ units are also entitled to custom duty and excise concessions on the input source by them.
- No license required for imports
- All activities on self – certification basis.
- Offshore Banking Units (OBUs) allowed in SEZs.
- An 100% EOU or any other unit with an export turnover of ₹ 50 crore will be allowed to function as virtual SEZ. A virtual SEZ Unit will be outside the physical boundaries of SEZ, but all the fiscal benefits for SEZ will be extended to virtual SEZs.
- 100% Foreign Direct Investment in manufacturing sector allowed through automatic route barring a few sectors.
- Facility to realize and repatriate export proceeds within 12 months.
- Full freedom for sub-contracting including sub-contracting abroad.
- In house custom clearance.
- No routine examination required for customs and Exim policy.
- No fixed wastage norms.
- SEZ shall be positive net foreign exchange counter. Net Foreign Exchange Earnings (NFE) shall be calculated cumulatively for a period of five years from the commencement of commercial production (as per the rules).
- SEZ unit shall be entitled for reimbursement of control sales tax
- Inter-unit transfer of goods, including partly processed / semi- finished goods from one SEZ unit to another unit will be allowed.
- Single window regulatory clearance.

Key Reforms Needed to Change Indian SEZs' Face

The success of SEZ is revealed by the success stories in international trade of many prominent countries implementing the dazzling concept of the SEZ. The Govt. of India also conscious of the fact that SEZ can do miracles for India's Exports. The operating SEZs in India logged on average export growth of 46% in dollar terms and 39% in rupee terms in 2003-04, as against the overall export growth of 17% and 11% in the year. Exports from SEZs in 2003-04 stood at \$3038 million (₹ 14,004 Crore) in 2003-04 as against \$2079 million (₹ 10,057) Crore) in the year before. Yet, the share of SEZs in the overall exports are quite low at just over 3%. In comparison, 23% of UAE's total exports are from the SEZs.

Out of the 27 approved SEZs many have not yet started. Many SEZs were bogged down due to delays in land acquisition.

Key Areas of Reform

To develop success stories, these reforms and steps should be taken by the Government with respect of SEZs:

a) Legal and Bureaucratic Changes

- Business friendly labour laws should be enforced just like China.
- A new labor law incorporating a work ethic, removing contract labor restrictions, freedom for multiple and night shift for workers of both sexes and designation of development commissions as labor commissioner is needed.
- Elimination of price control and distribution control (on power) is needed.
- Also needed are removal of capital account restrictions / Controls / prior permission for businesses operating within the SEZ.
- Unified industrial regulator, i.e. only one inspector for all continuing industrial regulations including pollutions and labor safety, is needed.
- Reduction of red tape and bureaucratic procedures is strictly needed.
- There is a need of stable, efficient and transparent policy.

b) Focus on incentives

- SEZ should be exempted from MAT and Dividend Tax
- No excise /CST/ST/Octroi should be charged for sales from DTA to SEZs

- There should be free entry and exit of telecom service providers into SEZ without any charges, subject only to the condition that the spectrum would be auctioned if and only if it ceases to be “free good” within the SEZ.
- Interconnectivity with other countries (ICD) should be free and unrestricted (subject to; that this cannot be used as a conduit for provision of unregulated telecom services into the DTA).
- Granting incentives in a streamline manner.

c) Developing Sector Specific Economic Zones

Sector Specific Economic Zones should be developed to harness locational advantages, local skills and infrastructure (For example, SEEPZ which focuses on Electronics and gems and Jewellery).

d) Developing linkages between SEZ and Domestic industry

- By sourcing raw materials from domestic sources.
- By developing local partnership through shared technology and investment in human resource.
- Developing Nodal Agency to act as a Facilitator and Catalyst to
- Aid in improving quality, productivity, R&D and other cater to training requirement.
- Act as a one step service to provide assistance in identification of investment opportunities, site location and obtaining clearances. Examples of nodal agencies which are already operating in other countries includes:
 - I. Mauritius Export Processing Zones Development Authority (MEPZDA).
 - II. Bangladesh Export Processing Zones Authority (BEPZA).

e) Involvement of Public Private Parties

- Law should be passed by the states which 100% privately owned townships can be set and run by private developers as private municipalities. Private SEZs should be designated as private municipalities under this, and road, electricity and other links should be provided by Government.
- Government should also undertake feasibility studies before the commencement of any SEZ. The role of Government should be clearly defined.

