**Rajasthan Institute of Engineering & Technology, Jaipur**

**University Roll No. \_\_\_\_\_\_\_\_\_\_\_\_\_\_**

2nd Year MBA 3rd Semester I Mid Term Examination, October – 2018

Subject: - IFM SET-A

Time: - 2 Hrs. [Maximum Marks: -20]

[Min. Passing Marks: 08]

Instructions to the Candidates:

Attempt any 4 questions from Section A and Section B is Compulsory.

**Section A**

1. **What do you understand by IMF? Explain the evolution of IMF. (3)**

Ans- The **International Monetary Fund (IMF)** is the central institution embodying the international monetary system and promotes balanced expansion of world trade, reduced trade restrictions, stable exchange rates, minimal trade imbalances, avoidance of [currency](http://www.investinganswers.com/node/120) devaluations, and the [correction](http://www.investinganswers.com/node/2590) of balance-of-payment problems. The IMF's goal is to prevent and remedy international financial crises by encouraging countries to maintain sound economic policies. Because of its size, the IMF is also a forum for discussion of global economic policies.

**Evolution of IMF**

The international monetary system consists of (i) exchange rate arrangements; (ii) capital flows; and (iii) a collection of institutions, rules, and conventions that govern its operation. ... It also encourages macroeconomic and financial stability by adjusting real exchange rates to shifts in trade and capital flows.

The flexible exchange rate regime followed the demise of the Bretton Woods System. The IMF met in Jamaica to agree to a new set of rules for the international monetary system. The key elements of the Jamaica Agreement included:

Flexible exchange rates were declared accepted to the IMF members and central banks were allowed to intervene in the exchange markets to iron out unwarranted volatility. Gold was officially abandoned as an international reserve asset. Non-oil exporting countries and less-developed countries were given greater access to IMF funds.

1. **Explain the concept of IFM. What are the recent trends and challenges in international**

**finance? (3)**

Ans- International Finance is an important part of financial economics. It mainly discusses the issues related with monetary interactions of at least two or more countries. International finance is concerned with subjects such as exchange rates of currencies, monetary systems of the world, foreign direct investment (FDI), and other important issues associated with international financial management.

# Challenges of International Financial Management

Financial management of a company is a complex process, involving its own methods and procedures. It is made even more complex because of the globalization taking place, which is making the world’s financial and commodity markets more and more integrated. The integration is both across countries as well as markets. Not only the markets, but even the companies are becoming international in their operations and approach.

**1. The international financial system, which consists of two segments:** the official part represented by the accepted code of behavior by governments comprising the international monetary system, and the private part, which consists of international banks and other multinational financial institutions that participate in the international money and capital markets.

**2. The foreign exchange market**, which consists of multinational banks, foreign exchange dealers, and organized exchanges where currency futures are regularly traded.

1. **Define BOP. Explain the types of BOP. (3)**

Ans- Set of accounts that record a country's international transactions, and which (because double entry bookkeeping is used) always balance out with no surplus or deficit shown on the overall basis. A surplus or deficit, however, can be shown in any of its three component accounts: (1) Current account, covers export and import of goods and services, (2) Capital account, covers investment inflows and outflows, and (3) Gold account, covers gold inflows and outflows. BOP accounting serves to highlight a country's competitive strengths and weaknesses, and helps in achieving balanced economic-growth.

#### Types of Balance Payment:

**Balance of payments is divided into two following ways:**

(i) Vertically into credit and debit (according to the principals of double entry systems of book-keeping)

(ii) Horizontally into two major categories (according to the nature of transactions).

Read more: http://www.businessdictionary.com/definition/balance-of-payments-BOP.html

1. **How the cross currency management should be done? (3)**

Ans- A pair of currencies traded in forex that does not include the U.S. dollar. One foreign currency is traded for another without having to first exchange the currencies into American dollars.

Historically, an individual who wished to exchange a sum of money into a different currency would be required to first convert that money into U.S dollars, and then convert it into the desired currency; cross currencies help individuals and traders bypass this step. The GBP/JPY cross, for example, was invented to help individuals in England and Japan who wanted to convert their money directly without having to first convert it into U.S dollars.

