Sem-6 F.C.

Foundation Course

B. com sem - VI

International Business

(English Med.)

1.1 INTRODUCTION

1.1.1 Meaning and Importance of International Business

International business means carrying on business activities beyond national boundaries. It normally includes the transactions of economic resources such as goods, capital, services (comprising technology, skilled labour, transportation etc.) and international production. Production may either involve production of physical goods or provision of services like banking, finance, insurance, construction, trading and so on.

International business means carrying on business activities beyond national boundaries. These activities normally include the transaction of economic resources such as goods, capital, services (comprising technology, skilled labour, and transportation, etc.), and international production. Production may either involve production of physical goods or provision of services like banking, finance, insurance, construction, trading, and so on. Thus, international business includes not only international trade of goods and services but also foreign investment, especially foreign direct investment.

International business has been playing a crucial role for centuries. In the present day world it has become indispensable for any country. Its role has increased in significance, both at the macroeconomic and microeconomic levels. No country—developed, or developing—produces all commodities to meet its requirements. It needs to import items that are not produced domestically. At the same time, it tries to export all items that are produced over and above its domestic requirements, so that its balance of payments may not worsen in the wake of imports. In a developing economy, the range of production is often limited, with the result that import requirements are bigger. On the other hand, such an economy tries to expand its exports in order to earn foreign exchange that could, in turn, meet its import requirements.

Foreign direct investment (FDI), which has gained importance in the recent past, is made for a variety of purposes. Acquiring of natural resources, recovery of large expenditure made on research and development, capturing a larger segment of the international market, and earning large profits are some of its important motives. In the case of a developing country with weak balance of payments position, foreign direct investment is very crucial. It helps obtain large foreign exchange resources and latest technology, and also develops managerial capabilities required for economic development programmes. In other words, foreign direct investment is essential as it bridges the resource gap. Thus, whether it is international trade or investment, it is an integral part of a country's economic behaviour.

Corporate wealth is the value of productive assets plus the present value of wealth created by those assets. Alternatively, it is the sum of the value of debt and equity in a firm.

At the microeconomic level, from the viewpoint of maximising corporate wealth, it is in the interest of a firm to export its product to foreign markets and to capture a large share of the markets abroad, especially when the domestic market is saturated. On the other hand, in order to minimise the cost and thereby, maintain a competitive edge, a firm likes to import inputs from least-cost locations. In offshore assembly operations, components involving capital-intensive mode of production are manufactured in a capital abundant economy and exported to a labour abundant economy for their assembly so that the firm can make use of cheap labour. The assembled product is again shipped to the home country and to other markets.

When the demand for a firm's product matures in foreign markets, it is in the interest of the firm to start production in those markets so that the transportation cost and tariffs can be avoided. Manufacturing in a foreign location involves not only investment of capital but also the transfer of technology. The transfer of technology helps improve the firm's competitiveness in markets abroad and at the same time is able to recover the huge cost incurred on research and development. Firms receiving capital and technology are also able to improve their competitiveness.

1.1.2 Domestic Business versus International Business

International business differs from domestic business in that the former involves across the country transactions or across the country production or provision of services, whereas, in the case of domestic business such activities are limited to the length and breadth of the country.

Again, there are many complexities in international business that are not found in case of domestic business. First of all, transactions in international business are mostly intra-firm. Final goods, intermediate goods, and raw material flow between the parent company and the subsidiary, or among different subsidiaries of the same firm. What is unique in such cases is that transactions often involve transfer pricing. This is meant primarily to reduce the overall tax and tariff burden and thereby, maximise the global profit of the firm. But sometimes its purpose is to make necessary adjustments in the cash requirements of different units. This means that the price of the intra-firm export and import is often different from the arm's length prices. The designing of prices is a complex task.

Transfer pricing is arbitrary pricing of intra-firm transactions at more/less than the arm's length prices.

International business is different from domestic business. In international business:

- Intra-firm transactions using transfer pricing is common.
- Varying environment—political, legal, economic, socio-cultural and ethical—in host countries, often not known to the firm.
- Presence of political risk and also of exchange rate risk, sometimes leading to financial risk.
- Varying strategies of business in different host countries.

Secondly, international business transactions are carried out in unfamiliar conditions prevailing in the host countries. The political and legal environment in the host country may be different, manifesting in different sets of policies, rules, and regulations. The economic environment may be different, manifesting in different levels of income, lifestyle and consumption patterns. For example, a host country having foreign exchange constraints may be adopting exchange control regulations, the financial market in the host country may not be developed, and the social and cultural set-up may be dissimilar, and the social behaviour, language, and the very attitude towards consumption and production may be different in the host countries. Firms involved in international business have to take care of all these factors and chalk out the strategy

A multi-domestic company is concerned with the market of the host country where it operates. While a **global company** is concerned with the global market. It considers the world as a single market.

situations. It is this behavioural distinction that influences Punnett and Ricks (1997) to differentiate between a multi-domestic company and a global company. The former is concerned more with the market of the host country where it operates. The latter is concerned with the global market. It finds the world as a single market and plans to cater it through integrated operations.

Again, basing on the behavioural features of MNCs, Bartlett and Ghoshal (1989) differentiate between a multinational company and a transnational company. In the former, decision making is normally decentralised and the activities of the firm in foreign countries are not tightly co-ordinated. In the latter, on the contrary, global business activities of the firm are perfectly configured, coordinated and controlled to achieve global competitiveness. However, in the present text, these different terms are used interchangeably.

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While business activities of a **transnational** firm are perfectly configured, coordinated and controlled.

1.2 EVOLUTION AND DEVELOPMENT OF INTERNATIONAL BUSINESS

1.2.1 Process of Evolution

MNCs do not emerge overnight. Domestic firms, after expanding their operation and going through various stages of the evolution process, qualify for being called an MNC. The process of evolution takes place in three successive stages. They are:

1. Trade
2. Assembly or production
3. Integration

The process of evolution of a domestic firm into an MNC involves three successive stages:
1. Trade
2. Assembly or production
3. Integration

Some firms are able to innovate products for which demand gradually develops in foreign markets, leading to export orders. Here begins the first stage of evolution. Initially, the exporting firm takes the help of some middlemen. But after export becomes a regular phenomenon, an export department is created to substitute middlemen. With growing trade, the firm sets up a branch in importing countries, which gradually evolves into a subsidiary. The subsidiary operates as a marketing aide that helps penetrate the foreign market and collect information regarding the changing tastes of consumers. The two-way traffic gradually becomes easier.

The firm is not satisfied with export alone. It intends to reach the consumers at the lowest possible cost, probably to compete with other suppliers. It may be noted here that the technology involved in the product does not remain the monopoly of the firm in due course of time. Reaching consumers at the least cost is marred by the imposition of tariff and transportation cost. So, the firm decides to assemble the final product in the importing country itself so as to avoid tariff and the transportation cost. In some cases, the firm starts manufacturing of the product in the importing country if necessary facilities are available there. The second phase of the evolutionary process starts here.

Lastly, the firm tries to integrate the activities of its different units. Intra-firm transfer of funds or material takes place in order to maintain an optimal trade-off between liquidity and profitability in the various units located in different countries. It is also undertaken for maximising the global profit. Sometimes, depending upon the cost and the facilities available, various stages of production and assembly of the same product are carried out in different countries. Integration is required in this case too for strengthening and optimising the vertical linkages. The implementation of financial, marketing, production, and personnel strategies too requires foolproof integration among different units. In this way, the third stage of the evolution process is completed and a perfect MNC appears to exist, although internationalisation of business sets in with the beginning of export business.

1.2.2 Early Developments

International trade is many centuries old. In the 16th and the 17th centuries, international trade was carried out by individuals seeking fortunes for themselves. The reward was often great, but the risk of the voyage was also very high. Exotic goods that were traded normally were those that were sold at home at soaring prices. It was the fabulous profits that motivated some firms to operate abroad. The East India Company was among the foreign trading companies that moved to India in the early decades of the 17th century.

However, in the wake of Industrial Revolution in Europe, the character of international business changed. International enterprises came to be engaged in extracting, processing, and transporting raw materials for industrial plants located in the home country and also in exporting their manufactured goods back to the raw material producing countries. In short, their activities were guided by the requirements of the home country industries. During the last quarter of the 19th century through the outbreak of the First World War, the British and other European and American companies operating abroad reached the peak of their trading activities.

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After the Great War of 1914–18, the functions of international companies widened. They also came to be engaged in various services that the government of host countries was not able to render efficiently. This was the reason why host governments provided western companies many concessions.

1.2.3 Post-War Developments

By the mid-1940s, the economy of the US turned out to be the strongest. American industries were well developed and needed to acquire new sources of raw material. Moreover, they wanted to capture the largest share of the world market. All this led to rapid internationalisation of US firms since 1950s. During the two decades beginning from 1950, US foreign direct investment grew from \$12 billion to \$80 billion (Wilkins, 1970).

Since 1960s, many European firms too turned into multinationals, and since 1970s, there was substantial growth in Japanese MNCs. In 1970 only one MNC was listed among the world's largest 50 companies. By the end of the decade, the number rose to six. By 1980s, the Japanese became the largest producers of automobiles—a position that was enjoyed by the USA until then.

Since 1970s, the firms of developing countries too began operating internationally. There were two sets of developing countries. One was represented by oil exporting countries that had acquired huge foreign exchange reserves in the wake of the oil crisis of the 1970s. The other group was represented by newly industrialising countries that had imported technology from the developed countries and built up their own industrial base. Firms from both types of the developing countries established their affiliates abroad in a big way.