- Size of SEZ should be considered necessarily as large size generate economics of scale.

Thus, by following all these steps, definitely Indian SEZs can emerge as benchmark for other and can therefore change the whole picture of India's exports.

Promotional Measures of EXIM Policy 2004-2009

The Government of India has set up several institutions whose main functions are to help an exporter in his work. It would be advisable for an exporter to acquaint him with these institutions and the nature of help that they can provide so that he can initially contact them and have a clear picture of what help he can expect of the organized sources in his export effort. Some of these institution are as follows.

- a) Export Promotion Councils
- b) Commodity Boards
- c) Marine Products Export Development Authority
- d) Agricultural & Processed Food Products Export Development Authority
- e) Indian Institute of Foreign Trade
- f) India Trade Promotion Organization (ITPO)
- g) National Centre for Trade Information (NCTI)
- h) Export Credit Guarantee Corporation (ECGC)
- i) Export-Import Bank
- j) Export Inspection Council
- k) Indian Council of Arbitration
- l) Federation of Indian Export
- m) Organizations
- n) Department of Commercial Intelligence and Statistics
- o) Directorate General of Shipping
- p) Freight Investigation Bureau

Duty Exemption / Remission Schemes of EXIM Policy 2004-2009

The Duty Exemption Scheme enables import of inputs required for export production. It includes the following exemptions-

Duty Drawback

The Duty Drawback Scheme is administered by the Directorate of Drawback, Ministry of Finance. Under Duty Drawback scheme, an exporter is entitled to claim Indian Customs Duty paid on the imported goods and Central Excise Duty paid on indigenous raw materials or components.

Excise Duty Refund

Excise Duty is a tax imposed by the Central Government on goods manufactured in India. Excise duty is collected at source, i.e., before removal of goods from the factory premises. Export goods are totally exempted from central excise duty.

Octroi Exemption

Octroi is a duty paid on manufactured goods, when they enter the municipal limits of a city or a town. However, export goods are exempted from Octroi. The Duty Remission Scheme enables post export replenishment/ remission of duty on inputs used in the export product.

DEPB

Duty Entitlement Pass Book in short DEPB

Rate is basically an export incentive scheme. The objective of DEPB Scheme is to neutralize the incidence of basic custom duty on the import content of the exported products.

DFRC

Under the Duty Free Replenishment Certificate (DFRC) schemes, import incentives are given to the exporter for the import of inputs used in the manufacture of goods without payment of basic customs duty. Duty Free Replenishment Certificate (DFRC) shall be available for exports only up to 30.04.2006 and from 01.05.2006 this scheme is being replaced by the

Duty Free Import Authorisation (DFIA)

DFIA: Effective from 1st May, 2006, Duty Free Import Authorisation or DFIA in short is issued to allow duty free import of inputs which are used in the manufacture of the

export product (making normal allowance for wastage), and fuel, energy, catalyst etc. which are consumed or utilised in the course of their use to obtain the export product. Duty Free Import Authorisation is issued on the basis of inputs and export items given under Standard Input and Output Norms (SION). Export Oriented Units (EOUs), Electronics Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) And Bio-Technology Parks (BTPs) of Exim Policy 2004-2009. The Export Import Policies relating to Export Oriented Units (EOUs) Electronics Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Bio-technology parks (BTPs) Scheme is given in Chapter 6 of the Foreign Trade Policy. Software Technology Park (STP)/Electronics Hardware Technology Park (EHTP) complexes can be set up by the Central Government, State Government, Public or Private Sector Undertakings. Export Promotion Capital Goods Scheme (EPCG) of Exim Policy 2004-2009.

