INTERNATIONAL MONEY AND FINANCE

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Introduction

International market entry has nowadays become an imperative area of study. The importance as well as the significance grew mainly because of increasing global expansion of the companies. However, one of the driving factors for the enormous increase in international expansion is the opening up of world economy and globalisation (Rothaermel, Kotha and Steensma, 2006). Also intense competition within the industry was also a major driving factor, and thus organisations felt that global expansion is the only way out to operate successfully in the marketplace. In order to enter the foreign soil, a company must choose a suitable mode of entrance. The mode of entry is the way by which a company enters the foreign market. There are different modes of entry namely Exporting, Licensing, Direct investment and Joint ventures. This study entails about the various factors related to the strategy of foreign direct investment (FDI) proposed by the managing director of Chemical Plc. This strategy has been proposed by the company management in lieu of the fact that the company is gradually losing its market share in United Kingdom because of the increasing competition in the domestic market of the country. Hence, the company is thinking of investing around £10 million in India in the form of FDI so as to decrease the overall costs incurred by the company and increase its sales to generate higher profits in the forthcoming years. Direct investment is the direct possession of amenities in the host country. The company transfers the technology, property and employees. The major advantage of embracing foreign direct investment is that it augments the earnings from export activities and reduces import activities. From the perspective of a firm, FDI helps them to invest and operate directly in the market, thereby removing any chances of third party involvement. The companies also embrace financial superiority (Kapil, 2011, p.630).

Exchange Rate Management System of India

Exchange rate is considered to be an important financial variable that has an impact on the various types of decisions made by the foreign exchange investors, importers, exporters, businesses, financial institutional, bankers, tourists and policymakers in the developing as well as developed nations of the world. The fluctuations observed in the foreign exchange rates has a considerable impact on the international investment portfolio values, and also affects the competitiveness observed in imports and exports. Moreover, the value associated with international reserves, tourists' costs and debt payments' currency values also gets affected due to fluctuations in foreign exchange rates. Hence, it is necessary to understand the foreign exchange rate system prevailing in India to gain insight on the possible ways through which Chemical Plc. can implement their FDI investment strategy in the country.

Since March 1993, India has been following a floating exchange rate system. This marked the beginning of an era which is considered to be the market determined exchange rate regime of rupee and having the provision for Central Bank intervening from time to time. Evolution in the India's exchange rate policy has occurred in the past in alignment with the global scenario and result of developments taking place in the country. The year 1991-92 is considered to be a major breakthrough in the foreign exchange policy followed in India wherein several reform measures were taken as a result of the crisis situation that occurred in the balance of payments and thus shifted to a foreign exchange rate system which was market determined. The central bank of India, Reserve Bank of India (RBI) has the responsibility of controlling the foreign exchange rate system in India (Dua and Ranjan, n.d., p. 12-13).

India thus follows an exchange rate system which has been termed as Liberalised Exchange Rate Management System (LERMS). LERMS was institutionalised in India with the objective of making balance of payments sustainable for long term by allowing market force to have a significant role to play in the determination of the exchange rate of rupee. Under the provisions of LERMS, rupee was made convertible for all types of external transactions that were approved and authorised by the Government of India. This system facilitated various parties like the exporters of services and goods to be able to sell foreign exchange receipts in bulk amounts. Hence, LERMS was enacted in India by the Indian Government with the objective of giving boost to the exports sector in the country. Some of the basic features of LERMS are stated below:

- The foreign exchange rate corresponding to the currency of rupee would be determined solely on the basis of various market forces of supply and demand. Hence, this system can also be termed as 'market determination exchange rate system'.
- All types of receipts whether it corresponds to the capital or current account and also the receipts of the balance of payments whether on private or Government account would be ultimately converted on the basis of market exchange rate.

