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Payment System Part - 2

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Academic Script

1. Introduction

International business is facilitated by markets that allow for the flow of funds between countries. The transactions arising from international business cause money flows from one country to another. The balance of payments is a measure of international money flows and is discussed in this session. Financial managers of MNCs monitor the balance of payments so that they can determine how the flow of international transactions is changing over time.

The balance of payments can indicate the volume of transactions between specific countries and may even signal potential shifts in specific exchange rates. The specific objectives of this session are to: explain the key components of the balance of payments, explain how international trade flows are influenced by economic factors and other factors, and explain how international capital flows are facilitated by various agencies and portfolio investment in India.

2. Balance of Payments

The balance of payments is a summary of transactions between domestic and foreign residents for a specific country over a specified period of time. It represents an ac-counting of a country's international transactions for a period, usually a quarter or a year. It accounts for transactions by businesses, individuals, and the government.

A balance-of-payments statement can be broken down into various components. Those that receive the most attention are the current account and the capital account. The current account represents a summary of the flow of funds between one specified country and all other countries due to purchases of goods or services, or the provision of income on financial assets. The capital account represents a summary of the flow of funds resulting from the sale of assets between one specified country and all other countries over a specified period of time. Thus, it compares the new foreign investments made by a country with the foreign investments within a country over a particular time period. Transactions that reflect inflows of funds generate positive numbers (credits) for the country's balance, while transactions that reflect outflows of funds generate negative numbers (debits) for the country's balance.

CURRENT ACCOUNT

The main components of the current account are payments for (1) merchandise (goods) and services, (2) factor income, and (3) transfers.

1) Payments for Merchandise and Services.

Merchandise exports and imports represent tangible products, such as computers and clothing, which are transported between countries. Service exports and imports represent tourism and other services, such as legal, insurance, and consulting services, provided for customers based in other countries. Service exports by the United States result in an inflow of funds to the United States, while service imports by the United States result in an outflow of funds

The difference between total exports and imports is referred to as the balance of trade. A deficit in the balance of trade means that the value of merchandise and services exported by the United States is less than the value of merchandise and services imported by the United States. Before 1993, the balance of trade focused on only merchandise exports and imports. In

1993, it was redefined to include service exports and imports as well. The value of U.S. service exports usually exceeds the value of U.S. service imports. However, the value of U.S. merchandise exports is typically much smaller than the value of U.S. merchandise imports. Overall, the United States normally has a negative balance of trade

2) Factor Income Payments.

A second component of the current account is factor income, which represents income (interest and dividend payments) received by investors on foreign investments in financial assets (securities). Thus, factor income received by U.S. investors reflects an inflow of funds into the United States. Factor income paid by the United States reflects an outflow of funds from the United States.

3) Transfer Payments.

A third component of the current account is transfer payments, which represent aid, grants, and gifts from one country to another.

Examples of Payment Entries

Table on screen shows several examples of transactions that would be reflected in the current account. Notice in the exhibit that every transaction that generates a U.S. cash inflow (exports and income receipts by the United States) represents a credit to the current account, while every transaction that generates a U.S. cash outflow (imports and income payments by the United States) represents a debit to the current account. Therefore, a large current account deficit indicates that the United States is sending more cash abroad to buy goods and services or to pay income than it is receiving for those same reasons.

Exhibit 1 Examples of Current Account Transactions

International Trade Transaction	U.S. Cash Flow Position	Entry on U.S. Balance-of-Payments Account
J.C. Penney purchases stereos produced in Indonesia that it will sell in its U.S. retail stores.	U.S. cash outflow	Debit
Individuals in the United States purchase CDs over the Internet from a firm based in China.	U.S. cash outflow	Debit
The Mexican government pays a U.S. consulting firm for consulting services provided by the fi rm.	U.S. cash inflow	Credit

Actual Current Account Balance

The U.S. current account balance in the year 2006 is summarized in Exhibit 2. Notice that the exports of merchandise were valued at $1,019 billion, while imports of merchandise by the United States were valued at $1,836 billion. Total U.S. exports of merchandise and services and income receipts amounted to $2,056 billion, while total U.S. imports amounted to $2,793 billion. The bottom of the exhibit shows that net transfers (which include grants and gifts provided to other countries) were $54 billion. The negative number for net transfers represents a cash outflow from the United States.