Introduced in the EXIM policy of 1992-97

Export Promotion Capital Goods Scheme (EPCG) enable exporters to import machinery and other capital goods for export production at concessional or no customs duties at all. This facility is subject to export obligation, i.e., the exporter is required to guarantee exports of certain minimum value, which is in multiple of total value of capital goods imported.

Capital goods imported under EPCG Scheme are subject to actual user condition and the same cannot be transferred /sold till the fulfillment of export obligation specified in the licence. In order to ensure that the capital goods imported under EPCG Scheme, the licence holder is required to produce certificate from the jurisdictional Central Excise Authority (CEA) or Chartered Engineer (CE) confirming installation of such capital goods in the declared premises.

Special Economic Zone (SEZ) under the Exim Policy 2004-2009

A Special Economic Zone in short SEZ is a geographically distributed area or zones where the economic laws are more liberal as compared to other parts of the country. SEZs are proposed to be specially delineated duty free enclaves for the purpose of trade, operations, duty and tariffs. SEZs are self-contained and integrated having their own infrastructure and support services.

The area under 'SEZ' covers a broad range of zone types, including Export Processing Zones (EPZ), Free Zones (FZ), Industrial Estates (IE), Free Trade Zones (FTZ), Free Ports, Urban Enterprise Zones and others.

In Indian, at present there are eight functional Special Economic Zones located at Santa Cruz (Maharashtra), Cochin (Kerala), Kandla and Surat (Gujarat), Chennai (Tamil Nadu), Visakhapatnam (Andhra Pradesh), Falta (West Bengal) and Noida (Uttar Pradesh) in India. Further a Special Economic Zone at Indore (Madhya Pradesh) is also ready for operation.

a) Free Trade & Warehousing Zones of Exim Policy 2004-2009

Free Trade & Warehousing Zones (FTWZ) shall be a special category of Special Economic Zones with a focus on trading and warehousing. The concept of FTWZ is new and has been recently introduced in the five-year foreign trade policy 2004-09. Its main objective is to provide infrastructure for growth of the economy and foreign trade.

Free Trade & Warehousing Zones (FTWZ) plays an important role in achieving global standard warehousing facilities as free trade zones. Free Trade & Warehousing Zones is a widely accepted model with a history of providing Substantial encouragement to foreign trade and warehousing activity.

Deemed Exports under the Exim Policy 2004-2009

Deemed Export is a special type of transaction in the Indian Exim policy in which the payment is received before the goods are delivered. The payment can be done in Indian Rupees or in Foreign Exchange. As the deemed export is also a source of foreign exchange, so the Government of India has given the benefit duty free import of inputs.

The growing trade deficit since 2008 can be attributed to destination wise collapse of India's exports. Trade with US, EU and Asia (India's most important trading partners) fell considerably during the year 2009, with the least being in case of Asia.

As a result, the value of export reduced from \$ 189001 million during 2008-09 to \$ 189442 million during 2009-10.

During the same period of economic crisis, our import bill too declined from \$ 308520 million to \$ 300644 million. This fact certifies the phenomenon that Indian trade flows was hit by the global crisis, but with a lag. However, Indian economy could find way out of the crisis driven path to the recovery as a result of various measures implemented by the Reserve Bank of India.

b) Emerging Role of Invisibles and Software Services in Balance of Payments

India's balance of payments, which is built up of a large trade deficit sustained by large positive invisible inflows, is truly a miracle of the new service-oriented global economy. The liberalized environment has made India's services attractive to the new IT dependent sector of the developed countries. The trade deficit is financed largely by net invisible earnings consisting of remittances from expatriates and software. The importance of invisibles in the BoP is increasing in the post reform period.

A notable development found in the performance of India's current account is the growing contribution of the invisibles. Among the three components such as services, transfers and income, the largest surplus is generated by the services followed by transfers while income flow is greater from India adding net deficit in the BoP account. The net invisible to the current account was deficit during 1990-91 worth \$ 242 million.