And, of late, multinational firms have come to emerge also among the East European Countries. Although their size is not big, they are expected to grow fast in view of their resource base and also in view of growing opportunities in the 25-member European Union.

Top Five Multinationals of East Europe
(Ranked on the Basis of Transnationality Index)

No.	Firm	Home Country	Industry	TNI%
1.	Primorsk Shipping Corp.	Russian Federation	Transportation	71.3
2.	Zalakeramia Rt.	Hungary	Clay product	59.9
3.	Pliva d.d.	Croatia	Pharmaceuticals	58.5
4.	Novoship Co.	Russian Fed.	Transportation	55.5
5.	Policolor S.A.	Romania	Chemicals	52.9

Note: TNI is the sum of three ratios: foreign assets/total assets, foreign sales/total sales, and foreign employment/total employment.
Source: *World Investment Report, 2004.*

On probing the growth of international business during the past five decades or so, its evident that prior to the 1960s, the dominant organisational pattern of international companies was distinctive in the sense that the affiliates were self contained as far as possible and they were barely small clones of the mother company scattered around the world. It is only since the 1960s that the organisational structure came to be more centralised in the hands of the parent company and this ushered a fast growth in the activities of international companies. But the growing control of the parent company was not relished by the host country governments as it often clashed with their interests. Host country governments began playing a decisive role in the decision making of international firms. They framed various rules and regulations for the conduct of international companies. With the lapse of time, the interest of the various groups became more complex and international business came to be fraught with growing complexities (Robinson, 1981).

1.2.4 Recent Trends

The past couple of decades have witnessed significant growth in international business. It is a fact that international business was greatly constrained by the oil shock and the restrictive policies pursued by many developing countries during the 1970s, but it was resumed by the mid-1980s and it grew in the subsequent period. Statistics show that between 1983 and 1990, FDI outflow grew at an average annual rate of 27 per cent, which was almost four-fold greater than the growth of world output and around three-fold greater than the growth of world exports. During 1990, the amount of FDI outflow stood at US $245 billion, over two-thirds of which were accounted for by only five countries, namely, the United States of America, the United Kingdom, Japan, Germany, and France. There were 170,000 foreign affiliates of over 37,000 parent companies. The worldwide sales of these affiliates were approximately US $5.5 trillion, which was greater than the world export of goods and non-factor services (United Nations, 1993). The fast growth in FDI outflows during the 1980s could be attributed to a host of factors. (1) The growing internationalisation of the Japanese economy resulted in the large explosion of FDI from this country; (2) The phenomenal growth in the demand for services in the wake of growth in per capita real income. Since many services were not tradable, FDI was the only way to participate in foreign markets. (3) This period witnessed more effective moves towards regional integration, as a result of which both intra-bloc and inter-bloc FDI increased.

Table 1.1 shows more recent trends. FDI outflows grew from US $ 245 billion in 1990 to US $ 1150 billion in 2000. During 2000s, there were ups and downs in the size of the flow. In 2005, it was US $ 779 billion. The annual growth rate ascended from 15.7 per cent during 1991–95 to 35.7 per cent during 1996–2000 but was negative by 5.1 per cent during 2001–05. The FDI outward stock rose from US $ 1,716 billion in 1990 to US $ 5,976 billion at the end of 2000 and to US $ 10,672 billion by 2005. The amount of world FDI inflows grew from US $ 209 billion in 1990 to US $ 1,271 billion in 2000. During 2000s, the size moved up

Table 1.1 Growth in FDI: 1990–2005

Item	*Value at Current Prices (US $ billion)*			*Annual Growth Rate (%)*		
	1990	*2000*	*2005*	*1991–1995*	*1996–2000*	*2001–2005*
FDI inflows	209	1271	916	20.0	40.2	-4.0
FDI outflows	245	1150	779	15.7	35.7	-5.1
FDI outward stock	1716	5976	10672	10.7	16.8	10.1
Cross-border M&As	151	1144	716	23.3	51.5	2.2
Sale of foreign affiliates	5503	15680	22171	10.4	10.9	13.6
Assets of foreign affiliates	5706	21102	45564	13.7	19.2	15.8
Employment in foreign affiliates (million)	23.6	45.6	62.0	5.0	14.2	6.5

Source: United Nations, *World Investment Report*, various issues.

and down. In 2005, it was US $ 916 billion. The total assets of foreign affiliates rose from US $ 5,706 billion in 1990 to US $ 21,102 billion by 2000 and to US $ 45,564 billion by 2005. Their sales surged up from US $ 5,503 billion to US $ 15,680 billion and to US $ 22,171 billion during the same period. The employment in foreign affiliates increased from 23.6 million to 45.6 million and to 62.0 million during this period.

What is remarkable is that the mergers and acquisitions (M&As) formed a large part of the FDI outflow. In 1990, FDI through cross-border M&As had amounted to US $ 151 billion which rose to US $ 1,144 billion in 2000 but fell to US $ 716 billion in 2005. If one looks at the annual growth rate, it rose from 23.3 per cent in 1991–95 to 51.5 per cent in 1996–2000 but fell to 2.2 per cent during 2001–05. A deeper probe reveals that the acquisitions were more common.

erger and quisition is the mbination of two rming firms

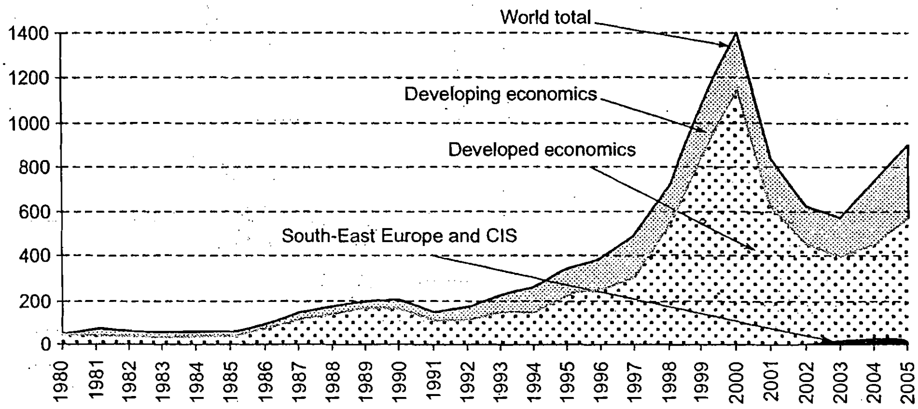
The other remarkable feature is that owing to the growth in FDI flow in general and the emergence of MNCs in developing as well as in transition countries in a big way, the share of these countries in FDI flow has increased. The figures in Table 1.2 show that the developing countries in general have improved their share from 36 per cent to 37 per cent in FDI inflows and from 14 per cent to 15 per cent in FDI outflow between 1991–96 and 2005. The respective share of transition economies has risen from 3 to 4 per cent and from a very negligible figure to 2 per cent during the same period. All this means a cut in the respective share of the developed countries.

able 1.2 Share of Different Groups of Countries in FDI Flow

% Share

roups of Countries	Inflows		Outflows	
	1991–96 Ann. Av.	2005	1991–96 Ann. Av.	2005
)eveloped	61	59	86	83
)eveloping	36	37	14	15
'ransition Economies	3	4	Neg.	2
'otal	100	100	100	100

›ource: UNCTAD, *World Investment Report: 2006*, New York, 2006



Source: World Investment Report: 2006

IGURE 1.1 FDI in Inflows, Global and Group of Economies, 1980-2005

Mini MNCs have large-scale overseas linkages despite their smaller size.

Along with rapid internationalisation of firms, world trade, both intra-firm and inter-firm, grew manifold. The reduction of tariff and non-tariff barriers under the aegis of GATT and now under the WTO umbrella too gave a fillip to international trade. During two and a half decades beginning from 1980, the value of world trade increased almost fivefold—from US $2,031 billion in 1980 to US $3,486 billion in 1990, to US $6,327 billion in 2000 and to US $10.2 trillion in 2005. MNCs have a big role in the increasing volume of trade. However, in recent decades, the small and medium-sized multinationals or the so-called mini-multinationals that have come to possess globalising efficiency almost at par with the big organisation, do account for sizeable world trade (UNCTAD, 1993). Again, there has not been any noticeable change in the share of the developed market economies in the world trade. Their share continued to remain at 64 per cent (UNCTAD, 2005). Thus, international business has witnessed a phenomenal growth in the recent past.

1.3 FACTORS LEADING TO GROWTH IN INTERNATIONAL BUSINESS

It is a fact that the desire to expand sales and revenue, to acquire inputs at the least cost, and to minimise business and financial risk through geographic diversification has led to the growth of MNCs; yet there are some other factors too that provided them a congenial atmosphere to expand their activities at a very fast rate. These factors are:

1. Rapid technological advancement
2. Emergence of supportive institutions
3. Openness of economic policies among large number of countries
4. Increase in competition

The past few decades have witnessed rapid advancement in product and process technology and in information technology. Many firms have emerged up with innovated products or with improved process technology. With the demand for such products and technology being price-inelastic, these firms have moved abroad in order to reap large profits. Sometimes the developed technology is meant for a larger market than the domestic one and in such cases it is imperative for the firm to go international in order to achieve economies of scale. The development of information technology has brought different countries closer and has encouraged firms to move abroad with the minimum of difficulties.

