UNIT IV – PRODUCTION, MARKETING, FINANCIALS OF GLOBAL BUSINESS

Syllabus: Global production: Location, scale of operations- cost of production- Standardization Vs Differentiation- Make or Buy decisions- global supply chain issues- Quality considerations. Globalization of markets: Marketing strategy- Challenges in product development- pricing- production and channel management. Foreign Exchange Determination Systems: Basic Concepts- types of Exchange Rate Regimes- Factors Affecting Exchange Rates.

Global Production

Production is the core of any business organization having its operations on an international scale. International business firms must look closely at production factors for profitability and sustainability. Production refers to manufacturing, acquiring, and developing products for the business market.

Factors that Affect Production

There are three major areas an international organization must focus on in order to increase its production efficiency. They are −

- Facility Location
- Scale of Operation
- Cost of Production

Facility Location

Facility Location refers to the appropriate location for the manufacturing facility; it should have optimum access to customers, workers, transportation, etc.

The main goal of an organization is to satisfy and delight customers with its product and services. The manufacturing unit plays a major role in this direction. One of the most important factors for determining the success of a manufacturing unit is its location.

To get commercial success and retain its competitive advantage, any international business firm would pay attention to the following critical factors while choosing its business location −

- **Customer Proximity** − Customer proximity is important to reduce transportation cost and time.
- **Business Area** − Having other manufacturing units of similar products around the business area is conducive for facility establishment.
- **Availability of Skilled labor** − There should be skilled labor available in and around the facility location.
- **Free Trade Zone** − Free-trade zones usually promote and augment the establishment of manufacturing facility by offering incentives in custom duties and applicable levies.
- **Suppliers** − Continuous availability and quality supply of the raw materials influences in determining the location of production facility.
- **Environmental Policy** − As pollution control is very important, understanding of environmental policy for the facility location is critical.

Scale of Operations

Scale is the synonym for size in business. Business organizations can leverage on their size by making dealings, favorable terms, and volume-discounts with other firms.

Operating the business at scale means allocating and optimizing resources to get the greatest results and volume in all market segments. It is linked with optimization, not duplication, of efforts. Keeping costs under control while increasing the sales offers the opportunity for reducing costs and acquiring new customers, and more market share, without lowering the average margin (economies of scale).

Small-Scale Business − Also termed a small business, a small-scale business employs a small number of workers and does not have a high volume of sales. The U.S. Small Business Administration states that small-scale businesses have fewer than 500 employees. Financially, a non-manufacturing small-scale business is one that earns below or equal to $7 million a year.

Large-Scale Business − Based on the home country and the industry, a small-scale company usually employs between 250 and 1,500 people. Anything above that is a large-scale company.

Economies of Scale − It refers to the cost advantages that a business obtains due to its size, output, or scale of operation. Usually, cost per unit generally decreases with the increasing scale, as fixed costs are spread out over more products.

Cost of Production

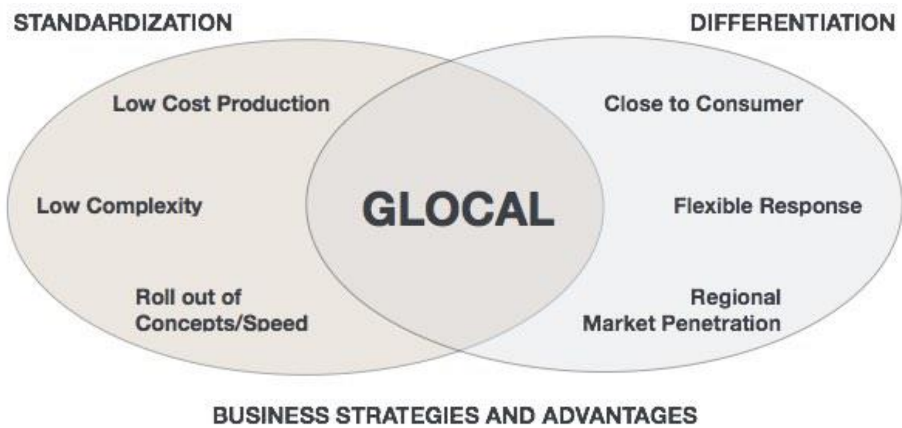
It is a cost incurred by a company in manufacturing a product or delivering a service. Production costs depend on raw material and labor. To determine the cost of production per unit, the cost of production is divided by the total number of units produced. It is important to know the cost of production to better price an item or a service and to decide its total cost to the company.

Cost of production includes both Fixed and Variable Costs.

- **Fixed costs** do not change with the level of output. They usually include rents, insurance, depreciation, and set-up costs. Fixed costs are also known as **overhead** cost.
- **Variable** costs refer to those costs which vary with the level of output, and are also known as **direct costs** or**avoidable costs**. Examples include fuel, raw materials, and labor costs.

Standardization Vs Differentiation

Standardization and differentiation are the two sides of globalization. By standardization, we mean to show the global representation, while differentiation looks upon local competitiveness. The following figure depicts how standardization differs from differentiation.



