INTERNATIONAL FINANCIAL MANAGEMENT

MBA

by

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INTRODUINTRODUCTION TO INTERNATIONAL FINANCE MANAGEMENT (IFM)

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An Overview Of International Finance Management (IFM)

- To identify the main goal of the multi national company (MNC) and conflicts with the goal
- To describe the key theories that justify the international business; and
- To explain the common methods used to conduct international business
- Doing of trade and making money through the exchange of foreign currency.

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An Overview Of (IFM)-Definitions

International finance is defined as the set of relations for the creation and using of funds (assets), needed for foreign economic activity of international companies and countries.

Assets in the financial aspect are considered not just as money, but money as the capital, i.e. the value that brings added value (profit).

Capital is the movement, the constant change of forms in the cycle that passes through three stages:

- the monetary,
- the productive,
- the commodity.

Financial management is mainly concerned with

how to optimally make various corporate financial decisions relating to

- **Investment**
- **capital structure**
- **dividend policy and**
- **working capital management**

so as to achieving a set of given corporate objectives.

An Overview Of (IFM)

IFM is having a direct bearing on international trade

-**Movement of goods correspond to currency transaction**

-**International Trade is the backbone of IFM - Reasons for International Trade:**

- **Resource abundance**
- **Increased Population**
- **High technology – High Production**
- **New form of business**

Importance to IFM

Six aspects provide importance to IFM

1) Specialization of some goods and services
2) Opening of new economies
3) Globalization of firms
4) Emergence of new form of business
5) Growth of world trade
6) Development process of Nations

management of financial operations of different international activities of an organization.

DISTINGUISHING FEATURES OF INTERNATIONAL FINANCIAL MANAGEMENT:

a) Foreign exchange risk

Variability of exchange rates is widely regarded as the most serious international financial problem facing corporate managers and policy makers.

b) Political risk

It the risk of losing money due to changes that occurs in a country's government. Political actions and instability may make it difficult for companies to operate. Acts of war, terrorism, trade barriers and military coups are all extreme examples of political risk.

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c) Expanded opportunity sets

Firms can raise funds in capital markets where cost of capital is the lowest.

Firms can also gain from greater economies of scale when they operate on a global basis.

d) Market imperfections

There are profound differences among nations' laws, tax systems, business practices and general cultural environments.

At least one of the assumptions for perfect competition is violated and out of this is comes what we call an imperfect market

Nature of the financial Management

- **IFM is concerned with financial decisions taken in international business.**

- **IFM is an extension of corporate finance at international level.**

- **IFM set the standard for international tax planning and international accounting**

- **IFM includes management of exchange rate risk.**

SCOPE OF INTERNATIONAL FINANCIAL MANAGEMENT

- International Institutions
- Balance of Payments
- International Financial Markets
- FOREX Markets
- International financial services
- International Taxation & Accounting

INTERNATIONAL INSTITUTIONS

There are various global bodies regulating different aspects of international finance.

International Finance Corporation

Supporting sustainable investments in the private sector of developing countries; source of multilateral loans and equity financing for projects undertaken by the private sector in developing countries; technical assistance to businesses and governments of developing countries.

International Monetary Fund

monitors the balance of payments of its member countries; lender of last resort for countries facing a financial crisis.

World Bank

funds the development of projects, mainly in developing countries

World Trade Organization

Resolves Multilateral And Bilateral Trade Disputes; Negotiation Of Different Trade Agreements

products and services offered by institutions for the facilitation of various financial transactions and other related activities.

a) **Asset/fund based service**: funds are arranged and interest is charged (Leasing/financing, Venture capital, foreign exchange etc)

b) **Fee based financial services:** Advisory services for which bank charges fee and & renders service (Merchant banking Project advisory, Custodian services etc)

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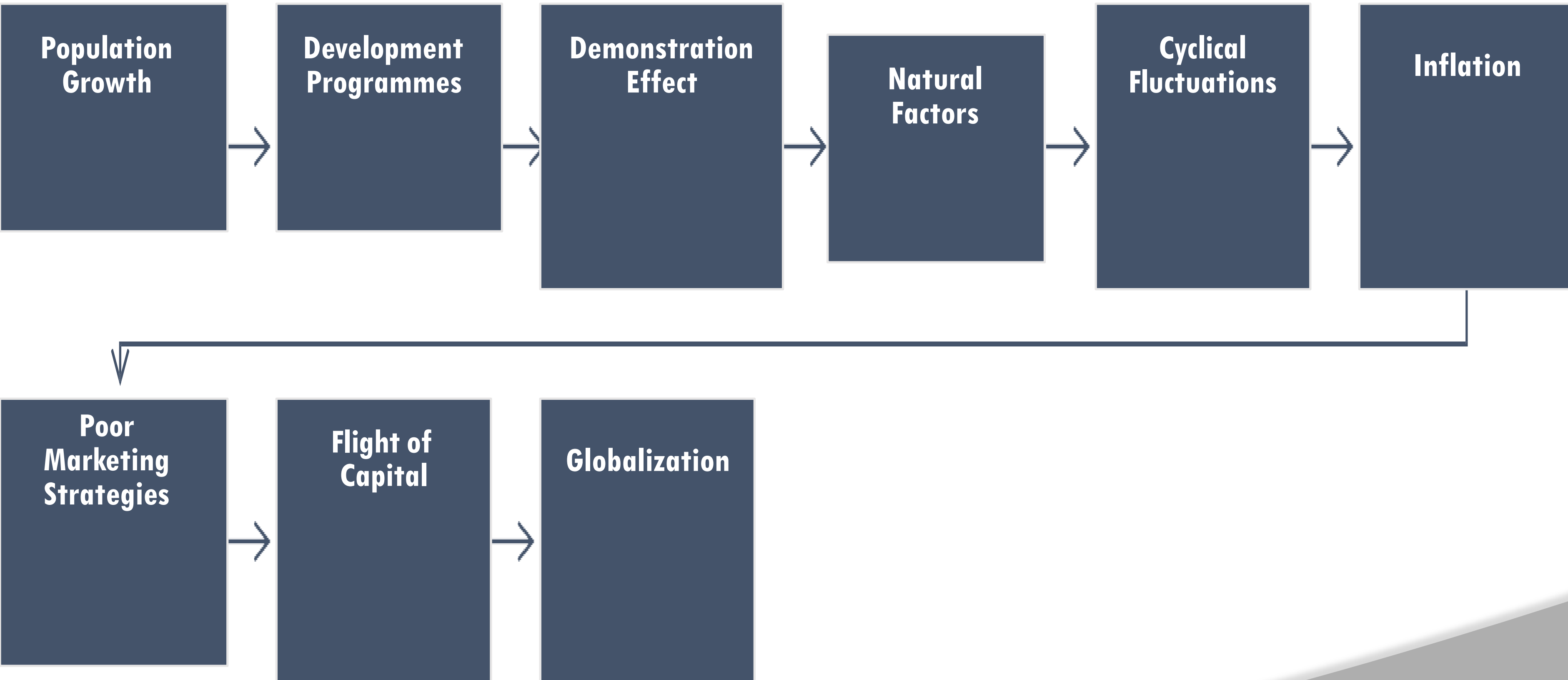
. **BALANCE OF PAYMENTS (Bop)**

Bop accounts are an accounting record of all monetary transactions between a country and the rest of the world.

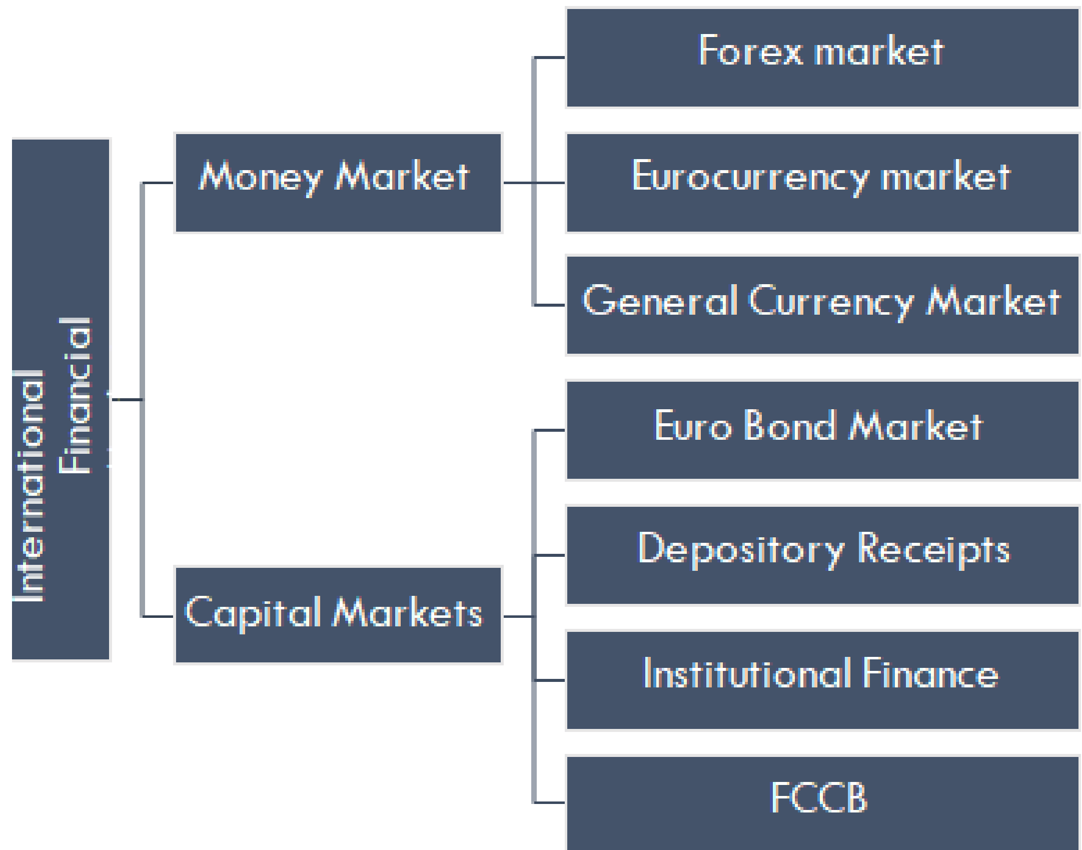
Credits (*Inflow of foreign exchange*)			**Debits** (*Outflow of foreign exchange*)		
Row(1)	Exports of goods (*Visible items*)	550	**Row(5)**	Imports of goods	800
Row(2)	Exports of services (*Invisibles*)	150	**Row(6)**	Imports of services	50
Row(3)	Unilateral transfers (*gifts, remittances, indemnities, etc. received from foreigners*)	100	**Row(7)**	Unilateral transfers (*gifts, indemnities, etc. paid to foreigners*)	80
Row(4)	Capital receipts (*borrowings from abroad, capital repayments by, or sale of assets to to foreigners*)	200	**Row(8)**	Capital payments (*lending to, capital repayments to, or purchase of assets from foreigners*)	70
	Total Receipts	**1,000**		**Total Payments**	**1,000**