### Nature of cross currencies

* The US dollar was the only world reserve currency for a long time and in order to exchange from one currency into another, you had to first convert to US dollars.  
    
  Cross currencies allowed direct exchange between two currencies without involving the US dollar. However, because the US dollar is still the most widely held reserve currency, the major pairs are traded much more often and are more liquid compared to the cross pairs.
* The major pairs are traded more often and are therefore much more liquid. The major crosses are also very liquid, but can produce more volatile movement. The exotic pairs are traded less, so are even less liquid, which can also produce more volatile movement.
* The major crosses such as the EUR/GBP and the GBP/JPY are also very liquid due to the size of the economies behind these currencies, but less so than major pairs. Exotic pairs are traded even less so and are even less liquid.  
    
  With less liquidity, the price can trend very well, because if a financial institution or a bank participates in trading a cross pair, there are less traders to potentially trade against them. So when large moves do occur, they can be in the form of a long trend and may move quite rapidly.

1. **Define exchange rate mechanism. (3)**

Ans- The use of mechanisms by a [central bank](http://www.investopedia.com/terms/c/centralbank.asp) to influence a home currency's exchange rate. An adjustment is specifically made if the [exchange rate](http://www.investopedia.com/terms/e/exchangerate.asp) is not pegged to another currency, meaning that the [currency](http://www.investopedia.com/terms/c/currency.asp) is valued according to a [floating exchange rate](http://www.investopedia.com/terms/f/floatingexchangerate.asp).

Central banks may become involved if they believe that movements in the home currency are too "extreme", especially since a rapid increase or decrease in a currency's value can lead to a significant effects on its economy.

### How ERMs Work?

Actively managed exchange rate mechanisms work by setting a reasonable trading range for a currency's exchange rate and then enforcing the range via interventions.

For example, [Japan](https://www.thebalance.com/how-to-find-and-invest-in-japanese-etfs-1979131) may set an upper and lower bound on the Japanese yen relative to the U.S. dollar. If the Japanese yen appreciates above this level, the Bank of Japan can intervene by buying large quantities of U.S. dollars and selling Japanese yen into the market to lower the price.

* ERMs are tools used to control the value of a country's currency relative to other currencies in the global markets.
* Most developed countries have flexible ERMs, while emerging market economies tend to have fixed ERM policies to help provide stability.
* There are many different ways to influence exchange rates, including open market transactions, tariffs, quotas, interest rates, and monetary policy.

**Section B**

1. **How many types are there in disequilibrium in BOP? Describe the remedial measures to correct the disequilibrium. (4)**

Ans- **Main Types of Disequilibrium in the Balance of Payments:**

### Cyclical Disequilibrium: Cyclical fluctuations cause disequilibrium in the balance of payments because of cyclical changes in income, employment, output and price variables.

### Structural Disequilibrium: It emerges on account of structural changes occurring in some sectors of the economy at home or abroad which may alter the demand or supply relations of exports or imports or both.

### Short-run Disequilibrium: A short-run disequilibrium in a country’s balance of payments will be a temporary one, ‘lasting for a short period, which may occur once in a while.

### Long-run Disequilibrium: The long-term disequilibrium thus refers to a deep- rooted, persistent deficit or surplus in the balance of payments of a country. It is secular disequilibrium emerging on account of the chronologically accumulated short-­term disequilibria — deficits or surpluses.

* Here we detail about the four methods adopted to correct disequilibrium in balance of payments.

**Remedial measures for correcting disequilibrium in BOPs:**

#### Method 1 : Trade Policy Measures: Expanding Exports and Restraining Imports:

Trade policy measures to improve the balance of payments refer to the measures adopted to promote exports and reduce imports.

Besides, on export earnings lower in­come tax can be levied to provide incentives to the exporters to produce and export more goods and services. By imposing lower excise duties, prices of exports can be reduced to make them competi­tive in the world markets.

On the other hand, imports may be reduced by imposing or raising tariffs (i.e., import duties) on imports of goods. Imports may also be restricted through imposing import quotas, introducing li­censes for imports. Imports of some inessential items may be totally prohibited.