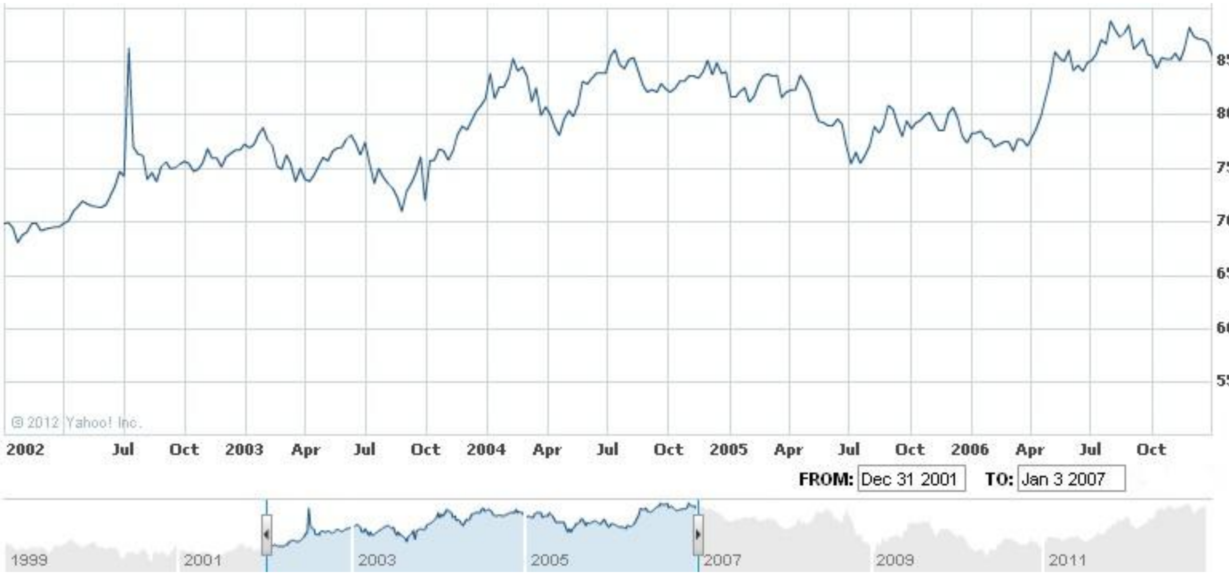
- Non-residential Indians would have the permission to be able to maintain the Residents Foreign Currency Account (RFCA) wherein the entire amount of foreign exchange that is brought into India would be credited.
- Any exporter who receives remittances in the form of foreign currency is needed to surrender then to an authorised dealer of foreign currency in India. However, they would be permitted to maintain 15% of the currencies received in the foreign currency account held under an authorised dealer.
- The authorised dealers are not obliged to sell any portion of the foreign currencies received by them directly to the central bank of India. They are allowed to sell those foreign currencies to any other authorised dealers or any other authorised transactions within India.
- When foreign currencies are remitted to outside India they are required to comply with the exchange control regulations of India. However, it does not mean that in every situation it is required to take a prior permission from the Reserve Bank of India.
- US dollar is considered to be the intervention currency of the Reserve Bank of India.

INR–GBP Exchange Rate: Recent Trends

Figure – 1 indicates the changes in the exchange rate involving Indian Rupee (INR) and British Pound (GBP) over the period of last two years or so.