However, the post reform period witnessed rapid growth in this category contributing a large surplus to India's BoP account. This surplus though not enough to eliminate the merchandise deficit, could contribute significantly to neutralize the magnitude of the impact of the huge deficit. From 2001-02 onwards, the growth of invisibles was at very high rate. Interestingly, it grew from \$ 14974 million during 2001-02 to \$ 91605 million during 2008-09. The very next two consecutive years, global crisis affected the net flow of invisibles as the surplus from it declined to \$ 80022 million and \$ 84648 million respectively.

However, 2011-12 figures show that net invisibles in the current account is positive and very high in value i.e. \$ 111604 million. It can be found that value has almost doubled within a gap of just 6 years.

The mounting share from software services shows another optimistic external sector picture. Software services include the software related services offered by Indian IT professional to foreigners including those done by the IT parks. Notable feature is that the credit from this.

item is very huge say for instance, during 2011-12, it stood at \$ 62212 million while the debit i.e., the amount we pay out for foreign software services was only a meager figure - \$ 1256 million only. The growth of India's IT sector especially during the period of globalization turned favorably.

The growth of software services earnings is a recent development in the reform period. India possesses huge manpower professionally equipped with software services

potentials who find the way in earning foreign exchange by exporting the services. The NASSCOM data exhibits the growing share of software services in India's current account balance. The Total software services exports was only \$754 million during 1995-96.

The total software export contribution increased unbelievably in the years of economic liberalization. The earnings from software services multiplied several times within a decade of time i.e., it increased from \$ 7556 million during 2001-02 to \$ 60956 million during 2011-12. The growth rate was steady and above 10 percent during every year despite the global challenges put forward by the so called financial crisis. Interestingly the debit in this item is very narrow say \$ 1256 million during 2011-12 that declined from \$2267 million during 2006-07. United States remained the major destination for software services exports from India. c) Unhealthy trends in Foreign Direct Investment

Foreign direct investment (FDI) has played an important role in the process of globalization during the past two decades. The rapid expansion in FDI by multinational enterprises since the mid-eighties may be attributed to significant changes in technologies, greater liberalization of trade and investment regimes, and deregulation and privatization of markets in many countries including developing countries like India.

The widening gap of deficit in India's current account is always compensated by the surplus accumulated in capital account. Major components in the capital account are foreign investment and borrowings. There are several studies revealing the relevance of FDI in the economy. Some of the literature reviews are worth mentioning at this moment. FDI plays a multidimensional role in the overall development of host economies.

It is widely discussed in the literature that, besides capital flows, FDI generates considerable benefits. These include employment generation, the acquisition of new technology and knowledge, human capital development, contribution to international trade integration, creation of a more competitive business environment and enhanced local/ domestic enterprise development, flows of ideas and global best practice standards and increased tax revenues from corporate profits generated by FDI (Klein et al., 2001; Tambunan, 2005) FDI in manufacturing is generally believed to have a positive and significant effect on a country's economic growth (Alfaro, 2003).

Total FDI inflows into India during 1991-92 were only \$ 129 million. There was gradual increase in inflows during that decade and it reached \$ 6130 million during 2001-02. Though the inflow fluctuated during first part of 2000s the year 2006-07 witnessed 154 percent hike in inflow which is treated as the highest in the last two decades.

However, during the global recession the inflow was negatively affected showing negative growth during 2009-10 and 2010-11. The Indian economy regained confidence of the foreign investors during 2011-12 attracting \$ 49007 million. The huge sum of FDI inflow is contributing significantly in reducing the deficit in

India's current account and maintaining surplus in overall balance of payment account.

