Module: 1

International Financial Environment

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In this session, international financial environment is discussed in details. The historical development of international trade is outlined and also the transition from GATT regime to functional aspect of WTO is discussed.

In this session, the following details about international financial environment are discussed.

- Global Economy - A Historical Perspective
- Financial Globalization- The Missing Link
- Experiences from India
- Openness of Indian Economy
- Indicators of Openness of Indian Economy

The session would help readers to understand the historical development of international trade and international financial environment and also articulate the structure of Balance of Payments.
1.1 Global Economy - A Historical Perspective

The process of globalization is not a new phenomenon. Some communication and trade took place among distant civilizations even in ancient times. In spite of occasional interruptions, the degree of economic globalization among different societies, around the world has generally been rising. More than a century ago, Marx and Engels rightly sensed the unprecedented efficiency of the industrial capitalism and predicted that capitalism would sweep through the entire world. Eventually capitalism spread to nearly the entire world, in a complex and sometimes fierce process. (Brookings Papers on Economic Activity, 1995).

Indeed, during the past half century, the pace of economic globalization has been particularly rapid. With the exception of human migration, global economic integration today is greater than it ever has been and is likely to deepen further.

It was the instrument of colonial expansion rather than the economic reforms through which the global capitalism came into existent. Western European powers with their superior industrial and military powers expanded their kingdom around the world. By the 1870s, the industrial revolution and colonial expansion led to establish a global market. Improvements in the technological progress in transportation and communication sectors, changing tastes and preferences of individuals and societies and public policies have significantly influenced the character and pace of economic globalization. Global economic system started functioning with the development of long distance communication system. Monetary standards, based on gold and silver, provided the vital support for the stability and spread of economic globalization.

First World War, Great Depression of the 1930s and political upheaval created unprecedented crises to global economy. The free trade regimes of 19th century were replaced by highly protected trade, state planning, authoritarianism and limited market based economy. At the end of the Second World War, the international economic system was in a state of collapse. International markets for trade in goods, services, and financial assets were essentially nonexistent. However, there was a silver lining in the midst of black cloud. It gave an opportunity for a completely new beginning for the world economy.

The new beginning started in the formation of International Monetary Fund for world level monetary standard. It also led in the establishment of various other international institutions like the International Bank for Reconstruction and Development, General Agreement on Trade and Tariff etc. Those institutions have contributed in the integration of world economy. After the World War II, most national governments began to lower their entry barriers, to make them more permeable for world trade.
The multilateral negotiations under the auspices of the General Agreement on Trade and Tariffs (GATT) stand out as the most prominent examples of reduction of barriers for trade in goods. The years between 1970 and 1990 have witnessed the most remarkable institutional harmonization and economic integration among nations in the world history. The decade of 1980, witnessed the integration of the communist world with the world economy as capitalism spread to their economies. The decade of 1980s also witnessed the practice of open economy macroeconomic policies by many developing countries. Several Latin American and Asian Countries had implemented financial reform policies or eliminated Government control of domestic interest rates, credit allocation and exchange rate etc. Countries like Korea, Malaysia, Chile, Argentina, Uruguay, Japan, Hong Kong, India and China have liberalized their economies. They have undertaken many policy decisions to reform their financial markets. One of the primary aims of financial reforms programme of these countries has been to integration of the various segments of financial markets.

The decade of 1990s is generally considered as the decade of re-unification of global economy. The world reached its climax in the process of integration of developed and developing worlds. Disintegration of the Soviet Union, the emergence of market-oriented economies in Asia, the creation of a single European market, formation of new era of trade liberalization through World Trade Organization etc., are few events of 1990s which led to global financial and economic integration. Development of IT-based communication system and services have significantly contributed in the further expansion of global financial system.

### 1.2 Financial Globalization-The Missing Link

If there is any arena of economic activity that has become extremely global in recent decades, it is finance. The world of finance has changed markedly over the past 40 years or so. During the early part of 1970s world economy witnessed scarcity of international liquidity primarily due to gold linked fixed monetary standard. There was also a growing realization that for achieving sustained growth with stability, it would be necessary to have open trade, liberalized external capital movements and a relatively flexible domestic monetary policy. Industrialized countries and emerging market economies took steps to liberalize capital account and allow capital to move across the globe.
Simultaneously, efforts were made to remove distortions in the domestic financial sector through financial sector reform measures. With the technological improvements in electronic payments, world economy became increasingly integrated in terms of trade, investment and financial flows among countries over the past decades.

There are primarily three traceable aspects of the growth of financial markets, which have led to financial globalization. These are:

(i) Significant expansion and deepening of the existing markets,
(ii) Emergence of new financial markets like derivatives
(iii) Development of secondary markets for many instruments.