- Adaptation of different marketing strategies
- global marketing strategies Vs. country specific marketing approach
- It is also called as Standardization and Customization

Factors FavouringStandardisation	Factors Favouring Differentiation
* economies of scale, e.g. in R&D, production and marketing (experience curve effects) * global competition * convergence of tastes and consumer needs (consumer preferences are homogeneous) * centralised management of international operations (possible to transfer experience across borders) * a standardised concept is used by competitors * high degree of transferability of competitive advantages from market to market * easier communication, planning and control (e.g. through Internet and mobile technology) * stock cost reduction	* local environment-induced adaptation, e.g. government and regulatory influences, legal issues, differences in technical standards (no experience curve effects) * local competition * variation in consumer needs (consumer needs are heterogeneous, e.g. because of cultural differences) * fragmented and decentralised management with independent country subsidiaries * an adapted concept is used by competitors * low degree of transferability of competitive advantages from market to market

Make-or-Buy Decisions

Make-or-buy decisions are taken to arrive at a strategic choice between manufacturing an item internally (in-house) or buying it externally (from an external supplier). The buy side of the decision is also known as **outsourcing**. Make-or-buy decisions of a firm is important when it has developed a product or part – or significantly modified a product or part – but is having problems with the current suppliers, or has decreasing capacity or changing demand.

The major reasons for manufacturing an item in-house include the following −

- Cost attributes (less expensive to make)
- Intentions to integrate the operations

- Productive use of excess plant capacity (using present idle capacity)
- For direct control over production / quality
- When design secrecy is applicable to protect proprietary technology
- Unreliable / incompetent suppliers
- Very small quantity of production
- Controlling lead time, transportation, warehousing costs
- Political, social, or environmental pressure

Buy decisions are applicable under the following conditions −

- Insufficient local expertise
- Cost considerations (less expensive)
- Small-volume requirements
- Limited production or insufficient capacity
- Intentions to maintain a multiple-source policy
- Indirect managerial control factors
- Procurement and inventory factors
- Brand preference

Global Supply Chain Issues

Globalization is changing the way the international firms used to deal with their supply chain networks. This is happening because companies are actively seeking to compete and gain market share. Global companies nowadays manage multiple supply chains, not only to deliver goods on time, but to meet diverse customer and supplier wants related with pricing and packaging. Personalizing the offerings for various customer clusters is necessary to address these issues.

Volatility of markets, economic contractions and mediocre recovery cycles influence distribution, manufacturing, invoicing and sourcing. Reaching out to encompass new markets brings complex taxation, invoicing and localization burdens. Moreover, dispersed segments of markets ask for different pricing models and services. Hence, optimizing the supply chain is necessary to stay competitive.

Globalization and its Effect on Supply Chain

Many businesses tend to apply outdated processes and technologies to global supply chain operations. Many times, available systems are not compatible with the modern demands. Lack of understanding of current situations and contemporary supply chain can be disastrous. It can result in a rise in costs and decreased efficiency. With the expansion of logistics, the ability to quickly estimate the cost and service implications must increase.

An optimized global supply chain can help a company in the following areas −

- **Reduced Costs** − Companies accessing information relating to suppliers make better procurement decisions. Online supplier and buyer community management can reduce supplier sourcing and procurement costs.
- **Increased Transparency** − Being a single point of access for supplier information as well as buyer-supplier communities is important. International supply chain operators can locate

reliable suppliers regardless of location preferences with a global approach and transparent policy.

- **Lower Risk** − An optimized supply chain lets the supplier meet financial, legal, safety, quality, and environmental regulations. As the regulations differ widely, flexibility becomes the key to risk management.
- **Support Legacy & New Products** − Contemporary global supply chains require a billing partner and a supplier settlement platform. The platform needs to take care of taxation, invoicing and other crucial functions. It must encompass multiple fluid business-models to let the company reach international markets.
- **Solutions to Global Supply Chain Challenges** − While looking for growth and quick expansion, companies must consider deeply about what their current supply chains are capable of. They must assess whether their capabilities are enough to meet global competition. In order to support the existing and future business objectives, companies must reconsider the management processes and implement best practices which are more flexible.

Quality Considerations

As the quality of life improves around the world, demand for better quality services and products increases. Customers demand assurance that the product or services for which they are paying will not only meet but exceed their expectations. In this customer-driven economy, businesses compete globally. The emphasis on quality products and services is forcing global industries to adopt internationally recognized quality management systems to stay in business. All of this demands a clear linkage between global success, strategy and planning, a practice we call global integration management.

Quality management

Successful quality management ensures that your organization will satisfy the needs for which it was created. Key parameters in the approach to quality management are the number of companies involved in an organization and their roles. Global, multicompany organizations require different approaches to quality management than single-company organizations. To be successful, you need to develop a shared consciousness on quality. In multicompany international organizations, if you are dependent on another company for a key deliverable, the other company’s openness is a critical dependency. To be successful, formal milestones and key metrics need to be established and documented for quality evaluation.

Status reports should be formal and documented as well. On-site representation can provide valuable information. Daily or at least weekly face-to-face contact on quality-related issues is critical. First-hand access to product development is key to both early warning and accurate data. No matter how effective the metrics or how frequent the milestones, off-site quality data will be filtered.

Another key parameter in quality management is hand-off time. When are the results of one location’s efforts turned over to another for completion,The correct timing of a transfer can positively affect how responsible one feels for the quality of his or her deliverable. It can also minimize costs. Incorrect timing can have a negative effect on quality and increase repair/warranty costs.

Another aspect of quality magnified by global organizations is problem resolution time. Resolution time grows longer with distance and language differences. Transmission time will take longer, and often everyone is working against the clock instead of with it. What could be described simply in one language may lose its meaning when translated to a second language. These factors can result in many requests to redefine a problem and the need for additional data. When resolution time lengthens, it's important to have an expedited path to handle critical problems.