Causes Of Disequilibrium In Balance Of Payment



INTERNATIONAL FINANCIAL MARKET

International financial market is a broad term describing any global marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives.



International Financial Management-Objectives

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Goals or objectives describe a particular result aimed to achieve with a prescribed time frame and with available resources.

Goals of Financial Management:

a) Profit Maximization b) Wealth Maximization

a) Profit Maximization: prime motto of any kind of business activity

Sales - Expenses = Profit

The term 'profit maximization' implies generation of huge amount of profits over

the time period, this includes both short-term and long-term.

b) Wealth Maximization: It is process of increasing shareholders wealth

Specialization of some goods and services

There are several theories of international business which favor international trade.

Relevant are discussed here under :

a) Theory of absolute advantage
b) Theory of comparative advantage
c) Factor proportion theory
d) New trade theory – High fixed costs – increase out put to achieve economies of scale and export

Theory of absolute advantage (Adam Smith)

If a country is capable of producing goods with lower amount of inputs compared to other countries – produce such goods and export surplus

- Import such goods if the country is not efficient to produce

Example:

USA :Export cotton, import wine

France : export wine – import cotton

- both get benefitted

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Comparative Advantage refers to the ability of a country to produce a particular good at a lower marginal cost/ opportunity cost over others

-Even if one country is absolute advantage in the production of all goods still gain by trading with others as long as they have relative advantage

-The country may not be the best at producing something. But the good or service has a low opportunity cost for other countries to import.

-A nation with a comparative advantage makes the trade-off worth it. The benefits of buying its good or service outweigh the disadvantages

Theory of comparative advantage

Example

Country	Cloth	wine
Britain	100	110
Portugal	90	80

Britain: Exports one unit of cloth against one unit of wine. Thus Britain got wine for 100 against 110 to be incurred

Portugal: Exports wine against for one unit of cloth. Thus Portugal got one unit of cloth for 80 against 90 to be incurred

Thus both the countries got benefitted in spite of Portugal having absolute advantage

Factor proportion theory (Huckster) -

- Export goods that require large amount of production factors that are abundantly available
- Import goods that require large amount of their scarce production factors
- It also emphasizes the import of goods that a nation cannot produce as efficiently.
- The equilibrium of trade between two countries that have varying specialties and natural resources.
- All countries benefit when they import the resources they naturally lack.

New trade theory

1.High fixed costs – Economies of scale

Industries with high fixed costs should produce more by specialization (learning curve)

Reap the benefit of economies scale(cost reduction)
Export surplus, exploit world market

New trade theorists relaxed the assumption of constant returns to scale, and some argue that using protectionist measures to build up a huge industrial base in certain industries will then allow those sectors to dominate the world market.

2.Opening of new economies

2) Opening of new economies & 3) Globalization of firms

Developing countries globalize due to economic pressure being generated by deficient resources

- in these countries always there is gap between savings and investments (exports and imports)

- Acute BOP problems prompt the countries to promote exports.

3) Globalization of firms `

- Trade occurs between nations through firms
- Exports and FDIs are the means of international trade

Why the firms globalize?

a) Theory of competitive advantage
b) Theory of imperfect markets
c) Product life cycle theory

Transfer Pricing:

A *transfer price* is the price one sub-unit charges for a product or service supplied to another sub-unit of the same organization.

It's the value placed on a transfer of goods and the services in transactions in which at least one of the two parties involved is a profit center (Anthony &Govindarajan)

General Definition :-

"It is the amount used in accounting or any transfer of goods and services centers in an organization."

Objectives of Transfer Pricing

- ✓ It should provide each Business Unit with relevant information so that Trade-off between company cost and revenue,
- ✓ Decision that improve business unit profit will improve company profit so It should induce Goal Congruence decision,
- ✓ Measure the economic performance of business unit
- ✓ Simple to understand, easy to administer

Approaches for Transfer pricing

There are four approaches to transfer pricing:

A.Market-Based : Market price refers to a price in an intermediate market between independent buyers and sellers.

B.**Cost-Based** : When external markets do not exist or are not available to the company or when information about external market prices is not readily available, companies may decide to use some forms of cost-based transfer pricing system.

C.Negotiated : Negotiated prices are generally preferred as a middle solution between market prices and cost- based prices. Negotiation strategies may be similar to those employed when trading with outside markets.

D.Administered : Selling division sells the transferred goods at a (i) market or negotiated market price or (ii) cost plus some profit margin.

Objective's of TP in views of MNCs :

1. Competitiveness in the international market place,
2. Reduction of taxes and tariffs,
3. Management of cash flows,
4. Minimization of foreign exchange risks
5. Avoidance of conflicts with home and host Governments over tax issues and repatriation of profits,
6. Internal Concerns – goal congruence or subsidiary manager motivation.

Transfer Pricing-Benefits to MNCs

- Lowering duty costs by shipping goods into high- tariff countries at minimal transfer prices so that duty base and duty are low.

- Reducing income taxes in high-tax countries by overpricing goods transferred to units in such countries; profits are eliminated and shifted to low- tax countries.

- Facilitating dividend repatriation when dividend repatriation is curtailed by government policy by inflating prices of goods transferred

Differences b/w IFM and traditional/domestic FM

International finance is different from domestic finance in many aspects and first and the most significant of them is foreign currency exposure. There are other aspects such as the different political, cultural, legal, economical, and taxation environment. International financial management involves a lot of currency derivatives whereas such derivatives are very less used in domestic financial management.

In domestic financial management, we aim at minimizing the cost of capital while raising funds and try optimizing the returns from investments to create wealth for shareholders. We do not do any different in international finance. So, the objective of financial management remains same for both domestic and international finance i.e. wealth maximization of shareholders. Still, the analytics of international finance is different from domestic finance.

Foreign Exchange Risk

It's an additional risk which a finance manager is required to cater to under an International Financial Management setting. Foreign exchange risk refers to the risk of fluctuating prices of currency which has the potential to convert a profitable deal into a loss making one.

DFM In domestic financial management the finance manager is required to deal in domestic currency only, there is no need to deal with foreign exchange, so there is no currency exchange risk.

Differences b/w IFM and traditional/domestic FM

Exposure to foreign exchange

IFM :The most significant difference is of foreign currency exposure. Currency exposure impacts almost all the areas of an international business starting from your purchase from suppliers, selling to customers, investing in plant and machinery, fund raising etc. Wherever you need money, currency exposure will come into play and as we know it well that there is no business transaction without money.

DFM In domestic financial management exposure to a single currency of particular country. Entire business transaction takes place in single currency.

Usage of derivatives

IFM :

In international financial management we use derivatives instrument to hedge the risk

Many of them employ these contracts to hedge exchange rate, interest rate (in order to lower the borrowing cost) and commodity price risk.

DFM:

In domestic financial management we do not use derivatives because there is less risk.