FDI inflow into India (US \$ million)

Year	FDI inflow	Annual growth rate of FDI inflow	FDI outflow	Annual growth rate of FDI outflow
2000-01	4029	---	829	---
2001-02	6130	52.1	1490	80
2002-03	5035	-17.9	1892	27
2003-04	4322	-14.2	2076	10
2004-05	6051	40.0	2309	11
2005-06	8961	48.1	6083	163
2006-07	22826	154.7	15897	161
2007-08	38844	70.2	21429	35
2008-09	41903	7.8	20634	-4
2009-10	38484	-8.2	20518	-1
2010-11	35464	-7.9	26104	27
2011-12	49007	38.2	26947	3

Source: Reserve Bank of India (2012)

Along with mounting credits in foreign investment account, there is growing debits in it in the form of capital outflow. It can be noted that the total outflow of FDI from India was only \$829 million during 2000-01. Until 2004-05, the growth rate of outflow was moderate but thereafter, the FDI outflow increased significantly. During last five years, the outflow stood above \$ 20000 million which seems unhealthy for India capital account is concerned. The logic behind this trend is that Indian companies are reaching overseas destinations to tap new markets and acquire technologies. Acquisitions bring with them major benefits such as existing customers, a foothold in the destination market and the niche technologies they require. Due to the rapid growth in Indian companies' M&A activity, Indian companies are acquiring international firms in an effort to acquire new markets and maintain their growth momentum, buy cutting-edge technology, develop new product mixes, improve operating

margins and efficiencies, and take worldwide competition head-on. It is noted that inflow of FDI has got very favorable impact on India's BoP balance. However, the danger alarmingly growing on the other side of the coin is in the form of outflow of FDI from India and massive withdrawal of foreign funds from the domestic economy.

Vulnerability and Challenges Ahead

Post 1991 crisis, Indian economists have managed to reduce the external debt through various strategies. They have succeeded as India withstood the global 2008 downturn well. But now, troubles are looming large over our emerging economy.

After the 2008 downturn of global economy, the vulnerability of India's external sector has increased. The latest report from Reserve Bank of India about the rising external debt is a case of worry for the government. According to the data given by the Reserve Bank of India, India's external debt stood at \$390 billion as of March 2013, which was up by 12.9 % from its previous year figure. External debt is a cumulative sum of External Commercial Borrowings (ECBs), Foreign Currency Convertible Bonds (FCCBs) and trade bill of the country. Any country's inability to repay the external debt may lead to a crisis situation and worsen our balance of payment sustainability in near future.

Yet another challenge to BoP emerges today in the form of rupee depreciation. The Indian Rupee has been losing its value against the US Dollar marking a new risk for Indian economy. Grim global economic outlook along with high inflation, widening current account deficit and FII outflows have contributed to this fall.

Though RBI has responded with timely interventions by selling dollars intermittently, in times of global uncertainty, investors prefer USD as a safe haven. To attract investments, RBI can ease capital controls by increasing the FII limit on investment in government and corporate debt instruments and introduce higher ceilings in ECB's, which may ultimately attract BoP burden on the economy. Government can create a stable political and economic environment. The depreciation of the rupee was brought about by the adverse external trade position and the depreciation of regional currencies. It was an inevitable response to the balance of payments difficulties caused by a huge trade deficit.

The deterioration in India's current account and thereby overall BoP has led to a series of debates in the policy arena relating to sustainability, the importance of exchange rates in influencing the trade balance, and the role of high and rising inflation.

Financial and Fiscal Incentives to Exporters in India

The final stage of an export procedure is to claim financial and fiscal incentives available to a registered exporter. With a view of facilitating the availability of imported materials, reducing costs, and making Indian products more competitive in International markets, the government has allowed the export assistance and incentives to registered exporters. An exporter should be well aware of various types of assistance available to him to make the exporters worth-while.

Need for Export Assistance and Incentives

India, being a developing country, faces the problem of unfavorable balance of payments. Due to several peculiar and unavoidable factors in our economy, the level of imports cannot be lowered down. India can improve the balance of payments position by increasing the level of exports. The level of exports cannot be increased unless an exportable surplus is increased after making up of domestic demand.

Therefore, government efforts are necessary to increase the exportable surplus and to get rid of or to minimize its unfavorable balance of trade situation.