Technological advances have coincided with growth in financial and other infra-structural facilities. Besides the efforts of different developing countries for strengthening their infrastructural sector, it is mainly the bilateral and multilateral aid flows that have been directed towards this end. The International Bank for Reconstruction and Development has been responsible for the creation of Industrial Credit and the Investment Corporation of India and similar financial institutions in many other developing countries. Similarly, one of the primary objectives of the American aid programme has been to build up necessary infrastructure in developing countries so that American business could managers of a firm are not well acquainted with the values, beliefs, customs, language, religion, and other aspects of the target market, the firm does not prefer to invest there. Rather, it limits its business only to trading activities in such cases. The company starts operation in the host country only when the managers are acquainted with the cultural environment in the host countries. Again, if the political conditions are not congenial in the target market or if the legal formalities are lengthy, large investment is often avoided. Sometimes, when the host government bans certain types of investment, foreign investors cannot make such investments even if they wish to make them. In India, in 1973, the government fixed a ceiling on foreign equity participation. Foreign companies that did not favour the ceiling dismantled their operations in India (Sharan, 1992). Yet again, it is the size of the market in the host country that influences the entry mode of foreign firms. When the market is large and ever expanding, foreign firms prefer to enlarge their involvement through investment. But if the size of the market remains small, trade is the only suitable option. Last but not least, if the cost of production in the host economy is lower than in the home country, the host country attracts foreign investment. In fact, this is one of the important reasons that companies from the developed world have moved to developing countries. If the shipping cost is also low, it is possible that the firm may shift the entire production process to the low cost host country and may ship the output back to the home country for meeting the domestic demand. If, on the other hand, the host country does not represent cost effectiveness, trading remains the only way out.

Besides these factors, it is risk involved in the different modes of entry that influences the decision of a firm in this respect. Different modes involve varying degrees of risk. The lesser the amount of control in a particular mode, the lower the risk. If trading activities are ranked on the lowest rung of the ladder from the viewpoint of control, it carries the least risk. On the contrary, if investment in a wholly owned subsidiary possesses the largest element of control, it is supposed to be highly risky. Thus, the choice of the entry mode depends, among other things, upon the control-risk consideration of the firm.

2.2 TRADE MODE

2.2.1 Direct and Indirect Export

In direct export a company takes full responsibility for making its goods available in the target market by selling directly to the end-users.

Indirect export takes place when the exporting company sells its products to intermediaries, who in turn sell the same products to the end users in the target market.

The trade mode presents the first step in international business. It includes export and import. Export may be either direct or indirect. In case of direct export, a company takes full responsibility for making its goods available in the target market by selling directly to the end users, normally through its own agents. Direct export is feasible when the exporter desires to involve itself greatly in international business; and at the same time possesses the capacity to do so. There are also some commodities where direct export is more convenient. They are, for example, air crafts and similar industrial products.

When the exporting company does not possess the necessary infrastructure to involve itself in direct exporting, indirect export takes place. It takes place

When an EMC functions as a distributor, it takes title to goods, sells them on its own account, and assumes the trading risk. Alternatively, when it acts as an agent, it charges a commission. Trading companies provide services to exporters in addition to exporting activities.

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It is a fact that the nature of intermediary differs in direct export or import from that in an indirect export and import. However, when one talks about intermediaries, export management companies (EMCs) and trading companies cannot be ignored. When an EMC functions as a distributor, it takes title to goods, sells them on its own account, and assumes the trading risk. Alternatively, when it acts as an agent, it charges a commission. Sometimes it acts as an agent for one client and as a distributor for the other. Trading companies, on the other hand, provide services to exporters, in addition to exporting activities, such as storage facilities, financing services, and so on. These companies originated in Europe but are now common in Japan and South Korea.

2.2.2 Counter-trade

Counter-trade is a sort of bilateral trade where one set of goods is exchanged for another set of goods.

Counter-trade is a sort of bilateral trade where one set of goods is exchanged for another set of goods. In this type of external trade, a seller provides a buyer with deliveries and contractually agrees to purchase goods from the buyer equal to the agreed percentage of the original sale contract value (US Department of Commerce, 1978). Counter-trade is classified broadly as:

1. Commercial counter-trade such as classical barter, counter-purchase and pre-compensation.
2. Industrial counter-trade such as buy-back agreements, develop for import arrangements, and framework agreements.

Commercial Counter-trade: Classical barter is one of the oldest modes of commercial counter-trade. It involves a once-only exchange of goods on the terms agreed upon between the buyer and the seller. The quantum, quality, and value of goods to be exchanged are well defined. Naturally, the trade flows in one direction are fully compensated by those in the reverse direction. There is no need for bridging finance. Negotiating parties are often governments. The exchange of Iranian oil for New Zealand's lamb or the exchange of Argentine wheat for Peruvian iron pillets are examples of classical barter (Banks, 1983).

In case of counter-purchase, which is also known as parallel barter, the contracts are often separate for import and export. The type and price of goods traded are generally not specified at the time of signing of the contract. The exporter of goods agrees to accept, in return, a wide range of goods from the importer. Balancing of the value of export and import is done every three to five years. If the two sides are not equal, the balance is paid in cash.

In case of pre-compensation, the value of exports is entered into an evidence account and imports are made on that basis. This means that payments for imports are not made immediately.

Industrial Counter-trade: Being a form of industrial counter-trade, buy-back agreements normally involve a larger amount corresponding to the sale of industrial equipment or turnkey plants in exchange for the products manufactured by these industrial plants. Naturally, the contract period is longer, varying from 10 to 20 years. The United Nations Economic Commission for Europe (1979) mentions the case of Austria selling pipeline equipment and related material to the then Soviet Union so that the latter could develop certain gas fields and could pipe a part of the output back to Austria. In case of developing countries, such agreements are common as they suffer from the technology gap on a large scale.

Develop-for-import arrangements are also a variant of the buy-back agreement where the exporter of the plant and machinery participates in the capital of the importing firm and, thereby, takes a share in the profits thereof. This means the involvement of the exporting firm is deeper than in a general buy-back arrangement. Japanese investment in an Australian firm developing gun-powder copper mine is an apposite example (Nameth, 1984).

Framework agreements are the long term protocol or bilateral clearing agreement normally concluded between governments. Trade is balanced after a long period as mentioned in the agreement. If the trade is not equal in value, the debtor sells the agreed upon commodity in the international market and the creditor is paid off. For example, Mexico sold cocoa to the United States of America to pay for its excess import from Malaysia (Far Eastern Economic Review, 1983).

Growth of Counter-trade: Barter trade was the mode of international trade in the eighteenth century when there was no sufficient monetisation. During the twentieth century, especially during the inter-War years, the West german government had resorted to bartering for strategic raw material (Banks, 1983). In the post-War period, counter-trade was initiated on a large scale by East European countries while trading with western countries and developing countries because they did not relish multilateral trade. In the wake of the oil crisis of 1970s, oil was exchanged for Soviet arms. The share of counter-trade in the world trade rose from around two per cent in 1964 to 20–30 per cent by the late 1980s (Debroy, 1987), although accurate estimates cannot be made on account of unavailability of figures. There is also region-wise difference as far as the volume of counter-trade is concerned.

Merits of Counter-trade: It is true that the multilateral trading system is beneficial, but the gains from it are limited in view of imposition of trade barriers. In such cases bilateral trade plays a vital role. First of all, it is a good option for meeting import requirements, especially in case of developing countries whose export faces high barriers.

Secondly, counter-trade helps stabilise export earnings because it pre-determines the size of export and import. It also helps stabilise the terms of trade as the ratio between export and import prices is predetermined. Through stabilising export earnings and terms of trade, it transfuses stability in the development process.

Thirdly, it helps in trade diversification and, thereby, reduces the risk of geo-political chaos. Diversification of exports allows greater outlets for exportable goods, which in-turn creates a more competitive market, increases export earnings, and reduces import costs.

Fourthly, counter-trade augments the flow of technology to developing countries, especially when they suffer from a serious technology gap. Buy-back agreements are particularly helpful in such cases.

Fifthly, when the counter-trade agreement is long term, the importing country gets the same advantage as it gets from loans. This means that counter-trade serves the purpose of loans and at the same time does not impose the burden of interest payment.

Sixthly, despite the fact that balancing of trade sometimes poses a problem, it reduces the net currency outflow and, thus, helps avoid foreign exchange problems.

Seventhly, developing countries often face distortions caused by unsuitable exchange rate policies. For example, overvaluation of currency tends to make export uncompetitive despite its impact in form of reduced import cost. Counter-trade helps correct such distortions. Goods can be exported at less than the quoted price and this can act as an export subsidy.

All this shows that counter-trade helps avert the problem of foreign exchange, which is endemic to developing countries. In fact, this has been a major factor for resorting to counter-trade. To quote a few examples, Brazil and Mexico opted for counter-trade in 1979 when their external balance was disturbed. So was the case with Indonesia in 1981. India was ready to exchange various raw materials for wheat and other agricultural commodities from the USA only after its foreign exchange crisis in the late 1950s.

Counter-trade

Merits

- Absence of tariff barriers
- Stabilisation of export earnings
- Scope for benefits from trade diversification
- Possibility for flow of technology, especially in buy-back agreements
- Some advantages similar to those of loans
- No need for foreign exchange for making imports
- Avoiding distortions caused by unsuitable exchange rate policy

Demerits

- Non-conforming with the norms of the multilateral trading system
- Absence of multilateral surveillance leading to distortions in markets and price
- Lack of encouragement for quality improvement
- Lack of double coincidence of goods to be traded
- Balancing of trade sometimes turns difficult

Demerits of Counter-trade: It is maintained that counter-trade goes against the norms of multilateral trade and so countries opting for it, abstain from reaping gains, from the multilateral trading system. There is always the possibility of market distortions because of the lack of multilateral surveillance.