Recent changes in IFM

International financial markets have undergone rapid and extensive changes in the recent past

Witnessed dramatic events in global financial markets, including the Asian crisis, the Russian crisis, and the near-collapse of Long Term Capital Management (LTCM), in 2008, in US and other European countries which was a highly leveraged hedge fund with enormous trading positions

Could see remarkable developments in stock prices around the world, and in particular in stocks in the telecommunications and internet sectors. Many of these so-called "tech. stocks", which experienced sharp price increases in late 1999 and early 2000

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Recent changes in global financial markets

- Vast and unprecedented changes are taking place
- After 1980's the pace of change has become too fast
- This period saw emergence of new financial instruments, securities, methods of settlement and persons involved in the market
- Development of information and communication technology furthered the change process

Recent changes in IFM (cont…)

Emergence of Euro market in 1960's the major cause for development and growth of IFM

- **A series of parallel money markets free from regulations**
- **led to internationalization of banking business and**
- **emergence of innovative funding techniques and securities**

Introduction of Floating Exchange Rate

- Introduced in 1973, another important change, which resulted in volatility
- This increased risk in exchange rates to both borrowers and lenders
- To manage risk new institutions and products emerged like futures, swaps, options etc.
- Reduction in the traditional income of banks like interest, commission brokerage etc. compelled them to introduce new products and services, which often the banks themselves cannot understood

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Integration among the different financial markets

Another remarkable change taken place in 1980's is the integration among the different financial markets in different countries

Integration resulted in

- **Reducing the gap between local, regional, national and offshore financial markets led to the creation of a unified, globalised financial markets**
- **Increasing the rate of growth of financial systems than that of production**

Recent changes in IFM (cont…)

- Establishment of branches of banks and financial institutions of developed and industrial countries in other countries
- Establishment of branch banks in different countries and permission to tap the national financial markets
- Integration among the financial markets of industrialized countries like US, Japan and Europe
- Resulted in reducing the gap between the financial markets of different advanced countries

Functional unification

- Different kinds of financial institutions to serve different kinds of financial services – specialized institutions for specific services
- Financial institutions were divided as commercial banks, investment banks, EXIM banks etc.
- Recently these functional specialization became unimportant and at present "everybody does everything"
- Financial institutions started to render wide range of services instead of specializing one or two tasks – from commercial banking to merchant banking
- Thus recently, there is a spatial and functional integration

Recent changes in IFM (contd…)

Major reasons for these changes are :-

I. Liberalization in cross boarder financial transaction

II. Deregulation within the financial system of the major industrialized nations

Major liberalization steps include:-

- Lifting exchange controls in UK, France and Japan (other nations like US, Germany, Switzerland etc, which were already liberalized)
- Removal of tax on interest paid for non-resident
- Opening up of domestic financial markets to foreign borrowers
- Allowing domestic borrowers to borrow from foreign markets

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Emergence and development derivative markets

- Another interesting development
- Rapid advances in technology, financial engineering, and risk management – major reasons
- These helped to enhance both the supply of and the demand for more complex and sophisticated derivatives products
- Increased use of derivatives to adjust exposure to risk in financial markets has also contributed to the rise in speculation in securities
- The leveraged nature of derivative instruments increased risks to individual investors
- derivatives also provide scope for a more efficient allocation of risks in the economy, which is beneficial for the functioning of financial markets, and hence enhances the conditions for economic growth.

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Launch of Euro

- Euro launched in 1st January 1999. Was a historic event.
- 11 national currencies were converted into one single currency overnight
- Marked the start of a period of profound change in Europe's financial settings
- The successful launch of the euro, resulted in the creation of a stable, prosperous and peaceful Europe, and boosted the integration of financial markets in the euro area
- This process of integration in European financial markets coincided with the trend towards globalization
- However, at present, there conflicts in the euro zone and UK is trying to come out from the Union

Recent Challenges of IFM

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- Financial management of a company is a complex process, involving its own methods and procedures. It is 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.
- the multiplicity and complexity of the taxation systems, which impact the MNC's operations and profitability.
- financing function is another challenge, due to the multiplicity of sources of funds or avenues of investment available-foreign exchange and political risks in positioning funds and in mobilizing cash resources.

INTERNATIONAL FLOW OF FUNDS

Definition :

Balance of payments accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, financial capital, and financial transfers.

BALANCE OF PAYMENTS

- The *balance of payments* is a measurement of all transactions between domestic and foreign residents over a specified period of time.
- Each transaction is recorded as both a credit and a debit, i.e. *double-entry bookkeeping*.
- The transactions are presented in three groups – a *current account*, a *capital account*, and a *financial account*.
- The current account is commonly used to assess the *balance of trade*, which is simply the difference between merchandise exports and merchandise imports.

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- *current account* summarizes the flow of funds between one specified country and all other countries due to the purchases of goods or services, the provision of income on financial assets, or unilateral current transfers
  (e.g. government grants and pensions, private remittances).
- A current account *deficit* suggests a greater outflow of funds from the specified country for its *current* transactions.

BALANCE OF PAYMENTS

- The new *capital account* (as defined in the*1993 System of National Accounts* and the fifth edition of IMF's *Balance of Payments Manual*) is adopted by the U.S. in 1999.
- It includes unilateral current transfers that are really shifts in assets, not current income. E.g. debt forgiveness, transfers by immigrants, the sale or purchase of rights to natural resources or patents.

BALANCE OF PAYMENTS

- **The *financial account* (which was called the capital account previously) summarizes the flow of funds resulting from the sale of assets between one specified country and all other countries.**
- **Assets include official reserves, other government assets, direct foreign investments, investments in securities, etc.**

INTERNATIONAL TRADE FLOWS

With U.S. Exports and imports of goods valued at $773.3 and $1,222.8 billions respectively for the year of 2000.

- Since 1976, the value of U.S. Imports has exceeded the value of U.S. Exports, causing a balance of trade deficit.
- In 1975, the U.S. Exported $107.1 billions in goods, and imported $98.2 billions. Since then, international trade has grown,

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- **Recent Changes in North American Trade**

¤ In 1998, a 1989 free trade pact between U.S. and Canada was fully phased in.

¤ Passed in 1993, the North American Free Trade Agreement (NAFTA) removes numerous trade restrictions among Canada, Mexico, and the U.S.

¤ In 2001, trade negotiations were initiated for a free trade area of the Americas. 34 countries are involved.

- **Recent changes in European trade**

¤ The single European act of 1987 was implemented to remove explicit and implicit trade barriers among European countries.

¤ Consumers in eastern Europe now have more freedom to purchase imported goods.

¤ The single currency system implemented in 1999 eliminated the need to convert currencies among participating countries.

- **Trade Agreements Around the World**
- In 1993, a General Agreement on Tariffs and Trade (GATT) accord calling for lower tariffs was made among 117 countries.
- **Other trade agreements include:**
  - Association of Southeast Asian Nations
  - European Community
  - Central American Common Market
  - North American Free Trade Agreement

- **Friction Surrounding Trade Agreements**

¤ Trade agreements are sometimes broken when one country is harmed by another country's actions.

¤ *Dumping* refers to the exporting of products by one country to other countries at prices below cost.

¤ Another situation that can break a trade agreement is *copyright piracy*.

Factors Affecting International Trade Flows

- **Inflation**

¤ A relative increase in a country's inflation rate will decrease its current account, as imports increase and exports decrease.

- **National Income**

¤ A relative increase in a country's income level will decrease its current account, as imports increase.

Factors Affecting International Trade Flows

- **Government Restrictions**

- A government may reduce its country's imports by imposing tariffs on imported goods, or by enforcing a quota. Note that other countries may retaliate by imposing their own trade restrictions.

- Sometimes though, trade restrictions may be imposed on certain products for health and safety reasons.

Factors Affecting International Trade Flows

- **Exchange Rates**
  If a country's currency begins to rise in value, its current account balance will decrease as imports increase and exports decrease.
- Note that the factors are interactive, such that their simultaneous influence on the balance of trade is a complex one.

Correcting: A Balance of Trade Deficit

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- By reconsidering the factors that affect the balance of trade, some common correction methods can be developed.
- For example, a floating exchange rate system may correct a trade imbalance automatically since the trade imbalance will affect the demand and supply of the currencies involved.

Correcting a balance of trade deficit

- **A weak home currency may not necessarily improve a trade deficit.**

¤ Foreign companies may lower their prices to maintain their competitiveness.

¤ Some other currencies may weaken too.

¤ Many trade transactions are prearranged and cannot be adjusted immediately. This is known as the *J-curve effect*.

¤ The impact of exchange rate movements on *intracompany trade* is limited

International Capital Flows

- Capital flows usually represent portfolio investment or direct foreign investment.
- The DFI positions inside and outside the U.S. have risen substantially over time, indicating increasing globalization.
- In particular, both DFI positions increased during periods of strong economic growth.

Factors Affecting DFI

- **Changes in Restrictions**

¤ New opportunities may arise from the removal of government barriers.

- **Privatization**

¤ DFI has also been stimulated by the selling of government operations.

- **Potential Economic Growth**

¤ Countries with higher potential economic growth are more likely to attract DFI.

Factors Affecting DFI

- **Tax Rates**

¤ Countries that impose relatively low tax rates on corporate earnings are more likely to attract DFI.

- **Exchange Rates**

¤ Firms will typically prefer to invest their funds in a country when that country's currency is expected to strengthen.

Factors Affecting International Portfolio Investment

- **Tax Rates on Interest or Dividends**
  - ¤ Investors will normally prefer countries where the tax rates are relatively low.
- **Interest Rates**
  - ¤ Money tends to flow to countries with high interest rates.
- **Exchange Rates**
  - ¤ Foreign investors may be attracted if the local currency is expected to strengthen.

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International Monetary Fund (IMF)

•The IMF is an organization of 183 member countries. Established in 1946, it aims

¤ to promote international monetary cooperation and exchange stability;

¤ to foster economic growth and high levels of employment; and

¤ to provide temporary financial assistance to help ease imbalances of payments.

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)*.

Agencies that Facilitate International Flows

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World Bank Group

- 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.
- Its MAIN SOURCES of funds is the sale of bonds and other debt instruments to private investors and governments.
- A key aspect of world bank mission is the structural adjustment loan (SAL) established in 1980

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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.

Agencies that Facilitate International Flows

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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.

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.

M IGA: 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.