The last consideration is more subtle. What is viewed as strength in one culture could be viewed as weakness or loss of face in another. For instance, most Americans believe admitting faults and failures is a strength. In some cultures, the exact opposite is true. This can create conflicts in priorities and a sense of urgency associated with problem resolution. Managers need to be careful when discussing problems if such cultural differences exist.

Quality in International Business

Maintain and enhance the quality has become such a significant competitive issue in most industries.

Quality is a vital importance for several reasons:

Many firms today compete on the basis of quality.

Quality is important because it is directly linked with productivity.

Higher quality helps firms to develop and maintain customer loyalty.

Quality consists of eight dimensions:

Performance: comprises the product's primary operating characteristics, such as, anautomobile's ability to transport its driver.

Features: include supplementary characteristics, such a power window on anautomobile.

Reliability: refers to the dependability of a product, such as the probability of anautomobile's starting.

Conformance: is how well the product meets normal standards.

Durability: refers to the product's expected lifespan.

Serviceability: refers to how fast and easily the product can be repaired.

Aesthetics: refers to how the product looks, feels, tastes, and/or smells.

Perceived Quality: is the level of quality as seen by the customer.

Quality Improvement Tools

Statistical process control: is a family of mathematically-based tools for monitoring andcontrolling quality. Its basic purpose is to define the target level of quality, specify an acceptable range of deviation, and then ensure that product quality is hitting the target.

Benchmarking: is the process of legally and ethically studying how other firms dosomething in high-quality way and then either imitating or improving on their methods.

Total Quality Management (TQM): is an integrated effort to systematically andcontinuously improve the quality of an organization's products and /or services. The components of TQM are – strategic commitment to quality, employee involvement, high-quality materials, up-to-date technology, and effective process.

Globalization of Market

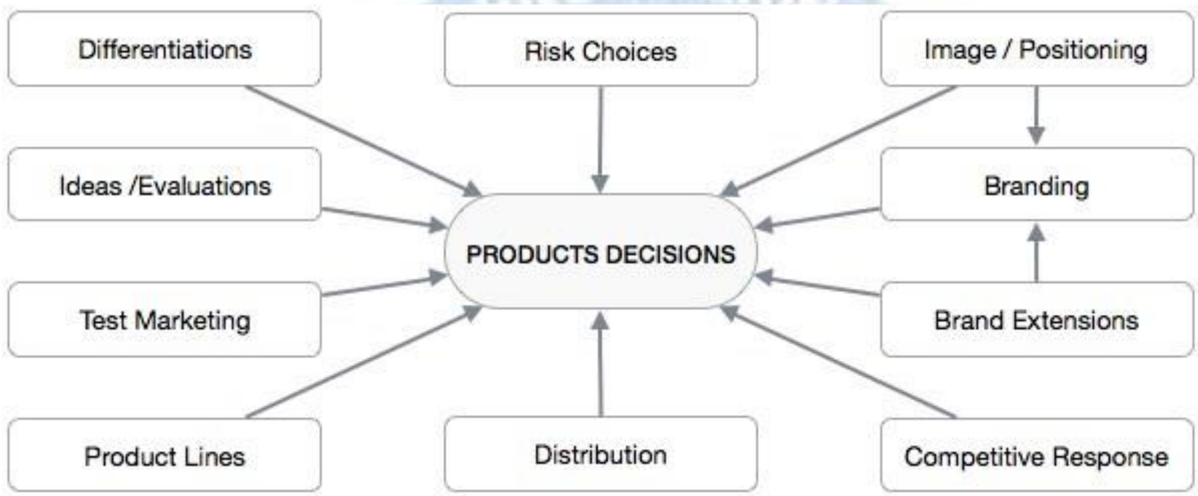
Global Marketing combines the promotion and selling of goods and services with an increasingly interdependent and integrated global economy. It makes the companies stateless and without walls.

The **4P's** of Marketing − **product, price, place, and promotion**− pose many challenges when applied to global marketing. We take each one of the **P's** individually and try to find out the issues related with them.

Global Marketing Mix: Products

The product and service mix is one of the most important ingredients for the global marketer today. The diverse demand for products and services in the era of globalization is mind-blowing. Presence of industrialized and emerging markets, increasing purchasing power, and the growth of Internet has made the customers aware, smart, and more demanding. The result is a greater competition between firms.

Here are the important factors to consider when going global with a product or service.



The global consumer makes purchasing decisions to get the best quality products at the most affordable price. They have information available in abundance, thanks to the Internet. Therefore, **innovation** takes center-stage to gain adequate attention from potential consumers.

A global marketer must be **flexible enough to modify the attributes** of its products in order to adapt to the legal, economic, political, technological or climatic needs of a local market. Overall, global marketing requires the firms to have available and specific processes for product adaptation for success in new markets.

Culture can differentiate a standardized product from an adapted one. Making cultural changes in product attributes is like introducing a new product in your home country. The product should meet the needs, tastes, and patterns that are permitted by the market culture.

Lastly, it is essential to understand that a product or service is not just one "thing." It should be seen as a part of the whole marketing mix so that a great synergy can be built among different strategies and actions.

Global Marketing Mix: Price

Pricing is a crucial part of the marketing mix for international firms. Pricing techniques play a critical role when a company wants to penetrate into a market and expand its operations.