Distortions can take place in many ways. The price of the import may be very low and hence may harm domestic industries. If it is abnormally high, terms of trade will deteriorate. Once caught in counter-trade, the weak trading partner is coerced by the strong counterpart.

Again, difficult to sell products are sometimes traded. This means the country exporting such goods never tries to improve its efficiency. This negatively influences the export performance in the long run.

Yet again, there is always a difficulty of double coincidence of traded goods with the result that the trade earnings become unstable.

Last but not least, the balancing of trade poses a serious problem both at the micro level and at the macro level. Experience shows that micro level balancing is often more cumbersome. The problem also occurs at the macro level when exports face supply constraints. This happened in Indonesia during 1982 and 1983, when the country faced serious problems in balancing trade (Miramon, 1985).

2.3 CONTRACTUAL ENTRY MODES

Contractual entry modes are found in case of intangible products such as technology, patents, and so on. When a company develops a particular technology through its own research and development programme, it likes to recover the cost of research and development. To this end, it sells the technology either to a domestic firm or to a foreign firm. But in this case, the secrecy of technology is not maintained and the firm's ownership advantage is always at stake. Thus, in order to maintain the ownership advantage, a firm passes on the technology only to its own subsidiary located abroad. But if the host government does not permit any foreign investment, the subsidiary of the firm in that host country cannot exist. Transfer of technology through contractual deals is the only way out. The contractual entry mode, often known as technical collaboration or technical joint-venture, is very common. It is preferred in many cases where:

Contractual entry modes are found in case of intangible products such as technology, patents, and so on. When a company develops a particular technology through its own research and development programme, it likes to recover the cost of research and development. To this end, it sells the technology either to a domestic firm or to a foreign firm.

1. The licensor does not possess enough capital for investment, nor does it possess the requisite knowledge of the foreign market for the purpose of export.
2. The licensor wishes to exploit its technology in the foreign market.
3. The licensor finds the host country market too small to make any investment for reaping economies of scale.
4. Nationalisation is feared in the host country.
5. Foreign investment in the host country is restricted.

Technical collaboration normally takes four forms. They are:

1. Licensing
2. Franchising
3. Management Contracts
4. Turnkey Projects

These different forms of the contractual mode are explained here.

tional resource allocation. The very discussion of the comparative cost advantage theory in the earlier sections of this chapter has shown how the total output and, thereby, the total consumption in trading countries increases owing to specialisation in the production of a particular commodity. The extent of increase in the total output and total consumption on this count is nothing but static gains from trade. Had there been no trade, there would have been no specialisation and each trading country could have produced both commodities (in a two country, two-commodity framework), with the result that the total output would not have increased and the total consumption would have remained at a lower level. If output and consumption increases as a sequel to trade, the increase is called the gains from trade.

3.7.2 Dynamic Gains from Trade

The increase in output or consumption is not once over. Rather, it is a continual phenomenon manifesting in higher rate of growth in income over a period of time. This type of continuity indicates dynamic gains from trade. In fact, dynamic gains have been discussed for a long time. John Stuart Mill's emphasis on the indirect effects of trade in the form of widening of the market and the resultant improvement in the process of production indicated dynamic gains. Similarly, the productivity theory of international trade, explained by Hla Myint (1958, 1977), links economic growth with the country's foreign trade. It is because trade encourages innovations, overcomes technical indivisibilities, and raises labour productivity. These are nothing but dynamic gains.

Leibenstein (1966) is of the view that free trade may lead to promote X-efficiency, which means better use of inputs so as to reduce real costs per unit of output. Here, the cost reduction is definitely the dynamic gain from trade.

3.8 TERMS OF TRADE

The concept of terms of trade is important in view of ascertaining the gains from trade. It is based on "what you get for what you give". If you get more than what you give, the terms of trade move in your favour and the trade brings in gain to you. For example, raising of oil prices in 1973 by the OPEC nations improved their terms of trade and worsened the terms of trade of the oil importing countries. To explain this phenomenon, if the import price rises relatively to the export price, it means that one physical unit of the export will buy fewer physical units of import than before. This is nothing but deterioration in the terms of trade. For a comparative analysis of the trend in the export and the import prices, one constructs the price index for exports and imports in the same fashion that the consumer price index is constructed.

There are different measures of terms of trade such as net barter terms of trade, gross barter terms of trade, income terms of trade, factoral terms of trade, utility terms of trade, and the real cost terms of trade (Meier, 1965). However, the first three measures are more commonly used for empirical analysis. Net

Net barter terms of trade index is defined as Export price index divided by import price index.

Gross barter terms of trade index refers to export quantity index divided by import quantity index.

Income terms of trade index is defined as net barter terms of trade index multiplied by the index of the size of export.

barter terms of trade represent the ratio between the export price index and the import price index. In form of an equation,

$$\text{Net barter terms of trade} = \frac{P_x}{P_m} \qquad ...(3.1)$$

Where P_x is the export price index, and
P_m is the import price index.

For example, if in India in 2001, the export price index is 183 and the import price index is 224 (1980 = 100), the net barter terms of trade in 2001 will be unfavourable at 0.817, showing a decline by 18 per cent over the base year.

In case of gross barter terms of trade, the index of import quantity and the index of export quantity are computed and then the ratio between the two is found out. Since the quantity of different commodities cannot be easily added up, it is the value of export and import that is taken into account for this purpose. Gross barter terms of trade are favourable if a given quantity (value) of export is able to import a larger quantity (value) of import. In other words, gross barter terms of trade are reciprocal of the net barter terms of trade. In the form of an equation,

$$\text{Gross barter terms of trade} = \frac{Q_x}{Q_m} \qquad ...(3.2)$$

Where Q_x is export quantity index, and
Q_m is the import quantity index.

If in India in 2001, the quantity of export index and quantity of import index are respectively, 110 and 105, with the base year as 1980, the gross barter terms of trade in 2001 will be unfavourable at 1.048, showing a decline of 4.8 per cent over the base year.

The computation of the income terms of trade is also important. With a fall in the export prices over a period, the net barter terms of trade will tend to deteriorate, but if the demand is highly price elastic, the export earnings will rise at a greater rate, which is beneficial from the viewpoint of the country's foreign exchange earnings. If this is the situation, the income terms of trade will tend to improve despite deterioration in the net barter terms of trade. The computation of income terms of trade is very simple. The net barter terms of trade index is multiplied by the index of the size of export.

Terms of Trade Index

- Net barter terms of trade index = (Export price index/import price index) × 100
- Gross barter terms of trade index = (Export quantity index/import quantity index) × 100
- Income terms of trade index = Net barter terms of trade index × Export size index

The preceding chapter deals with the theories of international trade. Therefore, it is benefical to discuss the theoretical aspects of FDI in the present chapter especially, the basic theories in this respect and the impact of FDI, both in macroeconomic and microeconomic framework. It also discusses how the cost FDI can be minimised through control of MNCs.

4.1 THEORIES OF FDI

There are a number of theories explaining FDI. Except for the MacDougall-Kemp hypothesis, FDI theories are primarily based on imperfect market conditions. A few among them are based on imperfect capital market. The others take non-economic factors into account. Still others explain the emergence of MNCs exclusively among developing countries.

4.1.1 MacDougall-Kemp Hypothesis

Investment flows from a capital-abundant economy to a capital-scarce economy until the marginal productivity of capital in both of them is equal or till the returns from investment is greater than the loss of output in the home country.

One of the earliest theories was developed by G.D.A. MacDougall (1958) and subsequently elaborated by M.C. Kemp (1964). Assuming a two-country model—one being the investing country and the other being the host country—and the price of capital being equal to its marginal productivity, they explain that capital moves freely from a capital abundant country to a capital scarce country and in this way the marginal productivity of capital tends to equalise between the two countries. This leads to improvement in efficiency in the use of resources that leads ultimately to an increase in welfare. Despite the fact that the output in the investing country decreases in the wake of foreign investment outflow, national income does not fall insofar as the country receives returns on capital invested abroad, which is equivalent to marginal productivity of capital times the amount of foreign investment. So long as the income from foreign investment is greater than the loss of output, the investing country continues to invest abroad because it enjoys greater national income than prior to foreign investment. The host country too witnesses increase in national income as a sequel to greater magnitude of investment, which is not possible in the absence of foreign investment inflow.

4.1.2 Industrial Organisation Theory

The industrial organisation theory is based on an oligopolistic or imperfect market in which the investing firm operates. Market imperfections arise in many cases, such as product differentiation, marketing skills, proprietary technology, managerial skills, better access to capital, economies of scale, government-imposed market distortions, and so on. Such advantages confer on MNCs an edge over their competitors in foreign locations and, thus, help compensate the additional cost of operating in an unfamiliar environment.

One of the earliest theories based on the assumptions of an imperfect market was propounded by Stephen Hymer (1976). To Hymer, a multinational firm is a typical oligopolistic firm that possesses some sort of superiority and that looks for control in an imperfect market with a view to maximising profits. Despite the fact that the international firm is posted disadvantageously in a foreign host country where it has no intimate knowledge of language, culture, legal system, and consumers' preference, it possesses certain specific advantages that outweigh the disadvantages. The firm-specific advantages in Hymer's view are mainly the technological advantages that help the firm to produce a new product different from the existing one. It is in fact related to the possession of knowledge, which helps in developing special marketing skills, superior organisational and management set-up, and improved processing. What is significant in this theory is that these advantages are transmitted more effectively from one unit to the other irrespective of their geographical distance. Since the market is imperfect, rival firms do not avail of the technological advantage. International firm harvests huge profits. Graham and Krugman (1989) found empirically that it was the technological advantage possessed by European firms that had led them to invest in the USA. Caves (1971) feels that firm-specific advantages are transmitted more effectively if the firm participates effectively in the production in the host country than through other ways such as export or licensing agreements.

