UNIT VI BUSINESS FINANCE

CHAPTER 20 INTERNATIONAL FINANCE

BHJ00

Learning Objectives

To enable the students to
- i. state the importance of International finance
- ii. explain the concept of Foreign Direct Investment
- iii. analyse the advantages and disadvantages of FDI
- iv. state the meaning of Global Depository Receipt and American Depository Receipt

20.01 Introduction

International finance is a branch of financial economics that deals with the monetary interactions that occur between two or more countries. This section is concerned with topics that include foreign direct investment and currency exchange rates. It also involves issues pertaining to financial management, such as political and foreign exchange risk that comes with managing multinational corporations.

Importance of International finance

International finance plays a pivotal role in the international trade and in the sphere of exchange of goods and services among the nations.

The following points highlight the importance of international finance.

1. International finance helps in calculating exchange rates of various currencies of nations and the relative worth of each and every nation in terms thereof.
2. It helps in comparing the inflation rates and getting an idea about investing in international debt securities.
3. It helps in ascertaining the economic status of the various countries and in judging the foreign market.
4. International Financial Reporting System (IFRS) facilitates comparison of financial statements made by various countries.
5. It helps in understanding the basics of international organisations and maintaining the balance among them.
6. International finance organisations such as IMF, World Bank etc. mediate and resolve financial disputes among member nations.

20.02 Foreign Direct Investment and Institutional Investors

Foreign Direct Investment occurs when an investor based on one's native country (the home country) acquires an asset or a company in another country (in host country) with the intention to manage the asset or the company. The investing company exercises control over decision-making in an enterprise located in a foreign country according to the level of equity shares held by it.

The foreign direct investments take the following forms

1. Establishment of a new enterprise in a foreign country.
2. Expansion of existing branch or subsidiary in a foreign country.
3. Acquisition of enterprise located in a foreign country.

Prior to 1999, FDI was permitted selectively on a case to case basis with a normal ceiling of 40% of total equity capital. However a higher percentage of equity was permitted in the case of high-tech import areas and export oriented units. After the Economic liberalisation, the ceiling was removed and 100% of foreign equities are permitted only in selected sectors.

Meaning

Foreign direct investment (FDI) is an investment made by a company or an individual in one country with business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company.

Advantages of FDI

1. **Achieving Higher Growth in National Income** Developing countries get much needed capital through FDI to achieve higher rate of growth in national income.
2. **Help in Addressing BOP Crisis** FDI provides inflow of foreign exchange resources into a country. This helps the country to solve adverse balance of payment position.
3. **Faster Economic Development** FDI brings technology, management and marketing skills along with it. These are crucial for achieving faster economic development of developing countries.
4. **Generating Employment Opportunities** FDI generates a lot of employment opportunities in developing countries, especially in high skill areas.
5. **Encouraging Competition in Host Countries** Entry of FDI into developing country promotes healthy competition therein. This leads to enterprise in developing countries operating efficiently and effectively in the market. Consumers get a variety of products of good quality at market determined price which usually benefits the customers.

Disadvantages of FDI

1. Exploiting Natural Resources: The FDI Companies deplete natural resources like water, forest, mines etc. As a result such resources are not available for the usage of common man in the host country.

2. Heavy Outflow of capital Foreign companies are said to take away huge funds in the form of dividend, royalty fees etc. This causes a huge outflow of capital from the host country.

3. Not Transferring Technology Some foreign enterprises do not transfer the technology to developing countries. They mostly transfer second hand technology to the host country. They keep the fundamental aspects of technology with the parent company. In such case, the host country may not get the advantage of technology transfer and consequent economic development.

4. Exploiting Cheap Labour Foreign enterprises employ cheap labour force at a lower pay in developing countries. They do not employ local people for higher posts in the management. Further they do not extend the privileges they usually give to the employees in their home country to the employees of the host country. Thus they are stated to exploit the labour in developing countries.

5. Creating Monopolistic Environment Multi National Companies (MNCs) which enter the host country through FDI route create monopolistic conditions in the host countries through their market power. They may not create competitive environment in the host country. Contrarily they may affect the competition altogether and establish supremacy.