Drivers in Foreign Market Pricing

The most important factors that decide the prices are labelled the**4 C's** −

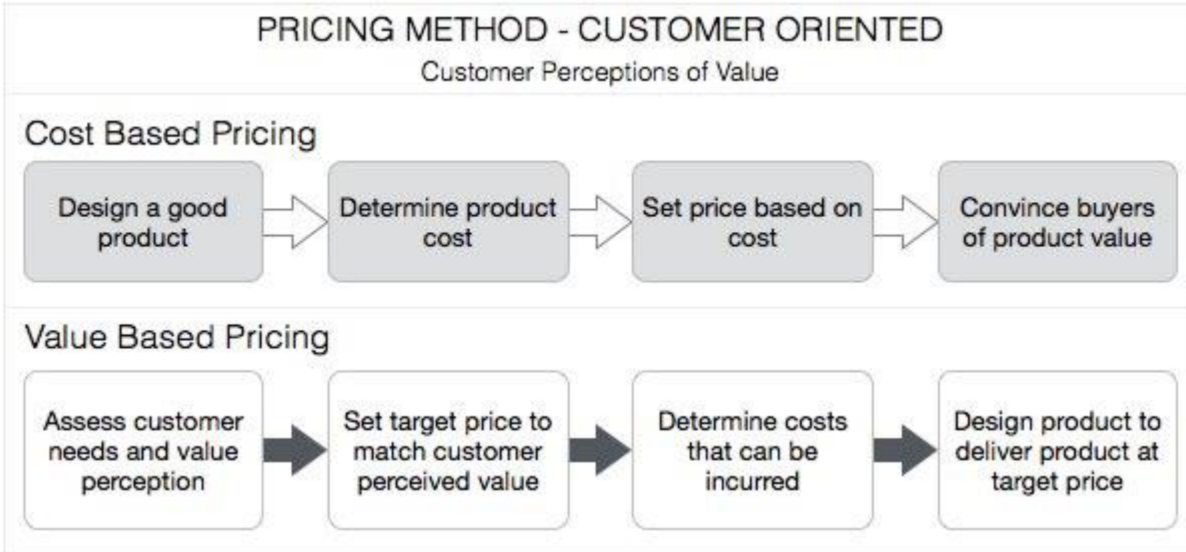
- Company (costs, company goals)

- Customers (price sensitivity, segments, consumer preferences)
- Competition (market structure and intensity of competition)
- Channels (of distribution)

International Pricing Challenges

Global firms face the following challenges while pricing their products and services to suit the requirements of international market −

- **Export Price Escalation** − Exporting includes more steps and higher risks than domestic sale. To make up for shipping, insurance and tariffs, and foreign retail prices, the export price may be much higher than domestic country. It is important to know whether external customers are willing to pay an additional price for the products/services and whether the pricing will be competitive in that market. If both answers are negative, then there are two approaches. One is to find a way to decrease the export price, and the second is to position the product as an exclusive or premium brand.
- **Inflation** − Intense and uncontrolled inflation can be a huge obstacle for MNCs. If inflation rates are rampant, setting prices and controlling costs require full dedication of marketing and financial divisions. Some alternatives to counter inflation include changing the components of products or their packaging, procuring raw materials from low-cost suppliers and shortening credit terms, etc.
- **Currency Movements** − Exchange rates being unstable, setting a price strategy that can get rid of fluctuations gets difficult. Key considerations include what proportion of exchange rate gain or loss should be transferred to customers (the pass-through issue), and finding which currency price quotes are given in.
- **Transfer Pricing** − Transfer prices are the charges for transactions that involve trade of raw materials, components, finished products, or services. Transfer pricing include stakeholders, such as the company, local managers, host governments, domestic governments, and joint-venture partners. Tax regimes, local conditions, imperfections, joint venture partners and the morale of managers affect transfer pricing.
- **Anti-dumping Regulations** − Dumping occurs when imports are sold at an unfair and very low price. Recently countries have adopted anti-dumping laws to protect their local industries. Anti-dumping laws should be considered when deciding global prices.
- **Price Coordination** − Price coordination is the relationship between prices charged in different countries. It is an important consideration while deciding the global pricing model. Price coordination includes the following factors − Nature of customers, Product differentiation amount, Nature of distribution channels, Competition type, Market Integration, Internal organizational characteristics, and Government regulations.
- **Countertrade** − Countertrades are unconventional trade-financing transactions including non-cash compensation. A monetary valuation can however be used in countertrade for accounting purposes. In dealings between sovereign states, the term bilateral trade is generally used. Examples include clearing arrangements, buybacks, counter purchases, switch trading, and offsets.



Global Marketing Mix: Promotion

Promotion comes into picture when a global company wants to communicate its offering to potential customers. How an organization chooses to promote its products and services can have a direct and substantial impact on its sales.

Advertising and Culture

Advertising can create a popular culture and a culture may influence the ad as well. Culture's impact in advertising is prevalent, especially in culturally-sensitive issues like religion and politics.

Cultural Effect

Procter & Gamble had problems advertising the Pert Plus shampoo in Saudi Arabia, where only veiled women can be shown in TV commercials. The company had to show the face of a veiled woman, and the hair of another from the back.