#### Method 2: Expenditure-Reducing Policies:

The important way to reduce imports and thereby reduce deficit in balance of payments is to adopt monetary and fiscal policies that aim at reducing aggregate expenditure in the economy.

**The two important tools of reducing aggregate expen­diture are the use of:**

(1) Tight monetary policy and

(2) Concretionary fiscal policy.

**Tight Monetary Policy:**

Tight monetary is often used to check aggregate expenditure or demand by raising the cost of bank credit and restricting the availability of credit. For this bank rate is raised by the Central Bank of the country which leads to higher lending rates charged by the commercial banks. This discourages businessmen to borrow for investment and consumers to borrow for buying durable consumers goods.

This therefore leads to the reduction in investment and consumption expenditure. Besides, availability of credit to lend for investment and consumption purposes is reduced by raising the cash reserve ratio (CRR) of the banks and also undertaking of open market operations (selling Government securities in the open market) by the Central Bank of the country.

**Contractionary Fiscal Policy:**

Appropriate fiscal policy is also an important means of reduc­ing aggregate expenditure. An increase in direct taxes such as income tax will reduce aggregate expenditure. A part of reduction in expenditure may lead to decrease in imports. Increase in indirect taxes such as excise duties and sales tax will also cause reduction in expenditure.

The other fiscal policy measure is to reduce Government expenditure, especially unproductive or non-developmen­tal expenditure. The cut in Government expenditure will not only reduce expenditure directly but also indirectly through the operation of multiplier.

#### Method 3: Expenditure – Switching Policies: Devaluation:

A significant method which is quite often used to correct fundamental disequilibrium in balance of payments is the use of expenditure-switching policies. Expenditure switching policies work through changes in relative prices. Prices of imports are increased by making domestically produced goods relatively cheaper. Expenditure switching policies may lower the prices of exports which will encourage exports of a country. In this way by changing relative prices, expenditure-switching poli­cies help in correcting disequilibrium in balance of payments.

The important form of expenditure switching policy is the reduction in foreign exchange rate of the national currency, namely, devaluation. By devaluation we mean reducing the value or exchange rate of a national currency with respect to other foreign currencies. It should be remembered that devaluation is made when a country is under fixed exchange rate system and occasionally decides to lower the exchange rate of its currency to improve its balance of payments.

**Marshall and Lerner**

Marshall and Lerner have developed a condition which states that devaluation will succeed in improving the balance of payments if sum of price elasticity of exports and price elasticity of imports is greater than one. Thus, according to Marshall-Lerner Condition, devaluation improves balance of payments if

ex + em > 1

where

ex stands for price elasticity of exports

em stands for price elasticity of imports

If in case of a country ex + em < 1, the devaluation will adversely affect balance of payments position instead of improving it. If ex + em = 1, devaluation will leave the disequilibrium in the balance of payments unchanged.

**Income-Absorption Approach to Devaluation:**

Further, for devaluation to be successful in correcting disequilibrium in the balance of payments a country should have sufficient exportable surplus. If a country does not have adequate amount of goods and services to be exported, fall in their prices due to devaluation or depreciation will be of no avail.

This can be explained through income-absorption approach put forward by Sidney S Alexander. According to this approach, trade balance is the difference between the total output of goods and services produced in a country and its absorption by it.

By absorption of output of goods and services we mean how much of them is used up for consumption and investment in that country. That is, absorption means the sum of con­sumption and investment expenditure on domestically produced goods and services.

**Expressing algebraically we have;**

B = Y – A

**Where:**

B = trade balance or exportable surplus

Y = national income or value of output of goods and services produced

A = Absorption or sum of consumption and investment expenditure

It follows from above that if expenditure or absorption is less than national product, it will have positive trade balance or exportable surplus. To create this exportable surplus, expenditure on domestically produced consumer and investment goods should be reduced or national product must be raised sufficiently.