Foreign Institutional Investors (FII)

The FII can be defined as an investment made by a Non-resident in equity of domestic company without intention of acquiring management control.

FIIs are the investments made by an individual investor or an investment fund, into the financial markets of another nation. Organisations like hedge funds, insurance companies, pension funds and mutual funds can be called as institutional investors.

Foreign Institutional Investors play a very important role in Indian economy. From 1992, Foreign Institutional Investors (FIIs) have been allowed to invest in all securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies. Over 1450 foreign institutional investors have registered their names with the Securities and Exchange Board of India (SEBI), the regulator for the securities market in India.

20.03 International Capital Market

International Sources of Business Finance

There are various avenues for organisations to raise funds internationally. The establishment of Indian economy after 1990s, has facilitated many Indian companies to expand their operations beyond the frontiers of India. Many Indian companies are now able to access funds in the international financial market. The various international sources from where funds may be generated are

1. Commercial Banks

Most of the commercial banks extend foreign currency loans for promoting business opportunities. The loans and services of various types, provided by banks differ from country to country.

2. International Agencies and Development Banks

International agencies and Development banks play an important role to promote international trade and business. They provide term loans and grants to promote the development of economically backward areas in the world. International Finance Corporation (IFC), EXIM Bank and Asian Development Bank are the agencies operating at International level to meet the needs of the international finance.

3. International Capital Markets

Modern organisations including multinational companies depend upon sizeable borrowings in rupees as well as in foreign currencies. Prominent financial instruments used for this purpose are Depository Receipts.

Depositary Receipts (DRs)

A depository receipt is a negotiable financial instrument issued by a bank to represent a foreign company's equity shares or securities. They are issued to attract a greater amount of investment from other countries. Any foreign investor can invest in a foreign stock directly without worrying about differences in currency, accounting practices, or language barriers, etc.

20.04 Global Depositary Receipt (GDR)

GDR is an instrument issued abroad by a company to raise funds in some foreign currencies and is listed and traded on a foreign stock exchange.

DO YOU KNOW?

Examples of Indian Companies that have raised funds through GDR

SBI BAJAJ AUTO WIPRO ITC
ICICI BANK GAIL Reliance infrastructure Ltd
L&T INFOSYS TECHNOLOGIES
HDFC BANK HINDALCO
MTNL TATA MOTORS

Process of Issuing GDRs

There are four steps in the process of issuing GDRs as follows.

i. The company issuing GDRs hands over its shares to one Domestic Custodian Bank (DCB).

ii. The DCB requests the Overseas Depository Bank (ODB) situated in the foreign country for issuing the shares as GDR.

iii. The ODB converts the shares shown in rupees into GDR which are denominated in US dollars.

iv. Finally, ODB issues them to the intending investors.

Features of GDR

1. It is a negotiable instrument and can be traded freely like any other security.
2. Indian companies with sound financial track of three years are readily allowed to access international financial markets through GDR. However clearances are required from the Foreign Investment Promotion Board (FIPB) and the Ministry of Finance.
3. GDRs are issued to investors across the country. It is denominated in any acceptable freely convertible currency.
4. GDR is denominated in any foreign currency but the underlying shares would be denominated in local currency of the issuer.
5. The holder is entitled to dividend and bonus on the value of shares underlying the GDR.
6. The investor can convert GDR into equity shares, and sell the shares mentioned in

the GDR through a local custodian. This provision can be used after 45 days from the date of issue.

7. Under GDR, the issuing company transacts with only one entity for all its transactions.

20.05 American Depository Receipts (ADR)

ADR is a dollar denominated negotiable certificate representing a non-US company in US market which allows the US citizens to invest in overseas securities.

Process of issuing ADRs

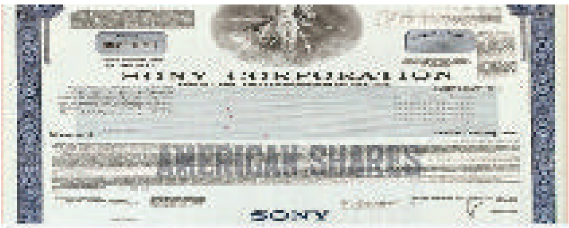
Steps

1. First of all, a company hands over the shares to a Domestic Custodian Bank (DCB)
2. Then DCB requests the American Depository Bank (ADB) to issue the shares in the form of ADRs
3. ADB converts the issue which are in rupees into US dollars
4. Finally, ADB issues them to the intending investors.