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.**

Agencies that Facilitate International Flows

World Trade Organization (WTO)

- 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

Bank for International Settlements (BIS)

- 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."

Bank for International Settlements (BIS)

- **The BIS functions as:**
- a forum for international monetary and financial cooperation;
- a bank for central banks;
- a center for monetary and economic research; and
- an agent or trustee in connection with international financial operations.

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Regional Development Agencies

- Agencies with more regional objectives relating to economic development include

¤ the Inter-American Development Bank;

¤ the Asian Development Bank;

¤ the African Development Bank; and

¤ the European Bank for Reconstruction and Development.

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Monetary System Before First World War: (1880-1914 Era of Gold Standard)

The oldest system of exchange rate was known as "Gold Species Standard" in which actual currency contained a fixed content of gold.

basis of money remained fixed gold but the authorities were ready to convert, at a fixed rate, the paper currency issued by them into paper currency of another country which is operating in Gold.

The exchange rate between pair of two currencies was determined by respective exchange rates against 'Gold' which was called 'Mint Parity

Monetary System (1880-1914 Era of Gold Standard)

Three rules were followed with respect to this conversion :

- The authorities must fix some once-for-all conversion rate of paper money issued by them into gold.
- There must be free flow of Gold between countries on Gold Standard.
- The money supply should be tied with the amount of Gold reserves kept by authorities.

The gold standard was very rigid and during 'great depression' (1929-32) it vanished completely.

The Bretton Woods Era (1946 to 1971)

- To streamline and revamp the war ravaged world economy & monetary system, allied powers held a conference in 'Bretton Woods', which gave birth to two super institutions - IMF and the WB.
- In Bretton Woods modified form of Gold Exchange Standard was set up with the following characteristics :

•One US dollar conversion rate was fixed by the USA as one dollar = 35 ounce of Gold

•Other members agreed to fix the parities of their currencies vis-àvis dollar with respect to permissible central parity with one per cent (± 1%) fluctuation on either side.

Flexible exchange rate regime

The flexible exchange rate regime that replaced the Bretton Woods system was ratified by the Jamaica Agreement.

Flexible exchange rates can be defined as exchange rates determined by global supply and demand of currency.

they are prices of foreign exchange determined by the market, that can rapidly change due to supply and demand, and are not pegged nor controlled by central banks.

The opposite scenario, where central banks intervene in the market with purchases and sales of foreign and domestic currency in order to keep the exchange rate within limits, also known as bands, is called **fixed exchange rate**.

Flexible exchange rate regime

There are two types of flexible exchange rates:

1. pure floating regimes and
2. managed floating regimes.

pure floating regimes exist when, in a flexible exchange rate regime, there are absolutely no official purchases or sales of currency.

managed (also called dirty) floating regimes, are those flexible exchange rate regimes where at least some official intervention happens.

Evaluation of floating rates

This system would reduce Economic volatility and

facilitates free trade Floating rates offset the differences in inflation rates so that other elements such as :

wages

Employment

output.

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IMF (International Monetary Fund) categories different exchange rate mechanism as follows:

Exchange arrangement with no separate legal tender

The members of a currency union share a common currency. Economic and Monetary Unit (EMU) who have adopted common currency and countries which have adopted currency of other country. As of 1999, 37 IMF member countries had this sort of exchange rate regime.

Currency Board Agreement

In this regime, there is a legislative commitment to exchange domestic currency against a specified currency at a fixed rate. As of 1999, eight members had adopted this regime.

Evaluation of floating rates

Conventional fixed peg arrangement

equivalent to Bretton Woods in the sense that a country pegs its currency to another, or to a basket of currencies with a band variation not exceeding ± 1% around the central parity.

Pegged Exchange Rates Within Horizontal Bands

the variation around a central parity is permitted within a wider band. It is a middle way between a fixed peg and floating peg.

Crawling Peg

A currency is pegged to another currency or a basket of currencies but the peg is adjusted periodically which may be pre-announced or discretion based or well specified criterion.

Evaluation of floating rates

Crawling bands

The currency is maintained within a certain margins around a central parity which 'crawls' in response to certain indicators.

Managed float

In this regime, central bank interferes in the foreign exchange market by buying and selling foreign currencies against home currencies without any commitment or pronouncement.

Independently floating

Here exchange rate is determined by market forces and central bank only act as a catalyst to prevent excessive supply of foreign exchange and not to drive it to a particular level. Including India, in 1999, forty eight countries had this regime.

Economic And Monetary Union

- **It involves the coordination of economic and fiscal policies, a common monetary policy, and a common currency, the euro.**

- **The European Monetary System (EMS) was the pioneer of Economic and Monetary Union(EMU), which led to the establishment of the Euro.**

- **an area of currency stability throughout the European Community by encouraging countries to co-ordinate their monetary policies.**

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Stage One Of EMU

- Complete freedom for capital transactions
- Increased co-operation between central banks
- Free use of the ECU (European Currency Unit)
- Improvement of economic convergence

Second Stage Of EMU

- Establishment of the European Monetary Institute' (EMI)
- Ban on the granting of central bank credit
- Increased co-ordination of monetary policies
- Strengthening of economic convergence
- Process leading to the independence of the national central banks to be completed at the latest by the date of establishment of the European System of Central Banks;

Foreign Exchange Market

Foreign Exchange Market

- Foreign exchange market is the market in which foreign currencies are bought and sold.
- The buyers and sellers include individuals, firms, foreign exchange brokers, commercial banks and the central bank.
- The transactions in this market are not confined to only one or few foreign currencies.
- The foreign exchange market assists international trade and investment by enabling currency conversion.
- The foreign exchange market (forex, FX, or currency market) is a form of exchange for the global decentralized trading of international currencies.

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Characteristics of foreign exchange market

1. Electronic market
2. Geographical Dispersal
3. Transfer of purchasing power
4. Intermediary Volume
5. Provision of credit
6. Minimizing Risk.

Foreign Exchange Market-Functions

Foreign exchange market performs the following three functions

Transfer Function

In performing the transfer function, the foreign exchange market carries out payments internationally by clearing debts in both directions simultaneously, analogous to domestic clearings.

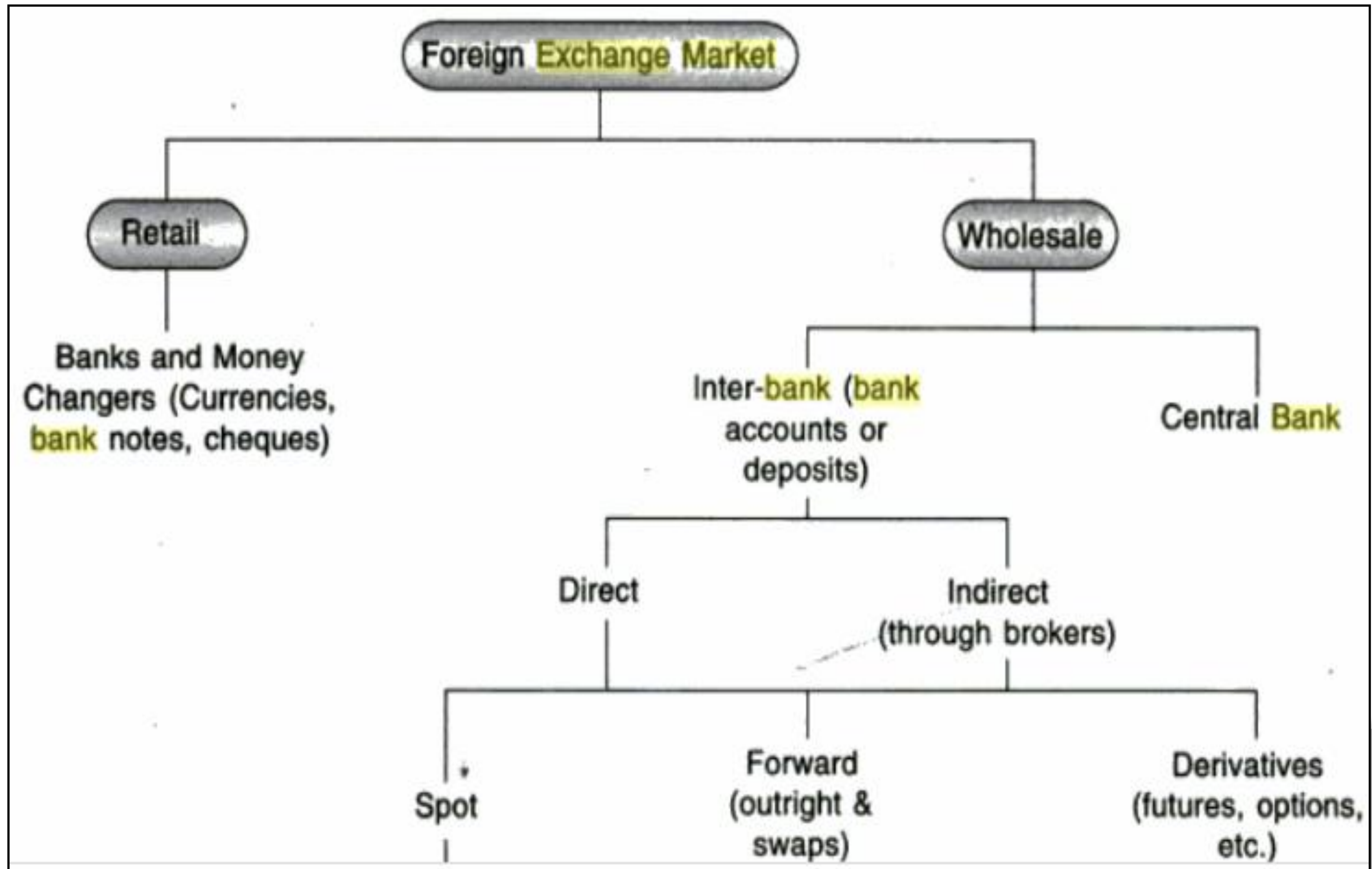
Credit Function

It provides credit for foreign trade. Bills of exchange, with maturity period of three months, are generally used for international payments. Credit is required for this period in order to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.