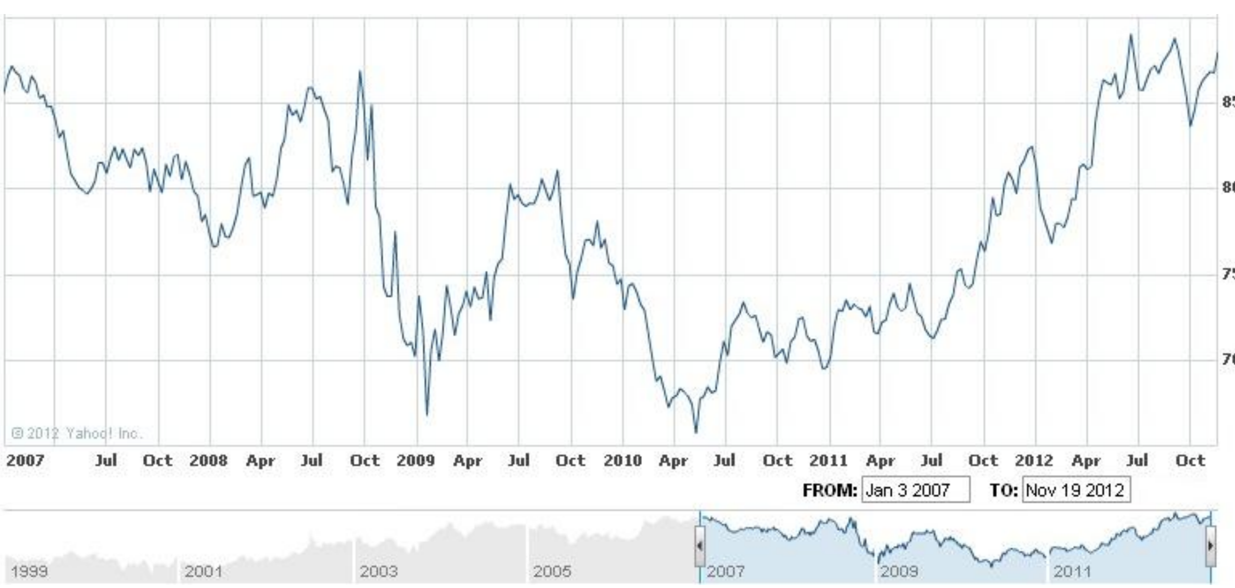
Figure – 1

Historical exchange rate of INR and GBP (31 Dec 2001 to 03 Jan 2007)



Source: (http://finance.yahoo.com/echarts?s=GBPINR%3DX+Interactive)

Historical exchange rate of INR and GBP (03 Jan 2007 to 19 Nov 2012)



Source (http://finance.yahoo.com/echarts?s=GBPINR%3DX+Interactive)

The figures shown above indicate that British Pound (GBP) has appreciated against Indian Rupee (INR) considerably in the recent past. However, several fluctuations in the foreign exchange rate have also been observed during the aforementioned period. This indicates the weak economic scenario prevalent in India in the recent times. One of the primary reasons behind the depreciating value trend of INR is the uncertainty prevailing in the global economy as a result of the recent global financial crisis and the Euro crisis situation in the European Union (Assocham, n.d., p. 2). This recent trend in the foreign exchange rate of INR and GBP can prove to be advantageous for Chemical Plc. because the money to be invested by the company in India in GBP can gain profit while getting converted to INR.