#### Method 4 : Exchange Control:

Finally, there is the method of exchange control. We know that deflation is dangerous; devalu­ation has a temporary effect and may provoke others also to devalue. Devaluation also hits the prestige of a country. These methods are, therefore, avoided and instead foreign exchange is controlled by the government.

Under it, all the exporters are ordered to surrender their foreign exchange to the central bank of a country and it is then rationed out among the licensed importers. None else is allowed to import goods without a licence. The balance of payments is thus rectified by keeping the imports within limits.

1. **Explain the international investment strategies in detail. (4)**

Ans**- International investment strategies**

International investing is the strategy of selecting globally-based investment instruments as part of an investment portfolio. International investing includes such investment vehicles as mutual funds, American Depository Receipts, exchange-traded funds (ETFs) or direct investments in foreign markets.

In finance, an investment strategy is a set of rules, behaviors or procedures, designed to guide an investor's selection of an investment portfolio. Individuals have different profit objectives, and their individual skills make different tactics and strategies appropriate.

Foreign Direct Investment

Foreign direct investment *(*FDI*)* is aninvestmentmade by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreigncompany.

**Advantages**

* Employment generation
* Quality of products and flow of technology
* Improvement of agricultural sector
* Increase in government revenue

**Disadvantages**

* Bad deal for the small entrepreneurs
* Trade Deficit
* Inflation
* Limited employment generation
* Impact on Farmers
* Corruption

Portfolio investment

A portfolio investment is an investment made by an investor who is not involved in the management of a company. This is in contrast to direct investment, which allows an investor to exercise a certain degree of managerial control over a company.

A portfolio investment is a hands-off or passive investment of securities in a portfolio, and it is made with the expectation of earning a return. This expected return is directly correlated with the investment's expected risk. Portfolio investment is distinct from direct investment, which involves taking a sizable stake in a target company and possibly being involved with its day-to-day management.

**Advantaged of Portfolio Investment:**

* Risk Diversification and Reduction
* Systematic Investment Approach
* Passive Investment Style
* Minimal Security Analysis

**Disadvantages of Portfolio Investment:**

### Too Complicated

### Market Risk

### Below Average Returns

### Indexing: If you have too many assets in your portfolio it essentially becomes an index fund

### Lack of Focus or Attention to Your Portfolio: If someone else is managing your portfolio you probably don’t pay as much attention to it.

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[Min. Passing Marks: 08]

Instructions to the Candidates:

Attempt any 4 questions from Section A and Section B is Compulsory.

**Section A**

1. **Describe the term “International Finance Management”. Discuss the evolution of IFM. (3)**

**Ans-** International Finance is an important part of financial economics. It mainly discusses the issues related with monetary interactions of at least two or more countries. International finance is concerned with subjects such as exchange rates of currencies, monetary systems of the world, foreign direct investment (FDI), and other important issues associated with international financial management.

**Evolution-**

**The Gold Standard**

Under the classical gold standard, from 1870 to 1914, the international monetary system was largely decentralized and market-based. There was minimal institutional support, apart from the joint commitment of the major economies to maintain the gold price of their currencies. Although the adjustment to external imbalances should, in theory, have been relatively smooth, in practice it was not problem-free. Surplus countries did not always abide by the conventions of the system and tried to frustrate the adjustment process by sterilizing gold inflows. Deficit countries found the adjustment even more difficult because of downward wage and price stickiness. Once the shocks were large and persistent enough, the consequences of forfeiting monetary independence and asymmetric adjustment ultimately undermined the system.

**Bretton Woods**

The Bretton Woods system of pegged, but adjustable, exchange rates was a direct response to the instability of the interwar period. Bretton Woods was very different from the gold standard: it was more administered than market-based; adjustment was coordinated through the International Monetary Fund (IMF); there were rules rather than conventions; [7](https://www.bankofcanada.ca/2009/11/evolution-international-monetary-system/#footnote-7) and capital controls were widespread.