Exhibit 2 shows that the current account balance (line 10) can be derived as the difference between total U.S. exports and income receipts (line 4) and the total U.S. imports and income payments (line 8), with an adjustment for net transfer payments (line 9). This is logical, since the total U.S. exports and income receipts represent U.S. cash inflows while the total U.S. imports and income payments and the net transfers represent U.S. cash outflows. The negative current account balance means that the United States spent more on trade, income, and transfer payments than it received.

Exhibit 2 Summary of U.S. Current Account in the Year 2006 (in billions of $)

(1)	U.S. exports of merchandise	$1,019
(2)	U.S. exports of services	411
(3)	U.S. income receipts	626
[redacted]	[redacted]	[redacted]
(4)	Total U.S. exports and income receipts	$2,056
(5)	U.S. imports of merchandise	$1,836
(6)	U.S. imports of services	341
(7)	U.S. income payments	616
(8)	Total U.S. imports and income	$2,793

CAPITAL AND FINANCIAL ACCOUNTS

The capital account category has been changed to separate it from the financial account, which is described next. The capital account includes the value of financial assets transferred across country borders by people who move to a different country. It also includes the value of nonproduced nonfinancial assets that are transferred across country borders, such as patents and trademarks. The sale of patent rights by a U.S. firm to a Canadian firm reflects a credit to the U.S. balance-of-payments account, while a U.S. purchase of patent rights from a Canadian firm reflects a debit to the U.S. balance-of-payments account. The capital account items are relatively minor compared to the financial account items.

The key components of the financial account are payments for (1) direct foreign investment, (2) portfolio investment, and (3) other capital investment and lastly (4) Errors & Omissions and reserves.

1) Direct Foreign Investment.

Direct foreign investment represents the investment in fixed assets in foreign countries that can be used to conduct business operations. Examples of direct foreign investment include a firm's acquisition of a foreign company, its construction of a new manufacturing plant, or its expansion of an existing plant in a foreign country. In 2006, the United States increased its direct foreign investment abroad by $248 billion, while non-U.S. countries increased their direct foreign investment in the United States by $185 billion.

2) Portfolio Investment.

Portfolio investment represents transactions involving long-term financial assets (such as stocks and bonds) between countries that do not affect the transfer of control. Thus, a purchase of

Heineken (Netherlands) stock by a U.S. investor is classified as portfolio investment because it represents a purchase of foreign financial asset without changing control of the company. If a U.S. firm purchased all of Heineken's stock in an acquisition, this transaction would result in a transfer of control and therefore would be classified as direct foreign investment in-stead of portfolio investment. In 2006, the U.S. net purchases of foreign stocks were $129 billion, while its net purchases of foreign bonds were $149 billion. Non-U.S. net purchases of U.S. stocks were $114 billion in 2006, while non-U.S. net purchases of U.S. bonds were $507 billion.

3) Other Capital Investment.

A third component of the financial account consists of other capital investment, which represents transactions involving short-term financial assets (such as money market securities) between countries. In general, direct foreign investment measures the expansion of firms' foreign operations, whereas portfolio investment and other capital investment measure the net flow of funds due to financial asset transactions between individual or institutional investors.

4) Errors and Omissions and Reserves.

If a country has a negative current account balance, it should have a positive capital and financial account balance. This implies that while it sends more money out of the country than it receives from other countries for trade and factor income, it receives more money from other countries than it spends for capital and financial account components, such as investments. In fact, the negative balance on the current account should be offset by a positive balance on the capital and financial account. However, there is not normally a perfect offsetting effect because measurement errors can occur when attempting to measure the value of funds transferred into or out of a country. For this reason, the balance-of-payments account includes a category of errors and omissions.