Features of ADR

The features of ADR are briefly given hereunder

1. ADRs are denominated only in US dollars.



2. They are issued only to investors who are American residents.
3. The depository bank should be located in US.
4. The approval of Securities and Exchange Commission (SEC) of US needs to be obtained for issuing ADR.
5. They are sub-classified on the basis of level of clearance made by SEC.

20.06 Foreign Currency Convertible Bonds (FCCB)

Foreign currency convertible bond is a special type of bond issued in the currency other than the home currency. In other words, companies issue foreign currency convertible bonds to raise money in foreign currency.

Features of FCCBs

1) FCCB is issued by an Indian company in foreign currency.
2) These are listed and traded in foreign stock exchange and similar to the debenture.
3) It is a convertible debt instrument. It carries interest coupon. It is unsecured.
4) It gives its holders the right to convert for a fixed numbers of shares at a pre-determined price.
5) It can be converted into equity or depository receipt after a certain period.
6) The amount received from the issue of FCCB should be utilised as per the guidelines of External Commercial Borrowing (ECB).

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Differences Between GDR and ADR

Basis	Global Depository Receipts GDR	American Depository Receipts ADR
Denomination	It is denominated in terms of any freely convertible currency	It is denominated only in US dollars
To whom it is issued	It is issued to investors in one or across more markets simultaneously	It is issued only to investors, who are residents of the United States of America.
Listed in	Non-US Stock Exchange such as London Stock Exchange or Luxemburg Stock Exchange.	American stock exchange
Approval	Issue of GDR does not require foreign regulatory clearances.	Issue of ADR requires approval from the Securities Exchange Commission (SEC) of United States of America.
Mode of expression	GDRs are normally co-related to equity shares of the issuing company expressed in whole numbers.	In many cases ADRs co-related to equity shares of the company are expressed as a fraction
Negotiation	It is negotiable all over the World.	It is negotiable only in America.

Key Terms

American Depositary Receipt (ADR)

Global Depository Receipt (GDR)

Foreign Currency Convertible Bond (FCCB)

Foreign Direct Investment (FDI

For Own Thinking

1. Role of World Bank in globalization
2. The concept of Hot Money

For Future Learning

1. Possibilities of making the western and American countries in favour of Indian Depository Receipt (IDR)
2. Petrodollar system and its future

Exercise

I. Choose the Correct Answer

1. An instrument representing ownership interest in securities of a foreign issuer is called ____________

a. an ownership certificate

b. a depositary receipt.

c. an ownership receipt

d. None of the above.

2. Issuance of DRs is based on the increase of demand in the

a. International market

b. Local market

c. Existing shareholders

d. All of the above

3. ADRs are issued in

a. Canada b. China

c. India d. The USA

4. Depositary receipts that are traded in an international market other than the United States are called

a. Global Depositary Receipts

b. International Depositary Receipts.

c. Open Market Depositary Receipts

d. Special Drawing Rights.

5. __________ bond is a special type of bond issued in the currency other than the home currency.

a. Government Bonds

b. Foreign Currency Convertible Bond

c. Corporate Bonds

d. Investment Bonds

Answers

1. b 2. a 3. d 4. a 5. b

II. Very Short Answer Questions

1. Who are Foreign Institutional Investors?
2. What is a Depository Receipt?
3. What is a Global Depository Receipt (GDR)?
4. What is American Depository Receipt (ADR)?

III. Short Answer Questions

1. Explain the importance of international finance. (any 3)
2. What is meant by Foreign Currency Convertible Bonds?
3. Explain any three disadvantages of FDI.

IV. Long Answer Questions

1. Distinguish between GDR and ADR. (any 5)
2. State any five features of FCCB. (any 5)

Reference

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3. www.ibef.org