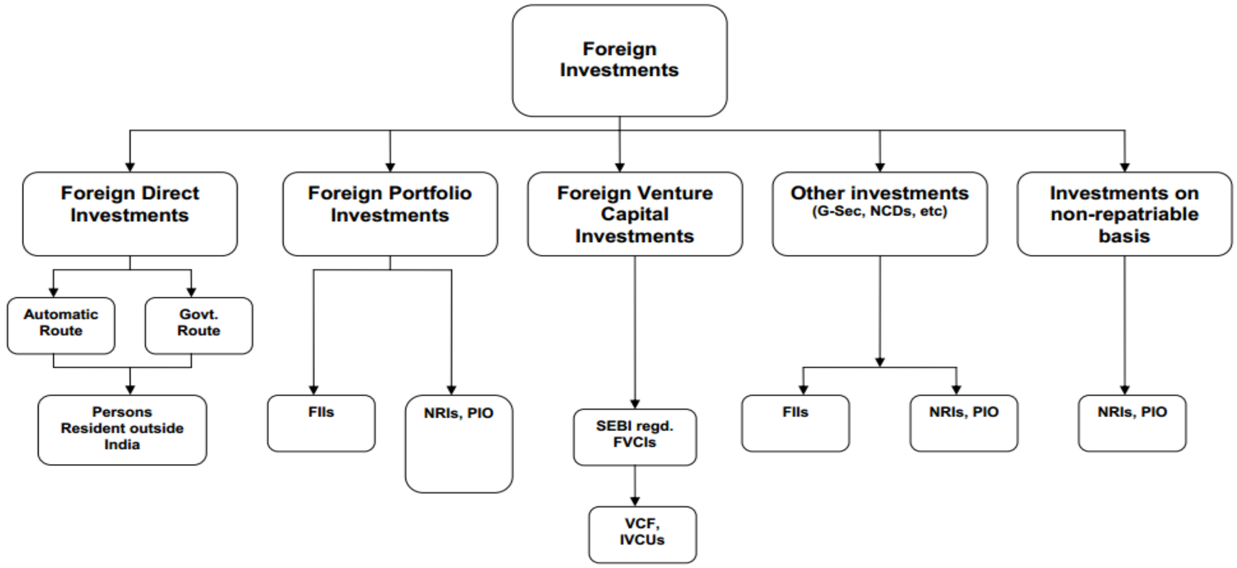
Methods of Financing FDI in India

Foreign direct investment (FDI) plays a vital role in the global business arena. It helps a company like Chemical Plc. to explore new market opportunities available in a foreign country. Moreover, it also helps to have provision for cheaper manufacturing facilities, having access to capital, new technologies, skills, products and financing. According to International Monetary Fund (IMF), FDI has been categorised as a type of international investment which specifies the motive of a resident business entity to have a long lasting interest and control over a business organisation that is located in a foreign country (Bandelji, 2002; Hein, 1992). FDI can thus be defined as a means of direct investment made by a company in one country to acquire certain assets located in a different country. Likewise in the context of this study, Chemical Plc. is trying make a FDI in India to explore the market opportunities present there in order to increase its sales and profitability. In the recent years, there has been a rapid change and growth in the investment patterns that occur worldwide. Hence, it has resulted in broadening the definition of FDI and includes acquisition of management interest in an organisation outside the home country of the investing business firm.

The following figure shows a schematic representation of the different types of foreign investments that are possible in India.

Figure – 2

Foreign Investments in India



Source: (Reserve Bank of India, n.d.)

The process of FDI in India is governed under the provisions of Foreign Exchange Management Act (FEMA), 1999 and the FDI Policy that has been announced by the Indian Government. Various regulations to be followed in the context of FDI in India have been mentioned in one of the notifications issued by Reserve Bank of India (Notification No. FEMA 20/2000-RB dated 3 May 2000). According to the provisions laid down by Reserve Bank of India (2012) regarding foreign investments in India, foreign companies like Chemical Plc. can start their business operations in India in two possible ways. They are a) By incorporating a new company under the provisions of Companies Act, 1956 either as a wholly owned subsidiary or as a joint venture, b) Setting up a representative office or a liaison office or a branch office or a project office in India that can undertake business activities which are permitted under the provisions of Foreign Exchange Management Regulations, 2000. FDI is permitted freely in almost all the industrial sectors of India. As indicated in Figure – 1 above, there are two entry routes through which FDI can be made in India. They are the government route and the automatic route. FDI financing is possible in India through the purchase of various financial instruments like equities, preference shares, and convertible debentures. Other option could be borrowing loans to source the funds needed to invest in India in the form of FDI. All these financing options available to Chemical Plc. could be associated with relative merits and demerits for the company.

The various advantages and disadvantages associated with FDI in India are illustrated below.

Advantages of FDI in India

The economy of India that is developing at a fast rate and the huge market size of India provide many opportunities for business organisations situated outside India to generate cash inflows in quickly. The purchasing power of the Indian people is also increasing in line with the developments taking place in the Indian economy (World Bank, 2004). Apart from these, huge amounts of diversified resources are also present in India which could be exploited by the foreign firms establishing their business in India. Very cheap labour forces are also available in abundance in India. The infrastructural facilities are also improving at a fast pace in India. The Indian Government is found to invest in various infrastructure improvement projects in the country in a significant manner. Foreign investors in India are also gaining advantage from the Private Public Partnership in various industrial sectors of the Indian economy. This has reduced the international trade barriers significantly in India (IMF, 2005). The regulatory frameworks related to FDI in India have also been made a lot flexible by the Indian Government.

Disadvantages of FDI in India

There are negative sides of investing in India as well. Although India has a huge market, the majority of it is composed of middle and lower class people who experiences budget deficits from time to time. The infrastructure in India also needs to be revamped to a large extent. Nonetheless, the Indian market is diverse in nature which can prove to be disadvantageous for foreign firms like Chemical Plc. to cater to the diverse needs of the people. Some other factors like entry-exit barriers, indirect taxes, import duties, etc. are also major disadvantages in case of FDI in India.