Hedging Function

A third function of the foreign exchange market is to hedge foreign exchange risks. Hedging means the avoidance of a foreign exchange risk.

Structure of the Foreign Exchange Market



Market participates of foreign exchange Market

The Market Participants are

Commercial Bank

- a type of financial institution and intermediary
- bank that lends money and provides transactional, savings, and money market accounts
- accepts time deposit in order to facilitate international trade and development, commercial banks convert and trade foreign currencies.

Central bank

- play an important role in the foreign exchange markets.
- try to control the money supply, inflation, and/or interest rates and often have official or unofficial target rates for their currencies.

Market participates of foreign exchange Market

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The Market Participants are (contd…)

Foreign exchange fixing

- Foreign exchange fixing is the daily monetary exchange rate fixed by the national bank of each country.
- The idea is that central banks use the fixing time and exchange rate to evaluate behavior of their currency.
- Fixing exchange rates reflects the real value of equilibrium in the market.

Hedge funds as speculators

- About 70% to 90% of the foreign exchange transactions are speculative.
- Hedge funds have gained a reputation for aggressive currency speculation since 1996.

Market participates of foreign exchange Market

The Market Participants are (contd…)

Hedge funds as speculators

- About 70% to 90% of the foreign exchange transactions are speculative.
- Hedge funds have gained a reputation for aggressive currency speculation since 1996. They control billions of dollars of equity and may borrow billions more,
- overwhelm intervention by central banks to support almost any currency, if the economic fundamentals are in the hedge funds' favor.

Market participates of foreign exchange Market

The Market Participants are (contd…)

Investment management firms

- Investment management is the professional management of various securities (shares, bonds and other securities) and assets (e.g., real estate) in order to meet specified investment goals for the benefit of the investors.
- These firms (who typically manage large accounts on behalf of customers such as pension funds and endowments) use the foreign exchange market to facilitate transactions in foreign securities.

Market participates of foreign exchange Market

The Market Participants are (contd…)

Retail foreign exchange traders

•One of the most important tools required to perform a foreign exchange transaction is the trading platform providing retail traders and brokers with accurate currency quotes.

•Retail foreign exchange trading is a small segment of the large foreign exchange market.

•Retail foreign exchange dealers are required to become members of the National Futures Association (NFA), in order to conduct business with the public.

•Types of transactions & settlements in FOREX Market

Types of transactions & settlements in FOREX Market

- Transactions refers to the sale and purchase of foreign currencies.
- Spot Market: The term spot exchange refers to the class of foreign exchange transaction which requires the immediate delivery or exchange of currencies on the spot. ...
- Forward Market: ...
- Futures. ...
- Options. ...
- Swap operation. ...
- Arbitrage.

- The Foreign Exchange Transactions refers to the sale and purchase of foreign currencies.
- is an agreement of exchange of currencies of one country for another at an agreed exchange rate on a definite date.

Spot Transaction

- the buyer and seller of different currencies settle their payments within the two days of the deal.
- the fastest way to exchange the currencies.
- currencies are exchanged over a two-day period, which means no contract is signed between the countries.

The exchange rate at which the currencies are exchanged is called the Spot Exchange Rate. The market in which the spot sale and purchase of currencies is facilitated is called as a Spot Market.

Forward Transaction

A forward transaction is a future transaction where the buyer and seller enter into an agreement of sale and purchase of currency after 90 days of the deal at a fixed exchange rate on a definite date in the future.

The rate at which the currency is exchanged is called a Forward Exchange Rate.

The market in which the deals for the sale and purchase of currency at some future date is made is called a Forward Market.

Future Transaction:

The future transactions are also the forward transactions and deals with the contracts in the same manner as that of normal forward transactions.

Swap Transactions:

The Swap Transactions involve a simultaneous borrowing and lending of two different currencies between two investors. Here one investor borrows the currency and lends another currency to the second investor.

The swap contracts allow the investors to utilize the funds in the currency held by him/her to pay off the obligations denominated in a different currency without suffering a foreign exchange risk.

Exchange rate quotations

Exchange rate quotations can be quoted in two ways

- Direct quotation and
- Indirect quotation.

Direct quotation is when the one unit of foreign currency is expressed in terms of domestic currency.

Indirect quotation is when one unit of domestic currency us expressed in terms of foreign currency.

Exchange-traded derivative

Exchange-traded derivative contract are standardized derivative contracts such as futures and options. Contracts that are transacted on an organized futures exchange.

Over The Counter derivatives

Over the Counter (OTC) derivatives are traded between two parties (bilateral negotiation) without going through an exchange or any other intermediaries.

OTC is the term used to refer stocks that trade via dealer network and not any centralized exchange. These are also known as unlisted stocks where the securities are traded by broker-dealers through direct negotiations.

Options

currency option (also known as a forex option) is a contract that gives the buyer the right, but not the obligation, to buy or sell a certain currency at a specified exchange rate on or before a specified date. For this right, a premium is paid to the seller.

Call options provide the holder the right (but not the obligation) to purchase an underlying asset at a specified price (the strike price), for a certain period of time.

If the stock fails to meet the strike price before the expiration date, the option expires and becomes worthless.

Put Options give the holder the right to sell an underlying asset at a specified price (the strike price). The seller (or writer) of the put option is obligated to buy the stock at the strike price. Put options can be exercised at any time before the option expires.

American option is a version of an options contract that allows holders to exercise the option rights at any time before and including the day of expiration.

European Option is a version of an options contract that limits execution to its expiration date.

Asian option/average price option is an option whose payoff is determined with respect to the (arithmetic or geometric) average price of the underlying asset over the term of the option.

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Swaps

Interest Rate Swaps

In an interest rate swap, the parties exchange cash flows based on a notional principal amount (this amount is not actually exchanged) in order to hedge against interest rate risk.

Commodity Swaps

These_involve the exchange of a floating commodity price

Currency Swaps

the parties exchange interest and principal payments on debt denominated in different currencies.

Debt-Equity Swaps

This involves the exchange of debt for equity – in the case of a publicly-traded company, this would mean bonds for stocks. It is a way for companies to refinance their debt or reallocate their capital structure

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Total Return Swaps

The total return from an asset is exchanged for a fixed interest rate. This gives the party paying the fixed-rate exposure to the underlying asset – a stock or an index.

Credit Default Swap (CDS)

It consists of an agreement by one party to pay the lost principal and interest of a loan to the CDS buyer if a borrower defaults on a loan.

Features of Futures Contracts-Foreign Exchange

There are six major features of futures contracts.

1. Organized Exchanges
2. Standardization
3. Clearing House
4. Margins
5. Marking to Market
6. Actual Delivery is Rare

Forward Contract Vs Future Contract

COMPARISON	FORWARD CONTRACT	FUTURES CONTRACT
Meaning	an agreement between parties to buy and sell the underlying asset at a specified date and agreed rate in future.	parties agree to exchange the asset for cash at a fixed price and at a future specified date
What is it?	It is a tailor made contract.	It is a standardized contract.
Traded on	Over the counter, i.e. there is no secondary market.	Organized stock exchange.
Settlement	On maturity date.	On a daily basis.
Risk	High	Low
Default	As they are private agreement, the chances of default are relatively high.	No such probability.
Size of contract	Depends on the contract terms.	Fixed
Collateral	Not required	Initial margin required.
Maturity	As per the terms of contract.	Predetermined date

i) The International Money Market

- The international money market is a market where international currency transactions between numerous central banks of countries are carried on and are mainly carried out using gold or in US dollar as a base.
- The basic operations of the international money market include the money borrowed or lent by the governments or the large financial institutions.

Functions of Money Market

- a balancing tool for equating the demand for and supply of short term funds.
- a centre for the intervention of central bank, for controlling liquidity and general interest rate level.

Over view of the other markets

ii) Euro currency market

- It is an International Market and it is under no National Control:
- It is a Short-Term Money Market
- The Eurodollar Loans are Generally for Short Periods

iii)Euro credit market

Euro credit helps the flow of capital between countries and the financing of investments at home and abroad. A major function of banks is matching surplus units (who deposit at the bank) with deficit units (who borrow from the bank).

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iv) Euro bond market

A Eurobond is debt instrument that's denominated in a currency other than the home currency of the country or market in which it is issued.

The characteristics of euro bonds are

Straight bonds: the fixed interest rate at periodic intervals, usually annually.

Floating-rate notes (FRNs): rollover pricing payment usually six months interest stated in terms of a spread over some reference rate.

Zero-coupon bonds: discount securities, sold either at a fraction of face value and redeemed at face value, or sold at face value and redeemed at a premium.

Convertible bonds: can exchange for some other type of asset: stock, gold, oil, other bonds.

Mortgage-backed Eurobonds: backed by a pool of mortgages, or other bonds Institutions which would otherwise exclude from Eurobond market can get access.