A number of developing countries, especially in Asia, that moved early on to the path of economic liberalization had experienced large capital inflows. Large capital inflows, however, carried with it risk of financial sector vulnerability. The world economy had witnessed many financial crises. The experiences helped in for setting regulatory and supervisory framework, in proper place, to ensure the safety and stability of financial systems. The costs of financial crisis falling on the sovereign governments, the notion of financial stability has come to occupy a centre-stage in public policy along with the requirement of ensuring that the efficiency of financial sector is high.

The sub-prime crisis, which engulfed the world economy, has called for establishing a new international financial architecture. According to the IMF's Global Financial Stability Report (GFSR), the widening and deepening fallout from the U.S. subprime mortgage crisis would have profound implications on financial system. Financial markets remain considerably stressed because of a combination of weakening balance sheets of financial institutions, continued process of deleveraging, free fall in asset prices and difficult macroeconomic environment in the wake of debilitating global growth.

The global financial system has proved to be woefully inadequate, particularly in view of the manifest structural deficiencies in meeting the regulatory requirements of the present-day international financial system of the Bretton Woods architecture. The extraordinarily synchronized nature of the sub-prime crisis makes it necessary to launch the creation of a “Global Monitoring Authority” to promote global supervision of cross-border investment, trade and banking with the fast-growing economies. Even in this era of sweeping globalization, the free play of unfettered market mechanism is fraught with great danger. The market on its own is not enough. Accordingly, the governments must play an important role in shaping the economic policies and the broader frame of reference.
1.3 Experiences from India

India’s link with international trade is as old as the Indian civilization. Prior to colonial rule, India was known as the hub of manufacturing goods and artifacts. During the colonial rule India was converted to a raw materials suppliers to rest of the World. On the eve of independence in 1947, foreign trade of India was typical of a colonial and agricultural economy. Trade relations were mainly confined to Britain and other commonwealth countries. Exports consisted chiefly of raw materials and plantation crops while imports composed of light consumer goods and other manufactures. Over the last 60 years, India's foreign trade has undergone a complete change in terms of composition and direction. The exports cover a wide range of traditional and non-traditional items while imports consist mainly of capital goods, petroleum products, raw materials, and chemicals to meet the ever-increasing needs of a developing and diversifying economy.

For about 40 years (1950-90), foreign trade of India suffered from strict bureaucratic and discretionary controls. Similarly, foreign exchange transactions were tightly controlled by the government and the Reserve Bank of India. From 1947 till mid-1990s, India, with some exceptions, always faced deficit in its balance of payments, i.e. imports always exceeded exports. This was characteristic of a developing country struggling for reconstruction and modernisation of its economy. Imports galloped because of increasing requirements of capital goods, defence equipment, petroleum products, and raw materials. Exports remained relatively sluggish owing to lack of exportable surplus, competition in the international market, inflation at home, and increasing protectionist policies of the developed countries.

Beginning mid-1991, the government of India introduced a series of reforms to liberalize and globalize the Indian economy. Reforms in the external sector of India were intended to integrate the Indian economy with the world economy. India's approach to openness has been cautious, contingent on achieving certain preconditions to ensure an orderly process of liberalization and ensuring macroeconomic stability. This approach has been vindicated in recent years with the growing incidence of financial crises elsewhere in the world. All the same, the policy regime in India in regard to liberalization of the foreign sector has witnessed very significant change. Over the years issues related to trade policy, export strategy, tariff policy, current account dynamics, exchange rate management, foreign exchange reserves, capital account liberalization, external debt and aid, foreign investments and WTO have been the center of discussion under the International Trade and Finance.
Openness of an economy relates to its cross-border movements of goods, services and factors of production. The basic indicators of openness is the Trade -GDP ratio, which has been increasing and staying above 15 per cent which a good indicator of an open economy. The sharp increase in the inflows of foreign private capital into India in the 1990s has increased the cross-border financial integration. Another way to measure degree of financial openness is to gauge the co-movements of indices in the domestic stock market and international stock market.

The ongoing process of reforms in trade, industry and finance, India’s openness to cross-border trade and private capital has increased considerably since 1993-94 indicating thereby the progressive integration of domestic financial markets with the international financial markets. Table 1.1 indicates the FDI and Foreign Portfolio Investment in US$.

In India, the very short-term interest rate is the inter-bank call money rate, which is an overnight rate. It is highly volatile in nature and significantly affected by the development of foreign exchange market, which, in turn, is influenced by the international financial developments. The significant correlation between call money rates and ‘three month’ and ‘six month’ forward premia is an encouraging sign of openness of Indian Economy.
### Table 1.1 Indicators of Openness of Indian Economy