Hedging the Exchange Rate Risk

Chemical Plc. deciding to invest in India through the means of FDI would mean that it would be exposed to the risk of fluctuations in foreign exchange rates in the market. As discussed earlier, the exchange rate system in India is market driven. Hence, depending on the market demand and supply situations the foreign exchange rate between INR and GBP would vary. If Chemical Plc. opts for FDI in India then it has to carry out all its business transactions in terms of Indian Rupee which is a foreign currency for Chemical Plc. since it is a UK based firm. Hence, the invested money in terms of GBP would require to be converted to INR while conducting the business processes in India. Any type of receivables or payables of Chemical Plc. with respect to its business activities performed in India would be exposed to the risk of changes in foreign exchange rates in the market. Thus, the company needs to think of hedging strategies that could minimise its exposure to such kinds of risks and ensure its long-term profitability and sustainability of its business in India. There are various financial derivative instruments that can be made use by Chemical Plc. to hedge the exchange rate risks. They are forward contracts, future contracts, options, swap contracts etc.

Hedging problems might occur in case of Chemical Plc. in situations where it holds various types of foreign assets like foreign securities for a long period of time (Muller, 1995, p. 2). The foreign assets that would be owned by Chemical Plc. while investing India would be denominated in INR which is a foreign currency for the organisation. The existing literature related to the selection of hedging instruments is limited. According to Geczy, Minton and Schrand (1997), currency swaps are considered to be more cost effective while hedging the risks associated with foreign debt and forward contracts are cost effective in nature in cases where the risks associated with foreign operations are considered. It is so because debt payments made in foreign currencies are long term in nature and are predictable too. Hence, in such situations the long-term nature of currency swap contracts is best suited. On the other hand, revenues generated in foreign currencies are unpredictable and short term in nature. Hence, forward contracts are best suited in such situations. According to a survey conducted by Marshall (2000), currency swaps have been best suited for hedging the translational risks and the forward contracts were found to be best suited for hedging the transaction risks. However, these results suggested above can vary for different currencies because of the dependency of such currencies on the different market factors. In case of Chemical Plc. which wishes to invest in India through FDI, it can hedge its exchange rate risks predominantly by using forward and options contracts. It is so because the company would be mainly hedging the risks associated with foreign currency revenues generated in India which would be short term in nature. Moreover, it has been observed that these two types of derivatives instruments are frequently used by the major Indian firms to hedge against the foreign exchange rate risks.

Conclusion

This study has been performed to analyse the proposed foreign direct investment (FDI) strategy of Chemical Plc. so as to capture the opportunities available in the foreign market to ensure its long-term profitability and sustainability. The company is thinking of investing through FDI in India. If we look at the existing exchange rate management system in India, it can be observed that the country follows a floating exchange rate system. It has been termed as Liberalised Exchange Rate Management System (LERMS) which is characterised of being market driven and is dependent on the demand and supply forces in the market. The recent trend in the value of INR–GBP foreign exchange rate indicates that the currency value of GBP has appreciated against the Indian Rupee (INR) in the recent times. However it has been associated with lot of volatilities in between. The various ways through which FDI can be financed in India have been discussed in this study. It has been observed that the foreign exchange rate management system is primarily governed by Reserve Bank of India which is its central bank. According to the foreign exchange and FDI policy of India, any company like Chemical Plc. that desires of financing FDI in India can do so using various means like investing through securities in India or convertible debentures or borrowing loans. However, the findings of the study suggest that doing business in India will lead Chemical Plc. to expose itself to the risk of volatility in foreign exchange rates involving INR and GBP. Hence, it needs to have proper hedging strategies in place to counter this type of risk. Forward and options contracts as hedging instruments have been found to be best suited for the company to hedge its foreign currency risk. Overall, it is a good opportunity for Chemical Plc. to invest in India through FDI to gain advantage of the huge market opportunity available in the Indian market and add to the profitability and sustainability of the company.

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