Dual-currency bonds: purchased in one currency, coupon or principal paid in a second currency.

v) International stock market

The stock market refers to the collection of markets and exchanges where regular activities of buying, selling, and issuance of shares of publicly-held companies take place which operate under a defined set of regulations.

Over view of the other markets

Functions Of A Stock Market:

Fair Dealing in Securities Transactions

Efficient Price Discovery

Liquidity Maintenance

Security and Validity of Transactions

Support All Eligible Types of Participants

Investor Protection

Balanced Regulation

Regulating the Stock Market

Significance of the Stock Market

It allows companies to raise money by offering stock shares and corporate bonds.

lets common investors participate in the financial achievements of the companies, make profits through capital gains and earn money through dividends, although losses are also possible.

The stock market works as a platform through which savings and investments of individuals are channelized into the productive investment proposals.

In the long term, it helps in capital formation & economic growth for the country.

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EXCHANGE RATES

- **Gold standard**
- **The Bretton Woods Era (1946 to 1971) (given in the previous module)**
- **Purchasing Power parity**
- According to the Purchasing Power Parity theory, the exchange rate is nothing but the ratio of prices between two countries.
- The monetary theory states that there is a direct connection between relative changes in money supply in two countries and the exchange rate between both countries, provided there are no transportation costs in moving goods between both countries.
- **Floating rate system**

When governments allow the exchange rate to be determined by market forces and there is no attempt to influence the exchange rate.

Factors influencing Exchange rates

Foreign Exchange rate (Forex rate) is one of the most important means through which a country's relative level of economic health is determined. A country's foreign exchange rate provides a window to its economic stability, which is why it is constantly watched and analyzed. While sending or receiving money internationally, it is important to understand what determines exchange rates.

- Inflation Rates & Interest Rates
- Country's Current Account / Balance of Payments
- Government Debt & Terms of Trade
- Political Stability & Performance
- Recession & Speculation

Government influence on exchange rates

- The Foreign Exchange Regulation Act (FERA), 1973 was replaced by the market friendly Foreign Exchange Management Act (FEMA), 1999.
- The Reserve Bank delegated powers to authorized dealers (ADs) to release foreign exchange for a variety of purposes
- Clearing Corporation of India Limited (CCIL) was set up in 2001.
- Technical Advisory Committee (TAC) on Money and Securities Markets set up by the Reserve Bank in 1999 was expanded in 2004 to include foreign exchange markets
- Additional hedging instruments such as foreign currency-rupee options, cross-currency options, interest rate swaps (IRS) and currency swaps, caps/ collars and forward rate agreements (FRAs) were introduced.

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Liberalization Measures

Authorized dealers were permitted to initiate trading positions, borrow and invest in overseas market.

Banks were also permitted to

(i) fix net overnight position limits and gap limits (with the Reserve Bank formally approving the limits);

(ii) determine the interest rates (subject to a ceiling) and maturity period of FCNR(B) deposits with exemption of inter-bank borrowings from statutory preemptions; and

(iii) use derivative products for asset liability management.

Government influence on exchange rates

The Reserve Bank has been taking initiatives in putting in public domain all data relating to foreign exchange market transactions and operations.

The Reserve Bank disseminates:

(a) daily reference rate which is an indicative rate for market observers

(b) data on exchange rates of rupee against some major currencies and foreign exchange reserves on a weekly basis in the Weekly Statistical Supplement (WSS)

(c) data on purchases and sales of foreign currency by the Reserve Bank.

Types of Exchange Rate Systems

There are three broad exchange rate systems

- currency board
- fixed exchange rate and
- floating rate exchange rate.

The fixed exchange rate has three variants and the floating exchange rate has two variants. This consists of –

(i) rigid peg with a horizontal band,

(ii) crawling peg and

(iii) crawling band.

Variants of a Fixed Exchange Rate System

Rigid Peg with a Horizontal Band

the exchange rate fluctuation is maintained by the central bank within a range that may be specified (Iceland) or not specified (Croatia). The specified band may be one-sided (+7% in Vietnam), a narrow range (+ 2.25% in Denmark) or a broad range (+ 77.5% in Libya).

Crawling Peg

The par value of the domestic currency is set with reference to a selected foreign currency (or precious metal or currency basket) and is reset at intervals, according to pre-set criteria such as change in inflation rate.

Crawling Band

The domestic currency is on a crawling peg which is maintained within a range (band).

Floating Exchange Rate

This consists of

(i) managed float and

(ii) free float.

Within the floating exchange rate system, a country can choose a free float or a managed float.

De Facto and De Jure Exchange Rate Systems

A de facto exchange rate is the one that a country actually follows.

De jure fixed exchange rate and a de facto floating exchange rate, the breach of commitment will likely have negative consequences. On the other hand, having a de jure floating exchange rate and a de facto fixed exchange rate does not breach its commitments

A de jure exchange rate system is the one that the country claims to follow. Both systems need not always be the same.

The scheme ranks exchange rate arrangements on the basis of their degree of flexibility and the existence of formal or informal commitments to exchange rate paths.

Foreign exchange risk

•Foreign exchange risk refers to the losses that an international financial transaction may incur due to currency fluctuations.

•Also known as currency risk, FX risk and exchange-rate risk, it describes the possibility that an investment's value may decrease due to changes in the relative value of the involved currencies.

Types Of Foreign Exchange Risk

Transaction risk: This is the risk that a company faces when it's buying a product from a company located in another country.

Translation risk: A parent company owning a subsidiary in another country could face losses when the subsidiary's financial statements, which will be denominated in that country's currency, have to be translated back to the parent company's currency.

Economic risk (forecast risk), refers to when a company's market value is continuously impacted by an unavoidable exposure to currency fluctuations.

Capital risk management-Different types

The risk of financial loss associated with either choosing to or being forced to sell a security when prices have declined is what is meant by capital market risk.

Market risk/ systematic risk

Market risk is the possibility of an investor experiencing losses due to factors that affect the overall performance of the financial markets in which he or she is involved.

Industry Risk refers to the impact that the state's industrial policy can have on the performance of a specific industry.

Regulatory Risk

Regulatory risk is the risk that a change in regulations or legislation will affect a security, company, or industry.

Business Risk

Business risk can be defined as uncertainties or unexpected events, which are beyond control. Business risk is the possibilities a company will have lower than anticipated profits or experience a loss rather than taking a profit.

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Interest rate risk

Interest rate risk is the danger that the value of a bond or other fixed-income investment will suffer as the result of a change in interest rates.

Liquidity Risk

Liquidity risk is the risk that a company or bank may be unable to meet short term financial demands.

Product Risk

Product risk is the risk that you may not actually be able to deliver the product to market within the resources (time, money) that you have available to you.

International arbitrage and interest rate parity

Arbitrage can be defined as capitalizing on a discrepancy in quoted prices. The funds invested are not tied up and no risk is involved.

Interest Rate Parity (IRP)

Sometimes market forces cause the forward rate to differ from the spot rate by an amount that is sufficient to offset the interest rate differential between the two currencies.

Then, covered interest arbitrage is no longer feasible, and the equilibrium state achieved is referred to as interest rate parity (IRP).

Relation between inflation, interest rates and exchange rates

- **Inflation** is normally measured by governments using groups of price levels for goods in varying sectors known as price indices. These include measures such as a producer price index (PPI), which measures wholesale inflation, and a consumer price index (CPI), which measures inflation for consumers.
- Through use of monetary policy, national central banks attempt to adjust their base **interest rates** and available banking money reserves to control the rate of lending by banks within their economies.
- While directly related to inflation control policy, interest rates are also considered to have their own particular relevance for foreign exchange trading because of what is known as interest rate parity.

Purchasing Power Parity Theory

Under the theory of Purchasing Power Parity, the change in the exchange rate between two countries' currencies is determined by the change in their relative price levels locally that are affected by inflation. It is generally agreed that this theory mostly holds true over the long run, but economists have found that it can suffer distortions over the short term because of trade and investment barriers, local taxation, and other factors.

•The absolute form of PPP is an extension of the law of one price. It suggests that the prices of the same products in different countries should be equal when measured in a common currency.

•The relative form of PPP accounts for market distortions like transportation costs, labor costs, tariffs, taxes, and quotas. It states that the rate of price changes should be similar.