> **Firm-specific advantage** refers to technological and similar other advantages possessed by a firm that enable it to produce new, differentiated products.

4.1.3 Location-specific Theory

Hood and Young (1979) stress upon the location-specific advantages. They argue that since real wage cost varies among countries, firms with low cost technology move to low wage countries. Again, in some countries, trade barriers are created to restrict import. MNCs invest in such countries in order to start manufacturing there and evade trade barriers. Sometimes it is the availability of cheap and abundant raw material that encourages the MNCs to invest in the country with abundant raw material.

> **Location-specific advantage** refers to advantages like cheap labour, abundantly available raw material, and so on for the production of a commodity to be established in a particular location or country.

4.1.4 Product Cycle Theory

Hymer explained "why" foreign investment takes place. Hood and Young explained "where" foreign investment takes place. It was Raymond Vernon (1966) who added "when" to "why" and "where", based on data obtained from US corporate activities. Raymond Vernon's theory is known as the product cycle theory.

Vernon feels that most products follow a life cycle that is divided into three stages. The first is known as the "innovation" stage. In order to compete with other firms and to have a lead in the market, the firm innovates a product with the help of research and development. The product is manufactured in the home country primarily to meet the domestic demand, but a portion of the output is also exported to other developed countries. The quality of the product, and not the price, forms the basis of demand because the demand is price-inelastic at this stage.

> **Innovation stage** is a stage in the product cycle when the product is in demand because of its new and improved quality, irrespective of its price.

Maturing product stage is a stage in the product cycle when the demand for the innovator's product is price-elastic in view of availability of similar products in the market.

The second stage is known as "maturing product" stage. At this stage, the demand for the new product in other developed countries grows substantially and it turns price-elastic. Rival firms in the host country itself begin to appear at this stage to supply similar products at a lower price owing to lower distribution cost, whereas the product of the innovator is often costlier as it involves the transportation cost and tariff that is imposed by the importing government. Thus in order to compete with rival firms, the innovator decides to set up a production unit in the host country itself, which would eliminate transportation cost and tariff. This leads to internationalisation of production. The imposition of tariff in the host country encouraging foreign direct investment is confirmed by Uzawa and Hamada, but they feel that entry of foreign capital in protected industry reduces welfare in the host country (Kojima, 1978).

Standardised product stage is a stage in the product cycle when technology does not remain the exclusive possession of the innovator. Competition turns stiffer.

In the final or "standardised product" stage, a standardised product and its production techniques are no longer the exclusive possession of the innovating firm, rival firms from the home country itself, or from some other developed countries, put stiff competition. This is not unusual because the follow-the-leader theory developed by Knickerbocker (1973) suggests that there is a tendency among followers to snatch the benefits of international production from the innovator. At this stage, price competitiveness becomes even more important; and in view of this fact, the innovator shifts the production to a low cost location, preferably a developing country where labour is cheap. The product manufactured in a low cost location is exported back to home country or to other developed countries.

Dematuring stage is a a stage when technological development breaks down product standardisation.

Literature on the subject identifies one more stage in the product's life cycle. It is known as "dematuring" stage, when development in technology or in the consumers' preference breaks down product standardisation. Sophisticated models of the product are manufactured again in technology advanced, high income countries so that the firm can have a close linkage with consumers' tastes and with the basic infrastructure required for production. Cheap labour does not matter much at this stage as sophisticated models involve a capital intensive mode of production. Globerman (1986) has explained the four stages with a simple example of television set that was first produced in the United States of America and then in other advanced countries. Technology became standardised. Production became concentrated in Japan owing to the cheap labour cost. Lastly, the dematuring stage appeared when sophisticated models were developed and produced in the USA itself.

The product cycle theory clearly explains the early post-Second World War expansion of US firms in other countries. But with changes in the international environment, different stages of the product life cycle did not necessarily follow in the same way. Vernon (1979) himself has pointed out this limitation in his later writing, showing how in the second stage itself firms were found moving to the developing world to reap the advantages of cheap labour. This was possible with the narrowing of the information gap.

Again, the assumptions of the theory that the "export threat" causes a firm to set up a subsidiary in that country are not always true. If this is true, all US firms should have set up subsidiaries abroad in countries to which they had been exporting (Bhagwati, 1972). Yet again, development in the second stage and in the third stage is contradictory in the sense that the former is anti trade oriented vis-à-vis the latter, which is trade-oriented. In fact, it is this difference that characterises US firms and differentiates them from the Japanese ones (Kojima, 1985).

4.1.5 Internalisation Approach

Buckley and Casson (1976) too assume market imperfection, but imperfection, in their view, is related to the transaction cost that is involved in the intra-firm transfer of intermediate products such as knowledge or expertise. In an international firm, technology developed at one unit is normally passed on to other units free of charge. This means that the transaction cost in respect of intra-firm transfer of technology is almost zero, whereas such costs in respect of technology transfer to other firms are usually exorbitantly high putting those firms at a disadvantage. Coase (1937) too believes that MNCs bypass the regular market and use internal prices to overcome the excessive transaction cost of an outside market. Thus, it is the internalisation benefit manifesting in the cost-free intra-firm flow of technology or any other knowledge that motivates a firm to go international. It can be said that the views of Buckley and Casson are more or less in common with the contents of the appropriability approach of Magee (1979) that emphasises on potential returns from technology creation as a prime mover behind internationalisation of firms.

Internalisation benefit is cost-free intra-firm flow of technology developed by the parent unit.

There are, of course, critics who argue that intra-firm transaction cost may not necessarily be low. If subsidiaries are located in an unfamiliar or uncongenial environment, the transaction cost is generally high. Kogut and Parkinson (1993) are of the view that if the transfer of intermediate goods involves substantial modification of well established practice, transaction cost is very large. Franke, Hofstede, and Bond (1991) opine that if the cultural differences between the home country and the host country are wide, the internalisation process will be a costly affair.

Again, the internalisation theory, says Rugman (1986), is a general theory explaining FDI and so it lacks empirical content. However, in a subsequent study, he feels that with a precise specification of some additional conditions successful testing is possible. Buckley (1988) himself is suspicious of the very limitation, but is hopeful of getting satisfactory results from a rigorous and precise test.

4.1.6 Eclectic Paradigm

Dunning's eclectic paradigm is a combination of the major imperfect market-based theories of FDI, that is, industrial organisation theory, internalisation theory and location theory. It postulates that, at any given time, the stock of foreign assets owned by a multinational firm is determined by a combination of firm specific or ownership advantage (O), the extent of location bound endowments (L), and the extent to which these advantages are marketed within the various units of the firm (I). Dunning is conscious that configuration of the O-L-I advantages varies from one country to the other and from one activity to the other. Foreign investment will be greater where the configuration is more pronounced.

Again, he introduces a "dynamised add-on" variable to his theory. This is nothing but a variable of strategic change, which may be either autonomous or a strategy induced change. International production during a particular period would be the sum of the strategic responses of the firm to the past configuration of O-L-I and to changes in such configuration as a sequel to exogenous and endogenous changes in environment. The example of autonomous change in strategy may be that a firm makes foreign investment more in innovatory activities because of greater O-advantage, or it invests more in a particular country because of L-advantage or it adopts a different marketing strategy depending upon the greater amount of I-advantage. Similarly, the strategy induced change may be evident from the fact that a market seeking investment has a different O-L-I configuration from that of a resource based investment. And ultimately, it is the varying configuration that shapes the direction and the pattern of FDI (Dunning, 1980, 1993).

The eclectic approach thus, has wider coverage. It has also been empirically tested by Dunning himself with satisfactory results.

4.1.7 Currency based Approaches

Firms from a strong-currency country move out to a weak-currency country.

The currency based theories are normally based on imperfect foreign exchange and capital market. One such theory has been developed by Aliber (1971). He postulates that internationalisation of firms can best be explained in terms of the relative strength of different currencies. Firms from a strong-currency country move out to a weak-currency country. In a weak-currency country, the income stream is fraught with greater exchange risk. As a result, the income of a strong-currency country firm is capitalised at a higher rate. In other words, such a firm is able to acquire a large segment of income generation in the weak-currency country corporate sector.

The merits of Aliber's hypothesis lie in the fact that it has stood up to empirical testing. FDI in the United States of America, Canada, and the United Kingdom has been found to be consistent with the hypothesis. However, the theory fails to explain why there is FDI in the same currency area.

Another theory based on the strength of currency has been developed by Kenneth Froot and Jeremy Stein (1989). The view is that depreciation in the real value of currency of a country lowers the wealth of domestic residents vis-à-vis the wealth of foreign residents. As a result, it is cheaper for foreign firms to acquire assets of domestic firms. The authors have found that this factor has been one of the determinants of foreign investment in the United States of America.

Yet another theory in this context has been propounded by Richard Caves (1988) in one of his later writings. Caves mentions a couple of channels through which exchange rate influences FDI. First, changes in exchange rate influence the cost and revenue stream of a firm. If the domestic currency depreciates, the import bill will inflate, diminishing in turn the net income. But, if export expands in the wake of currency depreciation, income will rise. Secondly, exchange rate changes influence FDI by giving rise to capital gains. Depreciation in the value of currency, which is expected to be reversed in the near future, will lead to capital gains following appreciation. In lure of capital gains, foreign capital will flow in. This theory has been tested empirically by Caves himself, who finds a negative correlation between the level of exchange rate and the level of FDI in the USA.