3. Agencies that Facilitate International Flows

International flow of finances if facilitated by these agencies;

1. ***International Monetary Fund (IMF);*** *Its* operations involve surveillance, and financial and technical assistance. In particular, its compensatory financing facility attempts to reduce the impact of export instability on country economies. The IMF uses a quota system, and its unit of account is the SDR (special drawing right).
2. ***World Bank Group;*** *The world bank was* Established in 1944, the Group assists development with the primary focus of helping the poorest people and the poorest countries. It has 183 member countries, and is composed of five organizations – IBRD, IDA, IFC, MIGA and ICSID.
3. ***IBRD: International Bank for Reconstruction and Development;*** Better known as the World Bank, the IBRD provides loans and development assistance to middle-income countries and creditworthy poorer countries. In particular, its structural adjustment loans are intended to enhance a country's long-term economic growth. The IBRD is not a profit-maximizing organization. Nevertheless, it has earned a net income every year since 1948. It may spread its funds by entering into co-financing agreements with official aid agencies, export credit agencies, as well as commercial banks.

4. ***IDA: International Development Association;*** IDA was set up in 1960 as an agency that lends to the very poor developing nations on highly concessional terms. IDA lends only to those countries that lack the financial ability to borrow from IBRD. IBRD and IDA are run on the same lines, sharing the same staff, headquarters and project evaluation standards.

5. ***IFC: International Finance Corporation;*** *The* IFC was set up in 1956 to promote sustainable private sector investment in developing countries by; financing private sector projects, helping to mobilize financing in the international financial markets and providing advice and technical assistance to businesses and governments.

6. ***MIGA: Multilateral Investment Guarantee Agency;*** *The* MIGA was created in 1988 to promote FDI in emerging economies by offering political risk insurance to investors and lenders and helping developing countries attract and retain private investment.

7. ***ICSID: International Centre for Settlement of Investment Disputes;*** *The* ICSID was created in 1966 to facilitate the settlement of investment disputes between governments and foreign investors, thereby helping to promote increased flows of international investment.

8. ***World Trade Organization (WTO);*** *It* was Created in 1995, the WTO is the successor to the General Agreement on Tariffs and Trade (GATT). It deals with the global rules of trade between nations to ensure that trade flows smoothly, predictably and freely. At the heart of the WTO’s multilateral trading system are its trade agreements. The functions of the World Trade Organisation (WTO) is administering WTO trade agreements, serving as a forum for trade negotiations, handling

trade disputes, monitoring national trading policies, providing technical assistance and training for developing countries and cooperating with other international groups.

9. ***Bank for International Settlements (BIS);*** *It* was Set up in 1930, the BIS is an international organization that fosters cooperation among central banks and other agencies in pursuit of monetary and financial stability. It is the "central banks' central bank" and "lender of last resort." The functions of the Bank of International settlements are; a forum for international monetary and financial cooperation, a bank for central banks, a center for monetary and economic research and act as an agent or trustee in connection with international financial operations.

10. ***Regional Development Agencies;*** *Th*ese are Agencies with more regional objectives relating to economic development and they include; the Inter-American Development Bank, the Asian Development Bank, the African Development Bank and the European Bank for Reconstruction and Development

MOST INFLUENTIAL FACTORS AFFECTING FOREIGN TRADE ARE AS FOLLOWS

Because international trade can significantly affect a country's economy, it is important to identify and monitor the factors that influence it

1) Impact of Inflation:

If a country's inflation rate increases relative to the countries with which it trades, its current account will be expected to decrease, other things being equal. Consumers and corporations in that country will most likely purchases more goods overseas (due to high local inflations), while the country's exports to other countries will decline.

2) Impact of National Income:

If a country's income level (national income) increases by a higher percentage than those of other countries, its current account is expected to decrease, other things being equal. As the real income level (adjusted for inflation) rises, so does consumption of goods. A percentage of that increase in consumption will most likely reflect an increased demand for foreign goods.

3) Impact of Government Policies:

A country's government can have a major effect on its balance of trade due to its policies on subsidizing exporters, restrictions on imports, or lack of enforcement on piracy.