Setting a Budget

A global marketer can consider budgeting rules such as percentage of sales (creating budget as a percentage of sales revenues), competitive parity (taking competitor's ad spending as a benchmark), or objective-and-task (treating promotional efforts to achieve stated objectives). Global markets use **three approaches** to reach allocation decisions −

- In **bottom-up budgeting,** the units independently determine the market budget and request resources from headquarters.
- In **top-down budgeting,** the headquarters set a total budget and split up the resources.
- Decisions may also be made at a **regional level** and submitted to the headquarters for their approval.

Promotional Strategy

When global marketers choose a standardized approach, the same global campaign is applied throughout all countries.

- **Advantages** − Achieving economies of scale in ad campaigns to reduce cost, maintaining a consistent brand image.

- **Barriers** − Cultural differences resulting in negative or ineffective consumer response, advertising laws and regulations, variations in degree of marketing development.

The NIH Syndrome: A Barrier to Standardized Approach

"Not Invented Here" syndrome occurs when agencies or business subsidiaries reject using a standardized campaign simply because they did not invent or come up with the campaign.

Assessing Global Media Decisions

Global media decisions are a big concern for global firms. The media buying patterns vary across countries. A global marketer must find the best media channels in a market.

Ad Regulations

Foreign regulations on advertisements may be present in a specific country. Research of the laws in the country of operation is necessary before developing a campaign, to avoid legal implications and waste of time and money.

Choosing an Agency

Choosing an ad agency may prove more effective due to their understanding of the country and market they are doing business in.

Other Communication Options

Sales events, direct marketing, sponsorships, mobile marketing, product placement, viral marketing, and public relations and publicity are also applicable.

Globally Integrated Marketing Communications (GIMC)

A GIMC is a system of promotional management that coordinates global communications - horizontally (from country to country) and vertically (promotion tools). GIMC is meant to harmonize the promotional and communication disciplines in every way. All communication vehicles may be integrated so that they convey the single idea to all concerned in a unified voice.

Global Marketing Mix: - Place(Distribution)

In order to be successful in a global market, a marketer must make its products and accessible to customers at all costs. Distribution channels make up the "place" in the 4 P's of the marketing mix (along with Product, Price, and Promotion).

Distribution Processes and Structures

The distribution process deals with product handling and distribution, the passage of ownership (title), and the buy and sell negotiations.

Negotiations take place between the producers and the middlemen and then between the middlemen and the customers.

Traditionally, **import-oriented distribution** structures relied on a system where importers controlled a fixed supply of goods. The marketing was based on the idea of limited suppliers, high prices, and smaller number of customers. Today, the import-oriented model is hardly used. Channel structures have become more advanced with overall development.

Distribution Patterns

To understand a foreign distribution system, marketers should never believe that it is the same as the domestic one. Many distribution patterns exist in retailing and wholesaling. Size, patterns, direct marketing, and the resistance to change affect the composure of distribution channels.

- **Retail size and pattern** − Company's may either sell to large, dominant retailers directly or distribute to smaller retailers.
- **Direct marketing** − The challenge in underdeveloped nations is handled through direct marketing. Direct marketing occurs when consumers are targeted through mail, telephone, email, or door-to-door selling. This process also doesn't take retailer and wholesaler types into consideration.

Choosing Your Middleman

The channel process starts with manufacturing and ends with the final sale to the customer. It is most likely to counter many different middlemen in the process. There are three types of middlemen in distribution channels −

- **Home-Country Middlemen** − They provide marketing and distribution services from a domestic base in the home country. The parties usually relegate the foreign-market distribution to others; including manufacturer or global retailers, export management companies, or trading companies.
- **Foreign-Country Middlemen** − For a greater control, foreign-country middlemen are hired who can create a shorter channel and have more market expertise.
- **Government-Affiliated Middlemen** − Government-affiliated middlemen are often responsible in distribution for the government's use.

Factors Affecting Choice of Channels

Channel of distribution or middlemen selection must precede the understanding of the characteristics of the foreign market and the established common system there. The major factors to consider while choosing a particular channel are −

- The specific target market within and across countries.
- The goals in terms of volume, market share, and profit margin.
- The financial and organizational commitments.
- Control of the length and characteristics of the channels.

Application of 4 P's

The following illustration depicts the global marketing mix of McDonald's. It shows how McDonald's varies its marketing strategy according to the requirements of different local markets.

McDonald's Global Marketing

Marketing Mix Element	Standardization	Localization
Product	Big Mac	McAloo Tikka Potato Burger (India)
Promotion	Brand Name Advertising Slogan: I'm Loving It.	Slang Macca's (Australia) MakDo (Phillipines)
Place	Free Standing	Home Delivery (India) Swiss Rail System Dining Cars
Price	Big Mac is $3.10 in US & Turkey	$5.21 (switzerland) $1.31 (China)

Foreign Exchange Determination Systems

Foreign Exchange Rate is the amount of domestic currency that must be paid in order to get a unit of foreign currency. According to Purchasing Power Parity theory, the foreign exchange rate is determined by the relative purchasing powers of the two currencies.

Example: If a Mac Donald Burger costs $20 in the USA and Re 100 in India, then the exchange rate between India and the USA will be (100/20=5), 1 $ = 5 Rs.

Basic Concepts

In a foreign exchange market comprising commercial banks, foreign exchange brokers and authorised dealers and the monetary authority (i.e., the RBI), one currency is converted into another currency.