Derivation of PPP

Assume that PPP holds. Over time, as inflation occurs exchange rates adjusts to maintain PPP: $P_{h1} \rightarrow P_{h0}(1 + I_h)$

Where P_{h1}=home country's price index, year-1 end

I_h =home country's inflation rate for the year

$P_{f1} \rightarrow P_{f0}(1 + I_f)(1 + e_f)$ where

Pf = foreign country's price index

I_f = foreign country's inflation rate

e_f = foreign currency's % in value

Purchasing Power Parity Theory

If PPP holds $\Rightarrow P_{h1} = P_{f1}$ and $P_{h0} (1 + I_h) = P_{f0} (1 + I_f) (1 + e_f)$

Solving for $e_f = (1 + I_h) / (1 + I_f) -1$

$I_h > I_f \Rightarrow e_f > 0$ i.e. foreign currency appreciates

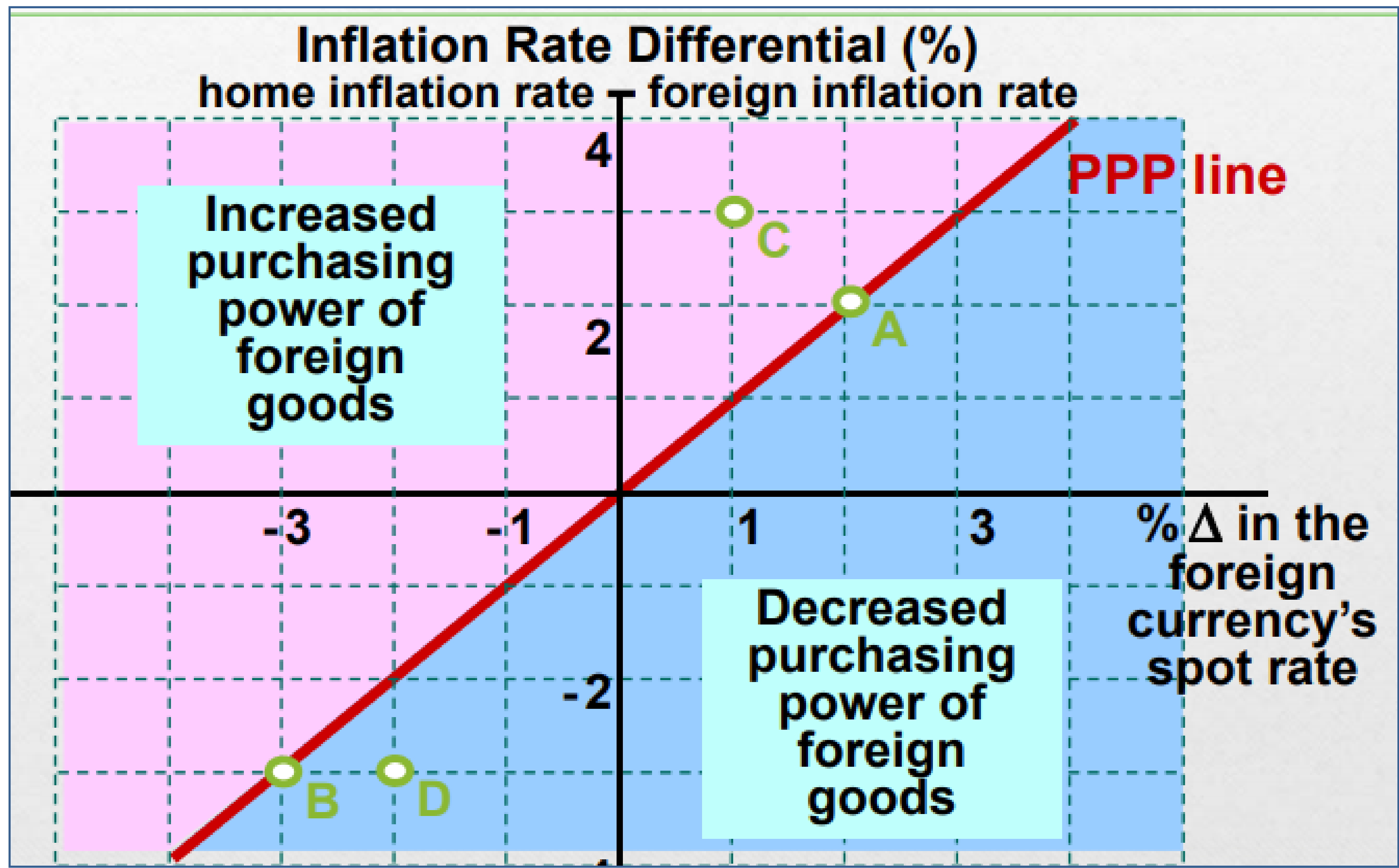
$I_h < I_f \Rightarrow e_f < 0$ i.e. foreign currency depreciates

Example: Suppose $I_{U.S.} = 9\%$ and $I_{U.K.} = 5\%$.

Then $e_{£} =\{ (1 + 0.09) / (1+0.05)\} - 1 = 3.81\%$

When the inflation differential is small, the PPP relationship can be simplified as $e_f \cong I_h - I_f$

Graphic Analysis of Purchasing Power Parity



International Fisher Effect (IFE)

International fisher effect (IFE)

According to the Fisher Effect, nominal risk-free interest rates contain a real rate of return and anticipated inflation $i_n = i_r +$ inflation

The International Fisher Effect (IFE) theory suggests that currencies with higher interest rates will depreciate because the higher nominal rates reflect higher expected inflation.

Hence, investors hoping to capitalize on a higher foreign interest rate should earn a return no higher than what they would have earned domestically

According to the IFE, $E(r_f)$, the expected effective return on a foreign money market investment, should equal r_h , the effective return on a domestic investment.

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Expectations theory

Expectations theory attempts to predict what short-term interest rates will be in the future based on current long-term interest rates. The theory suggests that an investor earns the same amount of interest by investing in two consecutive one-year bond investments versus investing in one two-year bond today. The theory is also known as the "unbiased expectations theory."

ASSET–LIABILITY MANAGEMENT

Foreign Direct Investment

A foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country.

Types of Foreign Direct Investment

Horizontal FDI

It is the investment done by a company or organization which practices all the tasks and activities done at the investing company, back at its own country of operation.

Vertical FDI: The industry of the investor and the company where investments are done are related to each other. This type of FDI is further classified as:

Forward Vertical FDI:

foreign investments are done in organizations which can take the products forward towards the customers.

Backward Vertical FDI:

foreign investments are done in an organization which is involved in sourcing of products for the particular industry.

Conglomerate FDI:

investments are done to gain control in unrelated business segments and industries in a foreign land.

Greenfield Entry: the investing company refers to an investing organization starting assembling from scratch

Foreign Takeover: takes the form of a foreign merger

Theories Of FDI

Mac Dougall -Kemp Hypothesis

•According to this theory, foreign direct investment is a result of differences in capital abundance between economies. This theory was developed by MacDougal(1958) and was later elaborated by Kemp(1964)

Industrial Organization Theory

• According to this theory, MNC with superior technology moves to different countries to supply innovated products making in turn ample gains .

•technological superiority is the main driving force for foreign direct investment rather that capital abundance.

Location –Specific Theory

Hood and Young(1979) stress on the location factor. According to them, FDI moves to a countries with abundant raw materials and cheap labor force.

Location theory has become an integral part of economic geography, regional science, and spatial economics. Location theory addresses questions of what economic activities are located where and why. Location theory or microeconomic theory generally assumes that agents act in their own self-interest. Firms thus choose locations that maximize their profits and individuals choose locations that maximize their utility.

Foreign Direct Investment

A foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country.

FDI takes place when an investor establishes foreign business operations or acquires foreign business assets in a foreign company.

FDIs are commonly made in open economies that offer a skilled workforce and above-average growth prospects for the investor, as opposed to tightly regulated economies.

Foreign direct investment frequently involves more than just a capital investment. It establishes either effective control of or at least substantial influence over the decision-making of a foreign business.

Types of Foreign Direct Investment:

- Horizontal FDI: It is the investment done by a company or organization which practices all the tasks and activities done at the investing company, back at its own country of operation.
- Vertical FDI: The industry of the investor and the company where investments are done are related to each other. This type of FDI is further classified as:
  - Forward Vertical FDI: foreign investments are done in organizations which can take the products forward towards the customers..
  - Backward Vertical FDI: foreign investments are done in an organization which is involved in sourcing of products for the particular industry

- **Conglomerate FDI:** Such investments are done to gain control in unrelated business segments and industries in a foreign land. Here the investing company ideally manages two challenges, first being gaining operational control in a foreign land, and the second being starting operations in a new industry segment.
- **Greenfield Entry:** In this special type of FDI, the investing company refers to an investing organization starting assembling from scratch just like Honda did in United Kingdom.
- **Foreign Takeover:** This type of FDI takes the form of a foreign merger.

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Theories Of FDI

i) Mac Dougall -Kemp Hypothesis

- This theory was developed by MacDougal(1958) and was later elaborated by Kemp(1964)
- FDI moves from capital abundant economy to capital scarce economy till the marginal production is equal in both countries.
- This leads to improvement in efficiency in utilization of resources in which leads to ultimate increase in welfare
- According to this theory, foreign direct investment is a result of differences in capital abundance between economies.

ii) Industrial Organization Theory

• According to this theory, MNC with superior technology moves to different countries to supply innovated products making in turn ample gains.

•Krugman (1989) points out that it was technological advantage possessed by European countries which led to massive investment in USA .

•According to this theory, technological superiority is the main driving force for foreign direct investment rather that capital abundance.

iii) Currency Based Approaches

A firm moves from strong currency country to weak currency country.

Aliber(1971)postulates that firms from strong currency countries move out to weak currency countries.

Froot and Stain(1989)holds that, depreciation in real value of currency of a country lowers the wealth of a domestic residents with regards to the wealth of the foreign residents, thus being cheaper for foreign firms to acquire assets in such countries. Therefore, foreign direct investments will move from countries with strong currencies to those with weak or depreciating currencies.

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iv) Location –Specific Theory

Hood and Young(1979) stress on the location factor. According to them, FDI moves to a countries with abundant raw materials and cheap labor force.

Since real wage cost varies among countries, firms with low cost technology move to low wage countries.

Abundance of raw materials and cheap labor force are the main factors for FDI. Countries with cheap labor and abundant raw material will tend to attract FDI.

v) Product Cycle Theory

- FDI takes place only when the product in question achieve specific stage in its life cycle (Vernon 1966) introduction, growth, maturity and decline stage.
- At maturity stage, the demand for new product in developed countries grow substantially and rival firms begin to emerge producing similar products at lower price.
- So in order to compete with rivals, innovators decide to set up production in the host country so as to beat up the cost of transportation and tariffs.