The need for export assistance can be understood from the following facts:

1. **Similar markets**-in case the size of the domestic market in respect of a product is not large enough; there is ample scope for increasing production. The government assists the manufacturers to produce more on large scale production while exportable surplus.
2. **To maintain the price competitiveness**- the government offers assistance in order to maintain the price competitiveness of the producers, because as compared to the developed countries the cost of production is high in India due to high labour cost.
3. **To meet trade promotion expenditure**-

In the developing countries like India, the manufacturing units are small and have considerably less expertise in the field of international trade promotion. Therefore, per unit cost of trade promotion expenditure tends to be higher. The marketing promotion expenditure can be subsidized through government assistance. The various types of incentives to exporters have been made simple from 1992. The important schemes are as under:

Financial Incentives Available to Exporters

Besides foreign exchange facilities and incentives under the Foreign Trade Policy, 2004-09, a number of financial and fiscal incentives are also available to the exporters are as under:

1. Marketing Development Assistance (MDA)

The marketing Development Assistance (MDA) scheme is intended to provide financial assistance for a range of export Promotion activities implanted by Export Promotion Councils, industry and trade association on regular basis every year.

As per the revise MDA guidelines effective from 1st April, 2004 assistance under MDA is available for exporters with annual export turnover upto ₹ 5 crores.

These include participation in trade fairs and buyer seller meets abroad or in India, export promotion seminars, etc. Further assistance for participation in trade fairs abroad and travel grant is available to such exporters if they travel to countries in of the four focus areas, such as, Latin America, Africa, CIS Region, ASEAN countries, Australia and New Zealand.

Financial assistance would be provided to deserving exporters on the recommendation of Export Promotion Councils for meeting the cost of legal expenses relating to trade relating matters.

2. Spices Export Promotion Scheme

Under these schemes the Spices Board develops the production and exports of value added spices through spice house certification, Spices Board logo, brand promotion scheme, financial assistance for printing of brochure/folders, assistance for packaging development, reimbursement of air freight/courier charges for sending samples abroad etc.

3. Air Freight subsidy on Horticulture and Floriculture Exports

In order to make exports of horticulture (i.e. specified fresh fruits, and specified fresh vegetables) and floriculture products competitive in world market, the government grants air freight subsidy on selected fruits and floriculture items.

4. New External Marketing Assistance Scheme for Jute

The scheme envisages grant of market assistance at the rate of 5-10% of the F.O.B. value realization of export of specified diversified products. The benefit under the scheme is available to both manufacturer-exporters and merchant exporters.

5. Financial Assistance Scheme for Agricultural, Horticulture and Meal Exports

The Agricultural Products Export Development Authority (APEDA) provides assistance up to 50% of the cost of study, subjects to the ceiling of ₹ 2 lakhs, per beneficiary for undertaking feasibility studies and market survey by growers, exporters and their organisations. The surveys may be conducted to find potential export markets/accessing market requirements etc. this assistance aims at encouraging exporters, growers and trade association to develop their own market and information sources.

6. Financial Assistance for Marine Products Exports

There are number of financial assistance schemes to promote export production and marketing of products of the fisheries sector. These schemes, *inter alia*, cover all stages or aspects like farming quality control, development of production infrastructure and equipment, transportation and air freighting of samples.

7. Market Access Initiative (MAI)

Financial assistance shall be available under the scheme to the export promotion councils, industry and trade association and other legible entities, as may be notified from time to time, on the basis of the competitive merits of proposals received in this regard for the following purposes which *inter-alia* includes:

- (i) Marketing studies on country product focus approach basis
- (ii) Setting of common showrooms under one roof and warehousing facility in the identified centres on the basis of marketing studies in important cities abroad.
- (iii) Participation in sales promotion campaign through international departmental stores.
- (iv) Publicity campaign for launching identified products in selected markets.
- (v) Participation in international trade fairs, seminars, buyers- sellers meet.
- (vi) Promotion of select brands.