A (foreign) exchange rate is the rate at which one currency is exchanged for another. Thus, an exchange rate can be regarded as the price of one currency in terms of another. An exchange rate is a ratio between two monies. If 5 UK pounds or 5 US dollars buy Indian goods worth Rs. 400 and Rs. 250 then pound-rupee or dollar-rupee exchange rate becomes Rs. 80 = £1 or Rs. 50 = $1, respectively. Exchange rate is usually quoted in terms of rupees per unit of foreign currencies. Thus, an exchange rate indicates external purchasing power of money.

A fall in the external purchasing power or external value of rupee (i.e., a fall in the exchange rate, say for Rs. 80 = £1 to Rs. 90 = £1) amounts to depreciation of the Indian rupee. Consequently, an appreciation of the Indian rupee occurs when there occurs an increase in the exchange rate from the existing level to Rs. 78 = £1. In other words, the external value of rupee rises. This indicates strengthening of the Indian rupee. Conversely, the weakening of the Indian rupee occurs if external value of rupee in terms of pound falls.

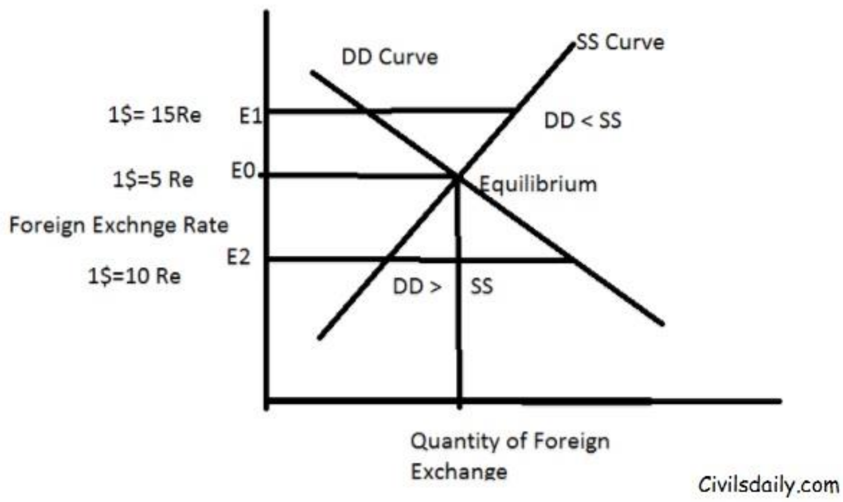
Forces behind Exchange Rate Determination

Foreign Exchange is a price of one country currency in relation to other country currency, which like the price of any other commodity is determined by the demand and supply factors. The demand and supply of the foreign exchange rate come from the residents of the respective countries.

Demand for Foreign Exchange
(Foreign Money goes out)

Supply of Foreign Exchange
(Foreign Money Comes in)

Foreign Currency is needed to carry out transactions in foreign countries or for the purchase of foreign goods and services (IMPORTS).	The source of foreign currency available to the domestic country are foreigners purchasing our goods and services (Exports).
Foreign currency is needed to invest in foreign country assets/shares/bonds etc.	Foreigners investing in Indian Stock markets, Assets, Bonds etc. (FPIs and FDIs)
Foreign currency is needed to make transfer payments. Example: Indian Parents sending Money to his/her son/daughter studying in the USA.	Transfer payments. Example: Indian working in the USA, sending money to his/her old aged parents.
Indians holding money in overseas Banks	Foreigners holding assets in Indian Banks.
Indians Travelling abroad for Tourism Purpose.	Foreigners travelling to India.



- The DD curve represents the demand for foreign exchange by India. The SS curve represents the supply of foreign exchange to India.
- The point where both DD and SS curves intersect is the point of equilibrium. At this point demand for foreign exchange is exactly equal to the supply of foreign exchange.
- At equilibrium point E0, the exchange rate is 1 $ equal to 5 Re.
- In normal day to day functioning of markets, the exchange rate may fluctuate. If at any point in time, the exchange rate is at E1, then the demand for foreign exchange falls short of supply of foreign exchange, as a result at this point Indians are demanding less foreign currency due to which Re will appreciate vis-à-vis foreign currency. The appreciation mainly occurs due to a favourable balance of payment situation (Surplus).
- By the same token at point E2, demand for foreign exchange is greater than the supply of foreign exchange, at this point Indians are demanding excess foreign exchange than what the foreigners are willing to supply, as a result, at E2 Re will depreciate vis-à-vis foreign currency. The depreciation mainly occurs due to the unfavourable balance of payments situation(Deficits).

Types of Exchange Rate Regimes

- **Fixed Exchange Rate versus Floating Exchange Rate**

Fixed Exchange Rate	**Floating Exchange Rate**
Under this system, there is complete government intervention in the foreign exchange markets.	Under this system, the market is allowed to determine the value of exchange rate freely.
The government or central bank determines the official exchange rate by linking exchange rate to the price of gold or major currencies like US dollar.	The exchange rate is determined by the forces of demand and supply.
If due to any reason, the exchange rate fluctuates, government intervenes and make sure that equilibrium pre-determined level is maintained.	If due to any reason exchange rate fluctuates, the government never intervenes and allows the market to function and determine the true value of exchange rate.
The only merit of fixed exchange rate system is that it assures the stability of exchange rate. It prevents both currency appreciation and depreciation.	The only demerit of floating exchange rate system is that exchange rate fluctuates a lot on day to day basis.
The many disadvantages of such a system are: It puts a heavy burden on governments to maintain exchange rate. This especially happens during the time of deficits, as the governments need to infuse a lot of money to maintain exchange rate. The foreign investors avoid investing in such countries as they fear to lose their investments because they believe that exchange rate does not reflect the true value of the economy.	The advantages of such a system are: the exchange rate is determined in well-functioning foreign exchange markets with no government interference. The exchange rate reflects the true value of the domestic currency which helps in establishing the trust among foreign investor. A country can easily access funds/ loans from IMF and other international institutions if the exchange rate is market determined.