4.1.8 Politico-economic Theories

The politico-economic theories concentrate on political risk. Political stability in the host countries leads to foreign investment therein (Fatehi-Sedah and Safizedah, 1989). Similarly, political instability in the home country encourages investment in foreign countries (Tallman, 1988). However, Schneider and Frey (1985) believe that the theory underlying the political determinants of FDI is less well developed than those involving economic determinants. The political factors are only additive ones influencing foreign investment.

> Political stability in the host countries leads to foreign investment therein. Similarly, political instability in the home country encourages investment in foreign countries.

4.1.9 Modified Theories for Third World Firms

The theories discussed above also apply to international firms headquartered in developing countries, but they need some modifications. These firms have long been importing technology from industrialised countries. But since imported technology is mainly designed to cope with a large market, firms export a part of their output after meeting the domestic demand. The products become gradually mature and then the firms set up units in the product importing countries. But it is different from the product cycle theory insofar as the firms do not necessarily innovate the product; rather they modify the product to suit the consumers' needs in different countries. The modification is of scaling-up kind when it concerns the consumers in the developed countries. For the low income consumers, it is a scaling-down modification. However, it cannot be denied that modification of these types confers upon the firms a sort of firm-specific advantage (Sharan, 1985). Winlee Ting (1982) cites an example of a Taiwanese firm manufacturing pressure cookers and table fans. The firm modified the imported technology and set up units not only in the developing countries but also in the country from where it had originally imported the technology.

> Developing country MNCs possess firm-specific advantage in form of modified technology. They move abroad also to reap advantages of cheap labour and abundance of natural resources.

Again, the firms in developing countries possess a pool of cheap labour that accompanies the investment. On the other hand, the developing host country possesses, in some cases, abundance of natural resources, which attracts investment from other developing countries. This is very much in common with the locational theory of FDI discussed above. Thus, the theories discussed so far applies also to MNCs of the developing world.

> The gains accruing to option buyers are unlimited, while the loss borne by them is limited to the amount of premium. For the seller, the profit profile is simply the mirror image of the loss profile of the option-buyer.

currency options provides an asymmetry between income and risk of loss. In case of a call option, the buyer will gain if the spot price is greater than the sum of the strike price and the premium. For the seller of the call option, the profit profile is simply the mirror image of the loss profile of the option-buyer. If the buyer does not exercise the option, the gain accruing to the seller will be equal to the amount of the premium. But if the buyer exercises the call option, the seller will have to face a loss equal to the excess of the spot price over the strike price, which can be any amount.

In case of a put option, the buyer will let the option expire if the spot rate is greater than the strike rate. The buyer will be put to a loss equivalent to the amount of premium. Profit will accrue to the buyer only if the spot price is lower than the sum of the strike price and the amount of the premium. As far as the seller is concerned, profit will be equal to the amount of premium. The amount of loss will be infinite, depending upon how much lower the spot price is.

13.3 INTERNATIONAL FINANCIAL MARKET

When a multinational enterprise finalises its foreign investment project, it needs to select a particular source, or a mix of the sources, of funds in order to finance the investment project. In this context, it may be asserted that international companies have easy access to the international financial market. Nevertheless, they should be acquainted with the different sources of funds and also with their comparative cost and benefit.

International Financial Market

A. **Official Sources:**
   1. Multilateral Agencies
      (i) International Development Banks such as the World Bank, IFC, and others
      (ii) Regional Development Banks such as Asian Development Bank, and others
   2. Bilateral Agencies or Different Governmental Agencies

B. **Non-Governmental Agencies:**
   1. Borrowing and Lending Market involving International Banks
   2. Securities Market
      (i) Debt Securities
      (ii) Equities

The international financial market can be compartmentalised into two segments. One is the international money market represented by the flow of short term funds. International banks or short term securities come under this segment. On the other hand, the international capital market forms the other segment where medium and long term funds flow. Irrespective of such a distinction between the two segments, there are a number of agencies and instruments through which funds move to resource needy institutions or firms. One can group the resource providing agencies under two heads. In one group come the official agencies; while in the other group come the non-official agencies. Among the official agencies, are, first, multilateral institutions such as international development banks and regional development banks, and, secondly, bilateral agencies such as different governmental agencies. The multilateral or bilateral funds can be concessional or they may be non-concessional. Those being highly concessional or, in other words, having large grant element, are known as official development assistance.

The non-official channel can be compartmentalised as the borrowing and the lending channel, on the one hand, in which international banks play a significant role; and on the other, the securities market in which the euro equities and debt instruments such as international bonds, medium term euro notes, short term euro notes and euro commercial papers are sold and purchased.

13.3.1 Multilateral Agencies

Up to the mid-1940s, there was no multilateral agency to provide funds. It was only in 1945 that the International Bank for Reconstruction and Development (IBRD) was established. It provided loans for reconstruction of the war ravaged economies of Western Europe and then also began providing development loans in 1948. The IBRD's function was limited to lending and so the provision of equity finance lay beyond its scope. Moreover, it lent only after the guarantee by the borrowing government. Thus, in order to overcome these problems, the International Finance Corporation (IFC) was established in 1956 to provide loans even without government guarantee and also provided equity finance. However, one problem remained to be solved. It was regarding the poorer countries of the developing world, which were not in a position to utilise the costly resources of the IBRD, because those funds were carrying the market rate of interest (Sharan, 1991). Another sister institution was created in 1960 for these countries and it was named the International Development Association (IDA). The two institutions—IBRD and IDA—together came to be known as the World Bank.

IBRD and IDA—together came to be known as the World Bank. IBRD, IDA, IFC, and MIGA—together are known as the World Bank Group.

When IBRD was established, its main objective was not to distribute direct loans but to encourage private investment. It began lending on a large scale only when the desired amount of private investment failed to come up during the initial years. Lending naturally became the major function but the issue of encouragement to international investment remained. And to this end, the Multilateral Investment Guarantee Agency (MIGA) was established in 1980s in order to cover the non-commercial risks of foreign investors. All these four institutions—IBRD, IDA, IFC, and MIGA—together are known as the World Bank Group. Talking liberally, the International Centre for Settlement of Investment Disputes (ICSID), that was set up in 1966, is also treated as a part of the World Bank Group.

When the World Bank Group emerged as a major funding agency, it was felt that its lending norms did not suit all member countries belonging to different regions equally. This is because the economic and political conditions as well as the requirements of the different regions of the globe were different. Thus, for tuning of the funding in line with varying requirements of the different regions, it was decided to set up regional development banks on the pattern of the international development banks. The 1960s were marked with the establishment of regional development banks in Latin America, Africa, and Asia. The Asian Development Bank, meant for the development of the Asian region, began operations from 1967.

13.3.2 Bilateral Agencies

The history of bilateral lending is not older than that of multilateral lending. During the first half of the twentieth century, funds flowed from the empire to its colonies for meeting a part of the budgetary deficit of the colonial government. But it was not a normal practice. Nor was it ever considered as external assistance, as it is in the present day context. Bilateral economic assistance was announced for the first time by the US President Truman in January 1951. In fact, the motivation behind the announcement was primarily political and economic. The cold war between the United States of America and the then Union of Soviet Socialist Republic (USSR) was at its peak during this period. The US government tried to befriend developing countries and bring them into its own camp in order to make itself politically more powerful. It could help the US economy to come closer to developing economies and also to get the desired raw material and food stuffs from them. The economic assistance could help build the infrastructural facilities in the developing countries, which could, in turn, help increase US private investment in those countries.

In the second half of 1950s, the then USSR bloc too announced its external assistance programme in order to counter the US move. By the late 1950s, many other governments of the Organisation of Economic Cooperation and Development (OECD) announced external assistance programmes. Thus, bilateral lending came to full bloom for the first time. In some cases, different governments joined hands with private agencies and the export credits came to form a sizeable part of the bilateral assistance programme.

13.3.3 International Banks

Among the non-official funding agencies, international banks occupy the top position. If one looks at their development since 1950s, distinct structural changes are evident. In the first half of the twentieth century and till the late 1950s, international banks were primarily domestic banks performing the functions of international banks. This means that they operated in foreign countries, accepting deposits from, and making loans to, the residents in the host countries. They dealt in the currency of the host countries, but at the same time, they dealt in foreign currency, making finance available for foreign trade transactions.

Euro banks deal with residents and non-residents, but not in the currency of the country where they are located.

Euro Banks: In the late 1950s and especially in the early 1960s, banks with a purely international character emerged on the global financial map. This new variety of banks came to be known as euro banks. The deposit with and the lending by the euro banks formed the euro currency market. The euro banks emerged on a footing quite different from the traditionally known international banks.

Euro banks deal with both residents and non-residents. They essentially, deal in any currency other than the currency of the host country. For example, if a euro bank is located in London, it will deal in any currency other than the British pound. The deposits and loans of the euro bank are remunerated at the interest rate set by the market forces operating in the euro currency market and not by the interest rate prevailing among the domestic banks in the host country. Again, the other difference between the traditional international bank and the euro bank is that the former is subjected to rules and regulations of the host country, but euro banks are free from the rules and regulations of the host government. The rationale behind the deregulation is that the activities of euro banks do not touch the domestic economy. This is because they are concerned normally with the movement of funds from one foreign market to another foreign market and so are neutral from the viewpoint of any direct impact on the balance of payments of the host country.

Factors behind the Emergence of the Euro Banks: There were a host of factors leading to the emergence and growth of euro banks.