<table>
<thead>
<tr>
<th>Year</th>
<th>Foreign Direct Investment (US $ million)</th>
<th>Foreign Portfolio Investment (US $ million)</th>
<th>Trade GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993-94</td>
<td>586</td>
<td>3567</td>
<td>22.62</td>
</tr>
<tr>
<td>1994-95</td>
<td>1314</td>
<td>3824</td>
<td>23.28</td>
</tr>
<tr>
<td>1995-96</td>
<td>2144</td>
<td>2748</td>
<td>24.70</td>
</tr>
<tr>
<td>1996-97</td>
<td>28121</td>
<td>3312</td>
<td>22.65</td>
</tr>
<tr>
<td>1997-98</td>
<td>3557</td>
<td>1828</td>
<td>21.54</td>
</tr>
<tr>
<td>1998-99</td>
<td>2462</td>
<td>-61</td>
<td>18.57</td>
</tr>
<tr>
<td>1999-00</td>
<td>2155</td>
<td>3026</td>
<td>19.05</td>
</tr>
<tr>
<td>2000-01</td>
<td>4029</td>
<td>2760</td>
<td>19.45</td>
</tr>
<tr>
<td>2001-02</td>
<td>6130</td>
<td>2021</td>
<td>17.95</td>
</tr>
<tr>
<td>2002-03</td>
<td>5035</td>
<td>979</td>
<td>19.97</td>
</tr>
<tr>
<td>2003-04</td>
<td>4322</td>
<td>11377</td>
<td>22.08</td>
</tr>
<tr>
<td>2004-05</td>
<td>6051</td>
<td>9315</td>
<td>26.83</td>
</tr>
<tr>
<td>2005-06</td>
<td>7722</td>
<td>12492</td>
<td>30.41</td>
</tr>
<tr>
<td>2006-07</td>
<td>19531</td>
<td>7003</td>
<td>33.03</td>
</tr>
<tr>
<td>2007-08</td>
<td>34362</td>
<td>27271</td>
<td>40.39</td>
</tr>
<tr>
<td>2008-09</td>
<td>35168</td>
<td>(-ve)13855</td>
<td>38.94</td>
</tr>
</tbody>
</table>

Economic and financial sector reform measures, which have been continuing in India since 1991, have facilitated in the process of International financial integration. Trade barriers have been declining and trade-GDP ratio and capital inflows have been accentuating. Various segments of money market are integrated. There is evidence for integration between money and foreign exchange markets. **Political risk, high transaction costs, high taxation, capital controls and capital market imperfections, which were the barriers of international trade and investments, have been reduced significantly over the years.** The economy has been consistently moving towards the path of noticeable degree of globalization and integration with the world financial markets.
1.4 Functions of International Financial Manager

In order to achieve the firm’s primary goal of maximizing stockholders’ wealth, the financial manager performs three major functions:

(1) **Financial planning and control** (supportive tools);
(2) **Efficient allocation of funds among various assets** (investment decisions);
(3) **Acquisition of funds on favorable terms** (financing decisions).

Financial planning and control must be considered simultaneously. For purposes of control, the financial manager establishes standards, such as budgets, for comparing actual performance with planned performance. The preparation of these budgets is a planning function, but their administration is a controlling function.

The foreign exchange market and international accounting play a key role when an MNC attempts to perform its planning and control function. For example, once a company crosses national boundaries, its return on investment depends on not only its trade gains or losses from normal business operations but also on exchange gains or losses from currency fluctuations. International reporting and controlling have to do with techniques for controlling the operations of an MNC.

**Meaningful financial reports** are the cornerstone of effective management. Accurate financial data are especially important in international business, where business operations are typically supervised from a distance. When the financial manager plans for the allocation of funds, the most urgent task is to invest funds wisely within the firm. Every dollar invested has alternative uses. Thus, funds should be allocated among assets in such a way that they will maximize the wealth of the firm’s stockholders. There are 200 countries in the world where a large MNC, can invest its funds. Obviously, there are more investment opportunities in the world than in a single country, but there are also more risks. International financial managers should consider these two simultaneously when they attempt to maximize their firm’s value through international investment.

One of the primary roles of the financial manager is to acquire funds on favorable terms. If projected cash outflow exceeds cash inflow, the financial manager will find it necessary to obtain additional funds from outside the firm. Funds are available from many sources at varying costs, with different maturities, and under various types of agreements. The critical role of the financial manager is to determine the combination of financing that most closely suits the planned needs of the firm. This requires obtaining the optimal balance between low cost and the risk of not being able to pay bills as they become due. MNCs can still raise their funds in many countries thanks to recent financial globalization.
This globalization is driven by advances in data processing and telecommunications, liberalization of restrictions on cross-border capital flows, and deregulation of domestic capital markets. International financial managers use a puzzling array of fund acquisition strategies. Instead of merely focusing on the efficient allocation of funds among various assets and the acquisition of funds on favorable terms, financial managers must now concern themselves with corporate strategy. The chief financial officer is emerging as a strategic planner. In an era of heightened global competition and hard-to-make-stick price increases, the financial fine points of any new strategy are more crucial than ever before.

**References**

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**Model Questions**

1. Write in brief the historical developments of international financial environment.
2. Discuss the importance of GATT and its transition to WTO.
4. Outlines the “missing-links” of globalization.