4) Subsidies for Exporters:

Some governments offer subsidies to their domestic firms, so that those firms can produce products at a lower cost than their global competitors. Thus, the demand for the exports produced by those firms is higher as a result of subsidies.

Many firms in China commonly receive free loans or free land from the government. These firms incur a lower cost of operations and are able to price their products lower as a result, which enables them to capture a larger share of the global market.

5) Restrictions on Imports:

If a country's government imposes a tax on imported goods (often referred to as a tariff), the prices of foreign goods to consumers are effectively increased. Tariffs imposed by the U.S. government are on average lower than those imposed by other governments. Some industries, however, are more highly protected by tariffs than others. American apparel products and farm products have historically received more protection against foreign competition through high tariffs on related imports.

In addition to tariffs, a government can reduce its country's imports by enforcing a quota, or a maximum limit that can be imported. Quotas have been commonly applied to a variety of goods imported by the United States and other countries.

6) Lack of Restrictions on Piracy:

In some cases, a government can affect international trade flows by its lack of restrictions on piracy. In China, piracy is very common; individuals (called pirates) manufacture CDs and DVDs that look almost exactly like the original product produced in the United States and other countries. They sell the CDs and DVDs on the street at a price that is lower than the original product. They even sell the CDs and DVDs to retail stores. It has been estimated that U.S. producers of film, music, and software lose $2 billion in sales per year due to piracy in China.

As a result of piracy, China's demand for imports is lower. Piracy is one reason why the United States has a large balance-of-trade deficit with China. However, even if piracy were eliminated, the U.S. trade deficit with China would still be large.

7) Impact of Exchange Rates:

Each country’s currency is valued in terms of other currencies through the use of exchange rates, so that currencies can be exchanged to facilitate international transactions.

4. Portfolio Investment in India

In India, the term “Foreign Portfolio Investor” refers to FIIs or their sub-accounts, or qualified foreign investors (QFIs) who are permitted to hold upto 10% stake in a company.

Origin

The term FPI was defined to align the nomenclature of categorizing investments of foreign investors in line with international practice. FPI stands for those investors who hold a short term view on the company, in contrast to Foreign Direct Investors (FDI). FPIs generally participate through the stock markets and gets in and out of a particular stock at much faster frequencies. Short term view is associated often with lower stake in companies. Hence, globally FPIs are defined as those who hold less than 10% in a company. In India, the hitherto existing closest possible definition to an FPI was Foreign Institutional Investor.

In the Union Budget 2013-14, announced on 28 February 2013, vide para 95, Honourable Finance Minister announced his intention to go by the internationally accepted definition for foreign investors.

Prior to this, in December 2012, SEBI had constituted a “Committee on Rationalization of Investment Routes and Monitoring of Foreign Portfolio Investments” under the chairmanship of Shri K. M. Chandrasekhar with a view to rationalize/harmonize various foreign portfolio investment routes and to establish a unified, simple regulatory framework. The Committee had submitted its report in June, 2013 to the Government of India.

Based on the committee report, on 7th January, 2014 the FPI Regulations, 2014 were notified in the Gazette of India.

The new FPI Regime came into effect from **1st June, 2014**. The FAQs on FPI Regulations can be seen here.

Features of FPI

Portfolio Investment by any single investor or investor group cannot exceed 10% of the equity of an Indian company, beyond which it will now be treated as FDI.

FIIs, Sub-Accounts and QFIs are merged together to form the new investor class, namely Foreign Portfolio Investors, with an aggregate investment limit of 24% which can be raised by the Company up to the applicable sectoral cap.

All existing FIIs and Sub Accounts can continue to buy, sell or otherwise deal in securities under the FPI regime.

All existing Qualified Foreign Investors (QFIs) may continue to buy, sell or otherwise deal in securities only till the period of one year from the date of notification of the FPI Regulation. In the meantime, they have to obtain FPI registration.

Non-Resident Indians (NRIs) and Foreign Venture Capital Investors (FVCI) are excluded from the purview of this definition.