- (vii) Transport subsidies for select agriculture products.
- (viii) Registration charges for product registration abroad for pharmaceuticals, biotechnology and agrochemicals and testing charges for engineering products.
- (ix) Inland freight subsidized for units located in North East, Sikkim and Jammu and Kashmir.
- (x) Setting up of “business centre” in Indian Missions abroad for visiting Indian Exporters/businessmen

8. Towns of Export Excellence (Dynamic Industrial Locations)

A number of towns in specific geographical locations have emerged as dynamic industrial locations handsomely contributing to India's exports. It is necessary to grant recognition to these industrial clusters with a view to maximizing their potential and enabling them to move higher in the value chain and tap new markets.

Selected towns producing goods of ₹ 1000 crore or more will be notified as Towns of Exports excellence on the basis of potential for growth in exports or town of export excellence on the basis of potential for growth in exports. For towns of export excellence in handloom, handicraft, agriculture and fisheries sector, the threshold limit would be ₹ 250 crores. Common service provider in these areas shall be entitled for the facility of the EPCG scheme. The recognized associations of units will be able to access the funds under the market access initiatives schemes for creating focused technological service.

9. Special focus on Cottage and Handicraft Sector

The small scale sector along with the cottage and handicraft sector has been contributing to more than half of the total exports of the country. The cottage and handicrafts sector, which mostly employs artisan and rural people, contributes significantly to this effort. In recognition of the export performance of this sector and to further increase its competitiveness,

The following facilities shall be extended to this sector:

- The unit in this sector shall be eligible for funds from Market Access Initiative (MAI) scheme. Fund shall be earmarked for this sector in the MAI scheme. The funds shall be utilized for developing their websites for virtual exhibition, among other activities.
- Under the EPCG scheme, these units will not be required to maintain average level of exports as given in Paragraph 5.4 (i) of the Export Policy;

- The units in handicrafts/handlooms sector shall be entitled to the benefit of double weightage of exports made for the grant of star export house status.

Fiscal Incentives Available to Exporters

The following fiscal incentives accrue to the exporters:

1. Duty Drawback in respect of customs and central excise duties;
2. Income tax exemptions/deductions;
3. Sales tax exemptions;
4. Reimbursement of Central Sales Tax to units in EPZ/FTZ/SEZ, and
5. Exemption from Service Tax

Duty Drawback

Under the duty drawback scheme the export products get relief in respect of customs and excise duties paid on raw materials and components used in their production. There are two types of rates of drawback. (i) All industry rates are published in the form of notification by government every year and are normally valid for one year, (ii) Brand rates are fixed on the individual request of an exporter/manufacturer where the government has not determined.

The all industry rates are fixed on the basis of averaging principle. As such all the industry rates may not compensate different exporters fully for the customs and excise duties actually paid by them. Thus drawbacks rules provide that where the all industry rate for any class of goods is less than 4/5th of the duties actually paid in their manufacture an application for fixation of special brand rates may be made.

Information on duty drawback rates is available from the concerned Export Promotion Council or from the Director (Drawback), Ministry of Finance, Jeevan Deep, Parliament Street, New Delhi-100 001.

For claiming the drawback on export of goods, the exporter is not required to file a separate application for granting the amount of drawback, as the drawback shipping bill itself treated as a claim and it is finalized after ensuring that the goods have been presented for examination by customs and cleared for being put on board a vessel/air craft and ensuring that the necessary formalities to enable processing of claims are complied with. The payment of drawback claim is made directly by the Customs House/Central Excise

Commissioner having jurisdiction over the port/airport/land customs stations through which the export is made.

1. Income Tax Exemptions and Deductions

The following exemptions and deductions at specified rates are available to the exporters and other foreign exchange earners under the Income Tax Act, 1961.