- ## Managed Floating Exchange Rate

Manage Floating exchange rate lies in between of the two extremes of fixed and floating exchange rate. Under such a system, the exchange is allowed to move freely and determined by the forces of the market (Demand and Supply). But when a difficult situation arises, the central banks of the country can intervene to stabilise the exchange rate.

There are mainly three sub categories under managed floating exchange rate:

1. **Adjusted Peg System**: In this system, a country should try to hold on to a fixed exchange rate system for as long as it can, i.e. until the country’s foreign exchange reserves got exhausted. Once the country’s foreign exchange reserves got exhausted, the country should undergo devaluation of currency and move to another equilibrium exchange rate.
2. **Crawling Peg System:** In this system, a country keeps on adjusting its exchange rate to new demand and supply conditions. The system requires that instead of devaluing currency at the time of crisis, a country should follow regular checks at the exchange rate and when require must undertake small devaluations.

3. **Clean Floating**: In the clean float system, the exchange rate is determined by market forces of demand and supply. The exchange rate appreciates or depreciates as per market forces and with no government intervention. It is identical to floating exchange rate.

4. **Dirty Floating**: In the dirty float system, the exchange rate is to a very large extent is determined by the market forces of demand and supply (so far identical to clean floating), but occasionally the central banks of the countries intervene in foreign exchange markets to smoothen or remove excessive fluctuations from the foreign exchange markets.

Exchange Rate Management in India

Over the last six decades since independence the exchange rate system in India has transited from fixed exchange rate regime where the Indian Rupee was pegged to the UK Pound to a basket of currencies during the 1970s and 1980s and eventually to the present form of market determined exchange rate regime since 1993.

- **Par Value System** (1974-1971): After Independence Indian followed the 'Par Value System' whereby the rupee's external par value was fixed with gold and UK pound sterling. This system was followed up to 1966 when the rupee was devalued by 36 percent.
- **Pegged Regime** (1971-1992): India pegged its currency to the US dollar (1971-1991) and to pound (1971-75). Following the breakdown of Breton Woods system, the value of pound collapsed, and India witnessed misalignment of the rupee. To overcome the pressure of devaluation India pegged its currency to a basket of currencies. During this period, the exchange rate was officially determined by the RBI within a nominal band of +/- 5 percent of the weighted average of a basket of currencies of India's major trading partners.
- **The period since 1991**: The transition to market-based exchange rate was in response to the BOP crisis of 1991. As a first step towards transition, India introduces partial convertibility of rupee in 1992-93 under LERMS.
- **Liberalised Exchange Rate Management System** (LERMS): The LERMS involved partial convertibility of rupee. Under this system, India followed a dual exchange rate policy, where 40 percent of the exchange rate were to be converted at the official exchange rate and the remaining 60 percent were to be converted at the market-based exchange rate. The exchange rate converted at the official rate were to be used for essential imports like crude, oil, fertilizers, life savings drugs etc. All other imports should be financed at the market-based exchange rate.
- **Market-Based Exchange rate Regime** (1993- till present): The LERMS was a transitional mechanism to provide stability during the crisis period. Once the stability is achieved, India transited from LERMS to a full flash market exchange rate system. As a result, since 1993, exchange rate fluctuations are marker determined. In the 1994 budget, 60:40 ratio was removed, and 100 percent conversion at market-based rate was allowed for all goods and capital movements.

Factors Affecting the Exchange Rate

Exchange rate is impacted by some factors which can be economic, political or psychological as well. The economic factors that are known to cause variation in foreign exchange rates are inflation, trade balances, government policies.

Political factors that can cause a change in the foreign exchange rate are political unrest or instability in the country and any kind of political conflict.

Psychological factors that impact the forex rate is the psychology of the participants involved in foreign exchange.

There are several factors that contribute to a foreign exchange rate. Some of the top factors that affect an exchange rate are:

1. Inflation

Inflation is the relative purchasing power of a currency compared to other currencies. For example, it might cost one unit of currency to buy an apple in one country but cost a thousand units of a different currency to buy the same apple in a country with higher inflation. Such differentials in inflation are the foundation of why different currencies have different purchasing powers and hence different currency rates. As such, countries with low inflation typically have stronger currencies compared to those with higher inflation rates.

2. Interest Rates

Interest rates are tightly tied to inflation and exchange rates. Different country's central banks use interest rates to modulate inflation within the country. For example, establishing higher interest rates attracts foreign capital, which bolsters the local currency rates. However, if these rates remain too high for too long, inflation can start to creep up, resulting in a devalued currency. As such, central bankers must consistently adjust interest rates to balance benefits and drawbacks.

3. Government/Public Debt

Most countries finance their budgets using large-scale deficit financing. In other words, they borrow to finance economic growth. If this government debt outpaces economic growth, it can drive up inflation by deterring foreign investment from entering the country, two factors that can devalue a currency. In some cases, a government might print money to finance debt, which can also drive up inflation.