Designated Depository Participants (DDPs) authorized by SEBI (as per prescribed norms) would henceforth register FPIs on behalf of SEBI subject to fulfillment of KYC (Know Your Customer) and due diligence norms. DDPs carry out necessary due diligence and obtain appropriate declarations and undertakings before registering an entity as FPI. The DDPs are either Authorized Dealer Category-1 bank authorized by Reserve Bank of India, or Depository Participant or a Custodian of Securities registered with SEBI. Existing SEBI approved Qualified Depository Participant who were registering the QFIs, but not meeting the DDP eligibility criteria, can operate as DDP only for a period of one year.

Categories of FPI

As part of Risk based approach towards customer identity verification (KYC), FPIs have been categorized into three major categories:

- **Category I (Low Risk)** which would include Government and entities like Foreign Central banks, Sovereign wealth Funds, Multilateral Organizations, etc
- **Category II (Moderate Risk)** which would include Regulated entities such as banks, Pension Funds, Insurance Companies, Mutual Funds, Investment Trusts, Asset Management Companies, University related endowments (already registered with SEBI)
- **Category III (High Risk)** which would include all other FPIs not eligible to be included in the above two categories

FPI Investment restrictions

FPIs are not allowed to invest in unlisted shares. However, all existing investments made by the FIIs/Sub-accounts/QFIs are grandfathered. In respect of those securities, where FPIs are not allowed to invest no fresh purchase shall be allowed as FPI. They can only sell their existing investments in such securities.

However, an exception has been made by permitting them to invest in unlisted non-convertible debentures/bonds issued by an Indian company in the infrastructure sector, where 'infrastructure' is defined in terms of the extant External Commercial Borrowings (ECB) guidelines;

FPIs are permitted to invest in Government Securities with a minimum residual maturity of one year. However, FPIs have been prohibited from investing in T-Bills.

FPI can invest in privately placed bonds if it is listed within 15 days.

The same debt allocation mechanism that is in place for FIIs/QFIs will be followed for FPIs.

The debt investment limits as in June 2016 are as follows

S.No.	Type of Instrument	Cap (USD bn)	Cap (INR Crore)	Remarks
1	Government Debt	20	99,546	Available on demand. Eligible investors may invest only in dated securities of residual maturity of one year and above, and existing investment in Treasury Bills will be allowed to taper off on maturity/sale.
2	Government Debt	10	54,023	Available on demand for FIIs registered with SEBI as Sovereign Wealth Funds, Multilateral Agencies, Endowment funds, Insurance Funds, Pension Funds and Foreign Central Banks. Eligible investors may invest only in dated securities of residual

FPIs belonging to Category III will not be allowed to issue Offshore

Derivative Instruments (ODIs) and/or Participatory Notes (PNs) However, issuers of ODIs and/or PNs shall directly report to SEBI.

Monitoring of FPI Investments

Since the commencement of the FPI regime from June 01, 2014, both the exchanges and the depositories have put in place a mechanism for the monitoring of the FPI investment limits for both equity and debt securities. The depositories ensure that the investment limits applicable to an FPI/ FPI group having common beneficial ownership, do not get breached. The designated depository participants provide on a daily basis, FPI-wise, ISIN-wise and Company-wise buy/sell information and any other transaction or any related information to their respective depositories on the same day i.e. the day on which the transaction was carried out. The stock exchanges provide the details of FPI positions in derivatives instruments and also on paid up equity capital of all the listed companies, ISIN-wise, to the depositories periodically and also provide information regarding change in paid-up equity capital in any listed company.

5. Summary

The balance of payments can indicate the volume of transactions between specific countries and may even signal potential shifts in specific exchange rates. In this session we have learnt about the key components of the balance of payments which includes Capital account and Current account; how international trade flows are influenced by economic factors and other factors like inflation, national income , government policy and much more; to explain how international capital flows are facilitated by various agencies like World Bank, IMF, WTO etc. and lastly portfolio investment in India which included its features, categories, restrictions and monitoring.