**The Current Hybrid System**

After the breakdown of the Bretton Woods system, the international monetary system reverted to a more decentralized, market-based model. Major countries floated their exchange rates, made their currencies convertible, and gradually liberalized capital flows. In recent years, several major emerging markets adopted similar policies after experiencing the difficulties of managing pegged exchange rate regimes with increasingly open capital accounts. The move to more market-determined exchange rates has increased control of domestic monetary policy and inflation, accelerated the development of financial sectors, and, ultimately, boosted economic growth.

1. **Define Different exchange rate regimes. (3)**

**Ans- Different Exchange Rate Regimes.**

An exchange rate regime is how a nation manages its currency in the foreign exchange market. An exchange rate regime is closely related to that country's monetary policy. There are three basic types of exchange regimes: floating exchange, fixed exchange, and pegged float exchange.

An exchange rate regime is the system that a country’s monetary authority, -generally the central bank-, adopts to establish the exchange rate of its own currency against other currencies. Each country is free to adopt the exchange-rate regime that it considers optimal, and will do so using mostly monetary and sometimes even fiscal policies.

The distinction amongst these exchange rates regimes is generally just made between fixed and flexible exchange rate regimes.

**1. Fixed Exchange Rate Regime**

A fixed exchange rate, sometimes called a pegged exchange rate, is a type of exchange rate regime where a currency's value is fixed against either the value of another single currency, to a basket of other currencies, or to another measure of value, such as gold.

**Floating Exchange Rate Regime**

A **floating exchange rate** refers to changes in a [currency](http://www.investinganswers.com/node/120)'s value relative to another currency (or currencies).

Floating exchange ratesmean that currencies change in relative value all the time. For example, one U.S. dollar might buy one British Pound today, but it might only buy 0.95 British Pounds tomorrow. The value "floats."

1. **What do you understand by FDI and Portfolio Investment strategies? (3)**

**Ans- Foreign Direct Investment**

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**Advantaged of Portfolio Investment:**

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**Disadvantages of Portfolio Investment:**

### Too Complicated

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### Indexing: If you have too many assets in your portfolio it essentially becomes an index fund

### Lack of Focus or Attention to Your Portfolio: If someone else is managing your portfolio you probably don’t pay as much attention to it.

1. **Define IMF and Evolution of International Monetary system. (3)**

**Ans-** The **International Monetary Fund (IMF)** is the central institution embodying the international monetary system and promotes balanced expansion of world trade, reduced trade restrictions, stable exchange rates, minimal trade imbalances, avoidance of [currency](http://www.investinganswers.com/node/120) devaluations, and the [correction](http://www.investinganswers.com/node/2590) of balance-of-payment problems. The IMF's goal is to prevent and remedy international financial crises by encouraging countries to maintain sound economic policies. Because of its size, the IMF is also a forum for discussion of global economic policies.

**History of The Bretton Woods Era: 1944–1973 (Terms of IMF)**

British and American policy makers began to plan the post war **international monetary system** in the early 1940s. The objective was to create an order that combined the benefits of an integrated and relatively liberal international system with the freedom for governments to pursue domestic policies aimed at promoting full employment and social wellbeing. The principal architects of the new system, John Maynard Keynes and Harry Dexter White, created a plan which was endorsed by the 42 countries attending the 1944 [Bretton Woods conference](https://en.wikipedia.org/wiki/United_Nations_Monetary_and_Financial_Conference), formally known as the [United Nations](https://en.wikipedia.org/wiki/United_Nations) Monetary and Financial Conference. The plan involved nations agreeing to a system of fixed but adjustable exchange rates where the currencies were pegged against the dollar, with the dollar itself convertible into gold. So in effect this was a gold – dollar exchange standard. There were a number of improvements on the old gold standard. **Two international institutions, the** [**International Monetary Fund**](https://en.wikipedia.org/wiki/International_Monetary_Fund) **(IMF) and the** [**World Bank**](https://en.wikipedia.org/wiki/World_Bank) **were created**

1. **Briefly explain the recent trends and challenges of International finance. (3)**

# Ans- Challenges of International Financial Management

Financial management of a company is a complex process, involving its own methods and procedures. It is made even more complex because of the globalization taking place, which is making the world’s financial and commodity markets more and more integrated. The integration is both across countries as well as markets. Not only the markets, but even the companies are becoming international in their operations and approach.