1. It may be mentioned that after Stalin's death, the erstwhile USSR moved away from a closed economic policy. Its trade with the West and the South began to expand since the late 1950s and the early 1960s. During that time the US dollar was the most desired currency in international transactions. So the USSR earned US dollars through trade and tried to earn more of this currency in view of its great strength in international payments. But since the cold war between the two super powers was then at its peak, the United Soviet Socialist Republic preferred to keep its dollars in a bank outside the United States of America. London and a few other European financial centres were the best choice as they possessed the requisite infrastructure and stable political climate. The **dollar deposits in London and other European country based banks** came to be known as euro dollar. Banks accepting such deposits came to be known as euro banks.
2. The British government placed **restrictions on the use of the pound sterling for external transactions** in the wake of the foreign exchange crisis of 1955–57. Naturally, the dollar was in great demand in the United Kingdom for external transactions. In view of readily available supply of dollars, this currency was largely used in external transactions. Moreover, the emerging convertibility of some European currencies by the late 1950s led to the emergence of an active foreign exchange market in Europe linking, in turn, the US dollar with those European currencies. These links enhanced, in turn, the use of the US dollar by banks located in Europe.

3. The emergence of euro banks was supported by some **capital control measures by the US government** in the wake of its balance of payments crisis in the 1960s. In early 1965, the introduction of the Voluntary Foreign Credit Restraint Programme limited the ability of US based banks to lend directly to the non-residents, whereas this provision did not apply to the foreign branches of US banks. This shifted foreign operations of US banks from those located in the United States of America to their offices located in other countries, mainly in Europe. Data show that the number of US banks having foreign branches rose from 11 in 1964 to 125 in 1973 and the number of foreign branches of those banks moved up from 181 to 699 during the same period. The assets of those branches went up from US $7.0 billion to US $118 billion during the same period (Johnston, 1982).
4. Some of the European governments put **restrictions on holding of deposits** by non-residents in domestic currency and on paying of interest on non-resident deposits. It encouraged non-residents to hold deposits in Euro banks that were not subjected to such regulations.
5. The **interest rate ceiling** was imposed by the US government too. It means that when credit was tight and the market interest rate had risen, the US banks could not raise interest rate. On the contrary, euro banks that were not under the purview of such ceilings, raised their interest rate on deposits and lured depositors away from US based banks.
6. When **domestic credit was restricted**, companies borrowed from euro banks, normally at lower rates of interest. Increased lending and deposits contributed to the growth of euro banks. It was not only that the US banks came to be based in Europe. European banks too spread their branches overseas, perhaps as a defensive measure. Statistics reveal that the number of their overseas branches increased from 1,860 in 1961 to 3,764 in 1973. The number of foreign branches of UK based banks alone rose from 1,105 to 1,973 during the same period (Bhatt, 1991).

Offshore banking centres are international banks dealing with non-residents only and not in the currency of the country where they are located.

Off shore Banking Centres: In the 1970s, a new type of international bank emerged which was different from traditional banks or from the Euro banks and these came to be known as off shore banking centres (OBCs). The distinctive feature of the OBCs was that they dealt with the non-residents only; although like the Euro banks, they did not deal in the currency of the host country. In fact, they channelled funds from one country to the other without influencing the domestic financial market.

OBCs came to cluster at places and in countries where the:

1. the Governmental control and regulations were the least interfering;
2. Tax rates were very low;
3. Necessary infrastructure for their smooth operation, such as an improved system of communication, supportive system, existence of an experienced financial community, and so on was available; and
4. political and economic stability was found.

Looking at specific cases, one finds that it was the non-flexibility of governmental restrictions that kept Germany, France, and Japan away from the growth of the OBCs. On the other hand, it was this flexibility that helped London, Luxembourg, Singapore, Hong Kong, and many others to attract OBCs. OBCs grew in Bahamas, Luxembourg, Cayman Islands, and in Panama in view of low rates of taxes. Better communication facilities and availability of experienced personnel were the additional factors for London based OBCs. The presence of exchange control measures grew with in the growth of OBCs in Latin American countries. On the contrary, Kuwait and Bahrain attracted OBCs on account of least governmental interference. Whatever might be the reasons for their growth, OBCs attracted a large number of borrowers and lenders. The foreign currency liabilities of OBCs in European reporting countries rose from US $79.3 billion in 1970 to US $801 billion in 1979 and the total liabilities of US banks' branches in the Bahamas and Cayman Islands alone grew from US $4.8 billion to US $121.8 billion during the same period (Johnston, 1982).

Syndicated lending is found when banks join hands to provide large loans.

Syndicated Lending: Another structural change that took place in the international banking system during the 1970s was evident in form of syndicated lending. In the wake of international oil price rise, a number of oil importing countries experienced a huge deficit in their current account. Consequently, they went for bigger loans which were normally beyond the capacity of a single bank. The banks joined hands for providing large loans. It reduced their individual risk of lending. Besides, from the borrowers' point of view, the cost of the syndicated loans was smaller than the sum of the cost of individual loans borrowed from many banks. Whatever might be the reasons for the coming together of the banks, such lending came to be known as syndicated lending. Such loans served the interest of both the lenders and the borrowers and so they took a great leap forward. Born in the early 1970s, 'Syndication' crossed US $88 billion mark by 1980 and reached US $320 billion by 1995 (IMF, 1997).

Syndicated loans are different from general loans. One of the lending banks is the lead manager who originates the transaction, structures it, selects the lending members, supervises the documentation, and in many cases, services the loan after the agreement is complete. It serves as a link between the borrower and the other banks of the syndicate. It collects interest and principal from the borrower and disburses the collected amount among the co-lenders. For its functions, the lead bank charges an additional fee.

Nature of Transactions in Euro-currency Market: Financial intermediation is the primary function of international banks. It has two aspects: one is to get deposits/borrowing, while the other is lending. A sizeable segment of financial intermediation, represented by inter-bank transactions, may be at a single financial centre or spread over different financial centres. Inter-bank deposits, borrowing and lending involve short term funds and, hence, they are very important from the viewpoint of smoothening of liquidity, transfer of liquidity, and equitable allocation of international liquidity. If a bank is short of liquidity, it can borrow immediately from other banks. If, on the other hand, it has surplus liquidity, it can lend or deposit the excess cash with other banks.

Inter-bank deposits, borrowing and lending, lead to smoothening of liquidity, transfer of liquidity, and equitable allocation of international liquidity.

Again, when banks borrow and lend in different currencies in different markets, the process influences the stock of a particular currency in a particular market. The allocation of liquidity in a particular market tends to move towards optimisation.

Non-bank depositors/borrowers are mainly corporate bodies and governments.

Non-bank depositors/borrowers are mainly corporate bodies and governments. Deposits in Euro banks and off shore banking centres are not subject to national regulations such as cash reserves ratio. As a result, they are able to pay a higher interest rate on deposits compared to other banks. They normally accept time deposits with maturity varying between one day and several years, but usually between seven days and six months.

In case of lending, international banks do not insist on restrictive covenants such as ratio limit, dividend restrictions, interest coverage, and so on. The loans are short term, medium term, and long term. The interest rate applicable to deposits as well as lending depends on the movement of LIBOR. However, the lending rate of short term funds is usually greater than the deposit rate by one-eighth of one per cent so that the financial intermediation proves profitable for the banks. The greater the maturity, the higher the interest rate. This means that medium term and long term loans carry a higher rate of interest than short term loans. Nevertheless, the rate of interest charged by Euro banks and OBCs for lending is often lower than those charged by other banks. This is mainly because they lie outside the purview of local regulations.

The credit creation ability of international banks is greater than the domestic banks' inasmuch as they do not have to abide by the host government's regulations.

It is not only the lending rate that is higher than the deposit rate, the amount of the loans given by the banks is often higher than their deposit base. This is because credit creation is common among international banks. It would not be an exaggeration to say that the credit creation ability of international banks is greater than the domestic banks' inasmuch as they also not have to abide by the host government's regulations (Lee, 1973; Bell, 1973; Klopstock, 1988). Fratianni and Savons (1971) estimated the credit creation multiplier among international banks between 3.0 and 7.0. Makin's estimate (1972) was higher, indicating between 10.31 and 18.45.

Besides financial intermediation, international banks are actively involved in the foreign exchange market. As mentioned earlier in this chapter, they play the role of middlemen in the foreign exchange market. They also function as arbitrageurs and speculators so they can play the role of a market maker by influencing the supply and demand of a particular currency.

13.3.4 International Securities Market

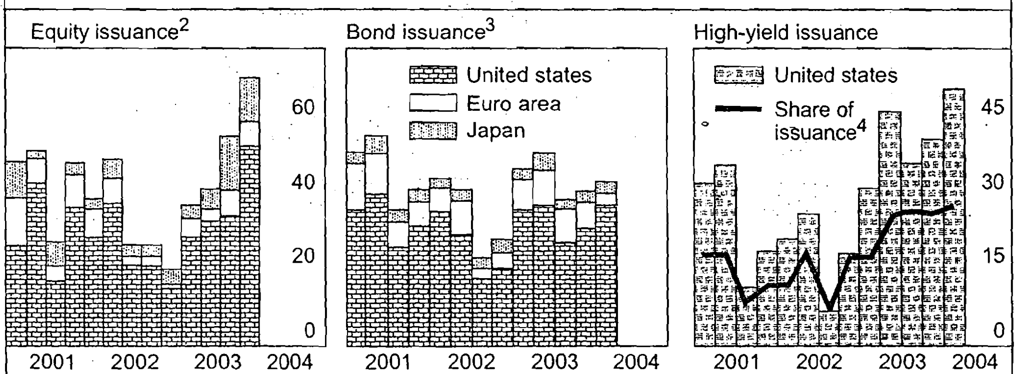
Shift towards Securities Market: There was a big leap in bank lending during the 1960s and more particularly during the 1970s, after international banks had acquired the surplus of oil exporting countries. But during the 1980s, a number of factors emerged on the map of international economy that led to a shift from bank lending to growing securitisation in the international financial market.