4. Political Stability

A politically stable country attracts more foreign investment, which helps prop up the currency rate. The opposite is also true – poor political stability devalues a country's currency exchange rate. Political stability also affects local economic drivers and financial policies, two things that can have long term effects on a currency's exchange rate. Invariably, countries with more robust political stability like Switzerland have stronger and higher valued currencies.

5. Economic Health

Economic health or performance is another way exchange rates are determined. For example, a country with low unemployment rates means its citizens have more money to spend, which helps establish a more robust economy. With a stronger economy, the country attracts more foreign investment, which in turn helps lower inflation and drive up the country's currency exchange rate. It is worth noting here that economic health is more of a catch-all term that encompasses multiple other drivers like interest rates, inflation, and balance of trade.

6. Balance of Trade

Balance of trade is the relative difference between a country's imports and exports. For example, if a country has a positive balance of trade, it means that its exports exceed its imports. In such a case, the inflow of foreign currency is higher than the outflow. When this happens, a country's foreign exchange reserves grow, helping it lower interest rates, which stimulates economic growth and bolsters the local currency exchange rate.

7. Country's Current Account/Balance of Payments

A country's current account reflects balance of trade and earnings on foreign investment. It consists of total number of transactions including its exports, imports, debt, etc. A deficit in current account due to spending more of its currency on importing products than it is earning through sale of exports causes depreciation. Balance of payments fluctuates exchange rate of its domestic currency.

8. Terms of Trade

A trade deficit also can cause exchange rates to change. Related to current accounts and balance of payments, the terms of trade is the ratio of export prices to import prices. A country's terms of trade improves if its exports prices rise at a greater rate than its imports prices. This results in higher revenue, which causes a higher demand for the country's currency and an increase in its currency's value. This results in an appreciation of exchange rate.

9. Recession

When a country experiences a recession, its interest rates are likely to fall, decreasing its chances to acquire foreign capital. As a result, its currency weakens in comparison to that of other countries, therefore lowering the exchange rate.

10. Confidence/ Speculation

Sometimes, currencies are affected by the confidence (or lack thereof) traders have in a currency. Currency changes from speculation tend to be irrational, abrupt, and short-lived. For example, traders may devalue a currency based on an election outcome, especially if the result is perceived as unfavorable for trade or economic growth. In other cases, traders may be bullish on a currency because of economic news, which may buoy the currency, even if the economic news itself did not affect the currency fundamentals.

11. Government Intervention

Governments have a collection of tools at their disposal through which they can manipulate their local exchange rate. Primarily, central banks are known to adjust interest rates, buy foreign currency, influence local lending rates, print money, and use other tools to modulate currency exchange rates. The primary objective of manipulating these factors is to ensure favorable conditions for a stable currency exchange rate, cheaper credit, more jobs, and high economic growth.

Foreign Exchange Risks

There are three types of risks associated with foreign exchange −

- **Transaction risk** − This is the risk of an exchange rate change on transaction date and the subsequent settlement date, i.e., it is the gain or loss arising on conversion.
- **Economic risk** − Transactions depend on relatively short-term cash flow effects. However, economic exposure encompasses the longer-term effects on the market value of a company. Simply put, it is a change in the present value of the future after-tax cash-flows for exchange rate changes.
- **Translation risk** − The financial statements are usually translated into the home currency to consolidate into the group's financial statements. It can pose a challenge when exchange rates change.

Hedging Forex Risks – Internal Techniques

Internal techniques to manage/reduce forex exposure include the following −

- **Invoice in Home Currency** − An easy way is to insist that all foreign customers pay in your home currency and that your company pays for all imports in your home currency.
- **Leading and Lagging** − If an importer (payment) expects that the currency it is due to pay will depreciate, it may attempt to delay payment. This may be achieved by agreement or by exceeding credit terms. If an exporter (receipt) expects that the currency it is due to receive will depreciate over the next three months, it may try to obtain payment immediately. This may be achieved by offering a discount for immediate payment. The problem lies in guessing which way the exchange rate will move.
- **Matching** − If receipts and payments are in the same currency and are due at the same time, matching them against each other is a good policy. However, the only requirement is to deal with the forex markets for the unmatched portion of the total transactions. Also, setting up a foreign currency bank account is an extension of matching.
- **Doing Nothing** − The theory suggests that long-term gains and losses gets hedged automatically. Short-term losses may be significant in such processes. Advantage is the savings in transaction costs.

Hedging Forex Risks – External Techniques

Transaction risks can also be hedged using a range of financial products −

- **Forward Contracts** − The forward market is used to buy and sell a currency, on a fixed date for a rate, i.e., the forward rate of exchange. This effectively fixes the future rate.
- **Money Market Hedges** − The idea is to minimize uncertainty by making the exchange at the current rate. This is done by depositing/borrowing the foreign currency till the real commercial cash flows occur.
- **Futures Contracts** − Futures contracts are standard sized, traded hedging instruments. The aim of a currency futures contract is to fix an exchange rate at some future date, subject to basis risk.
- **Options** − A currency option is a right, but not an obligation, to buy or sell a currency at an exercise price on a future date. The right will only be exercised in the worst-case scenario.
- **Forex Swaps** − In a Forex swap, the parties agree to swap equivalent amounts of currency for a period and then re-swap them at the end of the period at an agreed swap rate. The rate and amount of currency is fixed in advance. Thus, it is called a fixed rate swap.
- **Currency Swaps** − A currency swap lets the parties to swap interest rate commitments on borrowings in different currencies. The swap of interest rates could be fixed.