- (i) Deduction in respect of profits and gains from project outside India [Sec. 80HHB]
- (ii) Deduction in respect of export turnover [Sec. 80HHC]
- (iii) Deduction in respect of earnings in convertible foreign exchange [Sec. 80HHD]
- (iv) Deduction in respect of export of Computer Software [Sec. 80HHE]
- (v) Deduction for export or transfer of Film Software etc. [Sec. 80HHF]
- (vi) Ten Year Tax Holiday in respect of Newly Established Industrial undertaking in free Trade Zones, Electric Hardware Technology Parks and Software Technology as well as Economic Zones [Sec. 10A]
- (vii) Ten Year Tax Holiday in respect of Newly Established 100% Export Oriented Undertakings [Sec. 10B]

2. Sales Tax Exemptions

By virtue of Section 5 of Central Sales Tax, any dealer who is registered with the sales tax authorities can claim the exemption from sales tax in respect of his sales made in the course of exports out of the territory of India. The exporter may also buy the goods from dealer/manufacturer for the purpose of export trade without payment of sales tax by issuing Form H (where the selling dealer is in another State), to the selling dealer from whom he purchased goods for export should be registered with Sales Tax Department.

After registration with the sales tax authorities, the exporter should apply in the prescribed proforma to the concerned sales tax officer of issuing Form H along with the prescribed documents. On receipt of the application, the sales tax officer issues Form H to the Exporter. After the goods have been exported, the exporter will fill in Form H in triplicate. Once copy of the form H will be retained by the exporter and remaining two copies will be given to dealer and manufacturer from whom the exporter has purchased the goods for export.

3. Reimbursement of Central Sales Tax to 100% Export Oriented Units and EHTP/STP Units

100% export oriented units and EHTP/STP are entitled to full reimbursement of Central Sales Tax paid by them on purchases made by them from Domestic Tariff Area (DTA) for utilization the production of goods for export. The supplies from DTA must be utilised for export production and may include raw materials, components, consumables, packing materials, capital goods, spares material handling equipment etc.

4. Exemption from Service Tax

Export of Service Rules, 2005 which came into force with effect from 15.3.2005, provides that any service, which is taxable under the law, may be exported without payment of service tax. It further provides that where any taxable service is exported the Central Government may by notification grant rebate of Service Tax paid on such taxable service

Self Assessment Questions

- 1) Briefly Explain the General provisions of Export of Promotion Schemes
- 2) Discuss briefly the advance authorization schemes
- 3) Give a short note on Special Economic Schemes.
- 4) What are the Financial and fiscal incentives to exporters in India.
- 5) Discuss the Promotional measures of EXIM policy 2004-2009.

CASE STUDY

Case Study: 1

The globalization of Indian economy has led to the establishment of a number of large and a medium firm as licensing was not necessary. This resulted in production of a number of goods, more than the demand in some cases. Consequently, some small scale units which were receiving Govt. protection became sick. The earlier sick units became mortal. Some examples in this category were textile units in Ahmedabad, electronic units

in Delhi, consumer goods firms in Mumbai, AP Lightings, Anantapur, steel melting units in Hindupur, paper mills in Coastal Andhra and leather units in Chennai. Globalization resulted in the entry of a number of MNC's in India through exports, joint ventures etc. in the addition, U.S.A and Malaysia dumped cooking oil, steel, electronic products etc. The European countries exported milk and other agro-based products. These factors created a slump in the market due to excess supply. Further the decline in the employment opportunities affected the purchasing power of the middle class consumers adversely.

This created like China, S.Korea produced goods at a cheaper rate than India. This created a havoc in the market. The policy of globalization was criticized by some. Other quarters of the industry felt that Indian business and industry should learn management techniques and focus on high productivity and low cost.

In the light of above answer the following questions:

- 1) Is globalization desirable for the Indian economy? Why?
- 2) How globalization will benefit the Indian Consumers?
- 3) Identify the key areas where in the Indian manufactures need to improve to enable them to compete internationally.

Case Study: 2

1. Prepare one set of Documents as required by L/C issuing Bank.

Case Study: 3

You are an exporter of Gold and Diamond Jewellery in India. Approximately 85% of your product is sold in the domestic market and 15% is being exported. You are not availing any kind of incentive for your exports.

Now you want to upgrade your production facility and also wish to avail the incentives given to the exporter under FTP.

Question

1. Prepare a feasibility report to make your products more competitive in the export market by availing the provisions in the Foreign Trade Policy