1. With stagnant oil prices, international banks could not sustain any sizeable increase in loans.

2. External debts of some of the borrowing countries turned unmanageable. The borrowers found themselves unable to repay loans. Mexico's refusal to repay loans added fuel to fire. The risk of repayment grew so large that banks hesitated in lending.
3. A drop in long term interest rates during the 1980s and the reappearance of positive real interest rates, and more importantly, a rising trend in the yield from long term bonds made investors invest in international bonds.
4. The rising intermediation cost associated with bank lending moved the borrowers away from banks and brought them closer to the securities market (Honeygold, 1989).
5. The securities proved highly liquid as the investors could sell them in the secondary market which had developed along with the growth in securitisation.
6. International banks liked to compensate lost income from the lending business through their active participation in off-the-balance sheet activities. The more commonly used securities came to be international bonds and euro equities for long term funds, medium term euro notes meant for medium term funds, and euro notes and Euro commercial papers that were meant for short term funds.

International Equities: Euro equities are not debts as holders are paid dividend. They do not represent FDI as the holders do not enjoy voting rights. They represent a mixture of the two and, hence, are in great demand. (1) They are issued when the domestic market is already flooded with shares and the issuing company would not like to add further stress to the domestic stock of shares since such additions may cause a fall in share prices; (2) companies issue such

Fund-raising in capital markets
Gross issuance, in billions of US dollars[1]



[1]Issuance in other currencies is converted into US dollars at quarterly average exchange rates. [2]Initial and follow-on offerings. [3]Debt securities issued in domestic markets by non-financial corporations; data for the euro area refer to euro-denominated bonds issued in domestic and international markets.
Source: BIS Annual Report 2004

FIGURE 13.1

shares for gaining international recognition; (3) such issues bring in scarce foreign exchange; (4) capital is available at lower cost; and (5) funds raised this way do not add to foreign exchange exposure. From the viewpoint of investors, international equities bring in diversification benefits.

For the issue, the issuing company approaches a lead manager who advises the issuer on different aspects of the issue. On getting the advice, the issuer prepares a prospectus and other documents and takes permission from the regulatory authorities. It deposits the shares to be issued with a custodian bank located in the domestic country. The custodian bank is appointed by the depository in consultation with the issuing company. After the custodian holds the shares, the depository issues global depository receipts (GDRs). The ratio between the number of shares and the number of GDRs is decided before the issue is launched. The GDRs are sold to international investors and funds move from the investors to the depository, from the depository to the custodian bank, and from the custodian bank to the issuing company. The investor has right to surrender the GDR and to take back the investment. In this case, the GDR is submitted to the depository who informs the custodian who, in turn, will issue the share certificates in exchange for the GDR. The proceeds from the sale of shares are converted into foreign exchange and remitted to the investor through the depository.

> The GDRs are sold to international investors and funds move from the investors to the depository, from the depository to the custodian bank, and from the custodian bank to the issuing company.

In the process of the issue, the role of underwriting and listing is very important. The lead manager normally acts as the underwriter as well as the listing agent. After the listing formalities are over, the GDRs are traded on stock exchanges. International clearing houses facilitate the settlement of transactions.

International Bonds: International bonds may take many forms. They may be foreign bonds or euro bonds. A bond issued in a foreign country's financial market and denominated in the currency of that country is known as a foreign bond. But a euro bond being issued in a foreign country is denominated in any currency other than the currency of the country where it is issued. Foreign bonds are normally underwritten by underwriters in the country where they are issued. In case of euro bonds, the underwriters are multinational. Again, foreign bonds are normally subjected to the rules and regulations of the country where they are issued, but euro bonds are free from such regulations.

> International bonds are of different kinds: foreign bonds, euro bonds, global bonds, cocktail bonds, straight bonds, floating rate notes, convertible bonds, etc.

There are also global bonds issued for the first time by the World Bank in 1989 and now also being issued by companies. They are large in size, carry a high rating, and are offered for simultaneous placement in different countries. When bonds are denominated in SDRs, they are known as cocktail bonds as they represent more than one currency.

The bonds are either straight bonds carrying a fixed rate of interest; floating rate notes carrying a flexible interest rate based on the movement of the LIBOR; or they may be convertible bonds, meaning that they are convertible into equities after a specific period.

The procedure of issue is simple. The firm approaches a lead manager (a commercial bank or an investment bank) who advises the issuer on different aspects of the issue—such as timing, price, maturity, size, and the buyers' potential—for a fee. The lead manager may take the help of co-managers. After getting advice from the lead manager, the issuer prepares the prospectus and other legal documents and secures the approval of the regulatory authorities. After approval, it launches the issue. The documents accompanying the issue of bonds are normally: prospectus, subscription agreement, trust deed, listing agreement, paying agency agreement, underwriting agreement, and selling group agreement.

The lead manager underwrites the issue and charges an underwriting fee. After the underwriting is done, the bonds are sold. The lead manager functions as a selling group for a fee. There are also trustees appointed by the issuer, who protect the interest of the bondholders in case of default. In many cases, the lead manager functions as a trustee. Finally, there are listing institutions for listing the bonds for secondary marketing. The secondary market for international bonds is mainly an over-the-counter market, although the bonds are listed with stock exchanges. In case of foreign bonds, listing is limited to a particular country, but that in case of euro bonds involves many financial centres. Sometimes, before the secondary market starts functioning, the particular euro bond is in great demand and it is marketed. Such trading is known as grey trading, although such cases are rare.

Euro notes are promissory notes issued by companies for raising short term funds.

Euro Notes: Euro notes are promissory notes issued by companies for raising short term funds. They are denominated in any currency other than the currency of the country where they are issued. Unlike euro bonds, documentation formalities are minimal. They can be easily tailored to suit the requirements of different kinds of borrowers. Investors too prefer them in view of their short maturities.

For the issue of euro notes, the company hires a facility agent or a lead manager who advises them on the different aspects of the issue, underwrites the issue, and sells the notes through placement agents.

The cost components of euro notes are underwriting fee; one-time management fee for structuring, pricing, and documentation; and the margin on the notes themselves. The margin is either in form of a spread above/below the LIBOR or built in to the note price itself.

Documents accompanying these notes are the underwriting agreement, paying agency agreement, and information memorandum showing, among other things, the financial position of the issuer. The notes are settled either through physical delivery or through clearing.

ECP is a promissory note like the euro note. It is not underwritten and also it is issued only by highly creditworthy borrowers.

Euro Commercial Paper (ECP): This is also a promissory note like the euro note but it is different from euro notes in that it is not underwritten and also it is issued only by highly creditworthy borrowers. ECPs have evolved based on pattern of US and Canadian commercial papers that were issued as back as in 1960s. But they are different from the US CPs in the sense that ECPs have a longer maturity, going up to one year, and they are structured on the basis of all-in-costs, whereas in the case of the US CPs, various charges are collected separately.

ECPs vary in size from US $10 million to over US $1 billion and carry market based rates, normally the LIBOR. Non-interest-bearing ECPs are sold at discount. On maturity, they are settled through clearing houses. They are in great demand as they involve the least possible documentation.

Medium term Euro Notes: The euro notes met the requirements for medium term funds through rolling over. But the process of rolling over involved time and cost. This problem led to the issue of medium term euro notes that do not involve the rolling over process as they are issued for a medium term. They carry either a fixed rate of interest or a variable interest rate. Of late, the euro market has come up with global medium term notes where issues of different credit ratings are able to raise funds by accessing retail as well as institutional investors.

SUMMARY

- The foreign exchange market involves purchase and sale of foreign currencies. It is an over-the-counter, round-the-clock market. The participants are individuals, firms, banks, monetary authorities, and international bodies. The purpose is genuine transaction, hedging, arbitraging, and speculation. Transactions are spot and forward. In the forward market transactions are made for the future delivery of currency.
- There are markets for derivatives such as the market for currency futures and the market for currency options. The market for currency futures has a particular place where transactions take place through brokers. The size and maturity of the contract is fixed. There is provision for margin money and marking to market is an essential feature. The transactions in the market for currency options differ in the sense that the buyers of options have the privilege of exercising the option or letting it expire. They have to pay a premium to the options seller. Options contracts could be in different forms, such as the call option, put option, European option, American option, and so on. Such markets are either over-the-counter or they have a fixed place, known as the 'pit', where transactions are finalised.
- The international financial market witnesses the borrowing and lending of different currencies. There are different sources of funds. The multilateral sources are represented by the World Bank, the International Financial Corporation, and the regional development banks. There are also bilateral or governmental agencies involved in the lending business. Among the non-official sources, there are international banks comprising of traditional international banks, Euro banks, and off-shore banking centres. Primarily, they are engaged in financial intermediation, but they also operate in the foreign exchange market.
- International banking had its hey days during 1960s and more so during the 1970s. But due to a host of factors, their activities reached the lowest ebb by the early 1980s. As a result, the international securities market turned to be the most important source of funds. The instruments used in this market are international equities, international bonds, medium term euro notes, euro notes and euro commercial papers.

REVIEW

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