Managers of international firms have to understand the environment in which they function if they are to achieve their objective in maximizing the value of their firms, or the rate of return from foreign operations. The environment consists of:

**1. The international financial system, which consists of two segments:** the official part represented by the accepted code of behavior by governments comprising the international monetary system, and the private part, which consists of international banks and other multinational financial institutions that participate in the international money and capital markets.

**2. The foreign exchange market**, which consists of multinational banks, foreign exchange dealers, and organized exchanges where currency futures are regularly traded.

**3**. **The foreign country’s environment**, consisting of such aspects as the political and socioeconomic systems, and people’s cultural values and aspirations. Understanding of the host country’s environment is crucial for successful operation and essential for the assessment of the political risk.

1. **How the country manages its currency value to stabilize the demand in international**

**market? (3)**

## Ans- Exchange Rate Mechanism

The use of mechanisms by a [central bank](http://www.investopedia.com/terms/c/centralbank.asp) to influence a home currency's exchange rate. An adjustment is specifically made if the [exchange rate](http://www.investopedia.com/terms/e/exchangerate.asp) is not pegged to another currency, meaning that the [currency](http://www.investopedia.com/terms/c/currency.asp) is valued according to a [floating exchange rate](http://www.investopedia.com/terms/f/floatingexchangerate.asp).

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### How ERMs Work?

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* Most developed countries have flexible ERMs, while emerging market economies tend to have fixed ERM policies to help provide stability.
* There are many different ways to influence exchange rates, including open market transactions, tariffs, quotas, interest rates, and monetary policy.

**Section B**

1. **Define the concept of BOP also explain the disequilibrium in BOPs. (4)**

**Ans-** **Concept:** Balance of Payments (BoP) Balance of Payments (BoP) is a statistical statement that systematically summarises, for a specific time period (typically a year or a quarter), the economic transactions of an economy with the rest of the world (i.e. between residents and non-residents). BoP surplus/deficit.

**Main Types of Disequilibrium in the Balance of Payments:**

### Cyclical Disequilibrium: Cyclical fluctuations cause disequilibrium in the balance of payments because of cyclical changes in income, employment, output and price variables.

### Structural Disequilibrium: It emerges on account of structural changes occurring in some sectors of the economy at home or abroad which may alter the demand or supply relations of exports or imports or both.

### Short-run Disequilibrium: A short-run disequilibrium in a country’s balance of payments will be a temporary one, ‘lasting for a short period, which may occur once in a while.

### Long-run Disequilibrium: The long-term disequilibrium thus refers to a deep- rooted, persistent deficit or surplus in the balance of payments of a country. It is secular disequilibrium emerging on account of the chronologically accumulated short-­term disequilibria — deficits or surpluses.

* Here we detail about the four methods adopted to correct disequilibrium in balance of payments.

1. **What do you understand by International financing sources? Explain the source of**

**International financing. (4)**

**Ans- International Financing**

International sources from where funds may be generated include: Commercial Banks: Globally, Commercial banks provide foreign currency loans for business purposes. They play a vital role in sourcing finance to non-trade international operations.

**Sources of International Financing:**

* **Commercial Banks**

Foreign currency loans can also procured from commercial banks having international operations. Besides, Indian commercial banks provide credit to exporters in the form of pre-shipment and post-shipment finances.

* **Development Banks & Financial Institutions**

The EXIM Bank of India provides a number of credit facilities to Indian businessmen and foreign importers. The all-India financial institutions are providing foreign currency financial assistance to Indian projects through various lines of credit already procured by them from international financial market. AIFIs are raising funds in the international financial market through issue of bonds to cater the needs of domestic projects.

* **International Agencies**

A number of international agencies have emerged to finance international trade and business, such as, IBRD, IDA, IFC, IMF ADB, etc. IBRD and IDA make loans for high priority projects in member countries to further their development plans. These are made usually to the governments or the entities enjoying credit of governments. The IMF provides temporary or emergency currency reserves to countries in balance of payments difficulties, just as a local commercial bank provides overdraft facility to the companies.