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Political –Economic Theories

They concentrate on the political risks. Political stability in the host country leads to FDI (Fatehi-Sedah and Safizeha 1989).

Similarly, political instability in the home country encourages FDI in other countries(Tallman 1988).

political economy is a social science that studies production, trade, and their relationship with the law and the government. It is the study of how economic theories affect different socio-economic systems such as socialism and communism, along with the creation and implementation of public policy.

S

Strategy for FDI

i) Firm-Specific Strategy

It means offering new kind of product or differentiated product. When product innovation fails to work, a firm may adopt product differentiation strategy. This is done through putting trade mark on the product or branding. Sometimes a firm may adopt different brands for different markets to make them suitable for local markets.

ii) Cost –Economic Strategy

This strategy is done through lowering cost by moving the firm to the places where there are cheap factors of production. The cheapness of these factors of production reduces the cost of production and maintains an edge over other firm

iii) Joint Venture With a Rival Firm

Sometimes when a rival firm in a host country is so powerful that it is not easy for MNC to compete, the later prefer to join hands with the host country firm for a joint venture agreement and the MNC is able to operate the host country market.

iv) Investment Mode Strategy

This strategy depends on the move of investment favored by the host country. It depends also on the political and economic environment of the host country. If the host government does not favor a particular mode, an investing company can not adopt it even if it is the most suitable.

Costs And Benefits Of FDI

Cost and benefits of FDI can be classified as two:

i. **Cost and Benefits of the Host Country**

ii. **Cost and Benefits of the investing MNC**

i. Benefits of Host Country

- Improving the balance of payments
- Technology transfer
- Source of tax revenue
- Providing employment

Costs And Benefits Of FDI

Costs of the Host Country

- Cultural and political interference
- Unhealthy competition to Domestic players
- Over utilization of local resources (both natural and human resources)
- Violation of human rights
- Threat to indigenous technology
- Threat to local products

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ii) Benefits of Investing MNCs

- **Access to markets**

FDI can be an effective way for to enter into a foreign market. Some countries may extremely limit foreign company access to their domestic markets.

- **Access to resources**

FDI is also an effective way to acquire important natural resources, such as precious metals and fossil fuels.

- **Reduces cost of production**

FDI is a means for you to reduce your cost of production if the labor market is cheaper and the regulations are less restrictive in the target foreign market.

- Its also likely that Investors may get investment incentives, promotion, social amenities.

Costs to Investing MNCs

- **Risk from Political Changes:** Because political issues in other countries can instantly change, FDI is very risky.
- **Hindrance to Domestic Investment:** As it focuses its resources elsewhere other than the investor's home country, FDI can sometimes hinder domestic investment
- **Economic Non-Viability:** Considering that FDIs may be capital-intensive from the point of view of the investor, it can sometimes be very risky or economically non-viable.
- **Expropriation:** political changes can also lead to expropriation, which is a scenario where the government will have control over your property and assets. Investment abroad takes away employment opportunities of the people in the Home country.

International capital budgeting

The process through which different projects are evaluated is known as capital budgeting. Capital budgeting is defined “as the firm’s formal process for the acquisition and investment of capital. It involves firm’s decisions to invest its current funds for addition, disposition, modification and replacement of fixed assets”.

“Capital budgeting is long term planning for making and financing proposed capital outlays”-

“Capital budgeting consists in planning development of available capital for the purpose of maximizing the long term profitability of the concern” – Lynch

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The **main features f capital budgeting** are

a. potentially large anticipated benefits

b. a relatively high degree of risk

c. relatively long time period between the initial outlay and the anticipated return.

Significance of capital budgeting

- It's a main tool of financial management
- All types of capital budgeting decisions are exposed to risk and uncertainty.
- They are irreversible in nature
- Capital rationing gives sufficient scope for the financial manager to evaluate different proposals and only viable project must be taken up for investments.

Factors influencing capital budgeting

- Availability of funds
- Structure of capital
- Taxation policy
- Government policy
- Lending policies of financial institutions
- Immediate need of the project
- Earnings
- Capital return
- Economical value of the project
- Working capital
- Accounting practice
- Trend of earnings

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Methods of capital budgeting

Traditional methods

Payback period

Accounting rate of return method

Discounted cash flow methods

Net present value method

Profitability index method

Internal rate of return method (IRR)

Merits of IRR

‘It consider the time value of money. Calculation of cost of capital is not a prerequisite for adopting IRR. IRR attempts to find the maximum rate of interest at which funds invested in the project could be repaid out of the cash inflows arising from the project. It is not in conflict with the concept of maximizing the welfare of the equity shareholders.

Cons of IRR

•Computation of IRR is tedious and difficult to understand

•Both NPV and IRR assume that the cash inflows can be reinvested at the discounting rate in the new projects. However, reinvestment of funds at the cut off rate is more appropriate than at the IRR.

•IT may give results inconsistent with NPV method.

•This is especially true in case of mutually exclusive project

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International capital structure and cost of capital

The capital structure is the particular combination of debt and equity used by a company to finance its overall operations and growth. Debt comes in the form of bond issues or loans, while equity may come in the form of common stock, preferred stock, or retained earnings.

Many major firms throughout the world have begun to internationalize their capital structure by raising funds from foreign as well as domestic sources. As a result, these corporations are becoming multinational not only in the scope of their business activities but also in their capital structure.

International capital structure and cost of capital

By internationalizing its corporate ownership structure, a firm can generally increase its share price and lower its coast of capital. This trend reflects the ongoing liberalization and deregulation of international financial markets that make them accessible for many firms.

Cost of capital is the required return necessary to make a capital budgeting project, such as building a new factory, worthwhile.

The cost of capital metric is used by companies internally to judge whether a capital project is worth the expenditure of resources, and by investors who use it to determine whether an investment is worth the risk compared to the return.

The cost of capital depends on the mode of financing used. It refers to the cost of equity if the business is financed solely through equity, or to the cost of debt if it is financed solely through debt.

Many companies use a combination of debt and equity to finance their businesses and, for such companies, the overall cost of capital is derived from the weighted average cost of all capital sources, widely known as the weighted average cost of capital (WACC).

International Portfolio Management

- An international portfolio is a grouping of investment assets that focuses on securities from foreign markets rather than domestic ones.
- It is designed to give the investor exposure to growth in emerging and developed markets and provide diversification.
- Portfolio management refers to managing an individual's investments in the form of bonds, shares, cash, mutual funds etc so that he earns the maximum profits within the stipulated time frame.

Need for Portfolio Management

•Portfolio management presents the best investment plan to the individuals as per their income, budget, age and ability to undertake risks.

•Portfolio management minimizes the risks involved in investing and also increases the chance of making profits.

•Portfolio managers understand the client's financial needs and suggest the best and unique investment policy for them with minimum risks involved.

•Portfolio management enables the portfolio managers to provide customized investment solutions to clients as per their needs and requirements.

Types of Portfolio Management

Types of Portfolio Management

Active Portfolio Management: the portfolio managers are actively involved in buying and selling of securities to ensure maximum profits to individuals.

Passive Portfolio Management: the portfolio manager deals with a fixed portfolio designed to match the current market scenario.

Discretionary Portfolio management services: an individual authorizes a portfolio manager to take care of his financial needs on his behalf. The individual issues money to the portfolio manager who in turn takes care of all his investment needs, paper work, documentation, filing and so on.

Non-Discretionary Portfolio management services: the portfolio manager can merely advise the client what is good and bad for him but the client reserves full right to take his own decisions.

Modes of Global Portfolio Management

Two concepts are important here which can be categorized as Portfolio Equity and Portfolio Bonds. These are supposed to be the best modes of GPM.

Portfolio Equity

Portfolio equity includes net inflows from equity securities other than those recorded as direct investment and including shares, stocks, depository receipts (American or global), and direct purchases of shares in local stock markets by foreign investors.

Portfolio Bonds

Bonds are normally medium to long-term investments. Investment in Portfolio Bond might be appropriate for anyone if –
additional funds are to be invested.
they can seek income, growth potential, or a combination of the two.
They can invest for five years, ideally longer.
They can be a taxpayer of basic, higher, or additional-rate category.

Global Mutual Funds

Global mutual funds can be a preferred mode if the Investor wants to buy the shares of an internationally diversified mutual fund. In fact, it is helpful if there are open-ended mutual funds available for investment.

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Closed-end Country Funds

Closed-end funds invest in internationals securities against the portfolio. This is helpful because the interest rates may be higher, making it more profitable to earn money in that particular country. It is an indirect way of investing in a global economy. However, in such investments, the investor does not have ample scope for reaping the benefits of diversification, because the systematic risks are not reducible to that extent.

Draw back of global portfolio management

Unfavorable Exchange Rate Movement – Investors are unable to ignore the probability of exchange rate changes in a foreign country.

Drawbacks of Global Portfolio Management

Frictions in International Financial Market : There may be various kinds of market frictions in a foreign economy. These frictions may result from Governmental control, changing tax laws, and explicit or implicit transaction costs.

•Manipulation of Security Prices :Government and powerful brokers can influence the security prices. Governments can heavily influence the prices by modifying their monetary and fiscal policies.

•Unequal Access to Information :Wide cross-cultural differences may be a barrier to GPM. It is difficult to disseminate and acquire the information by the international investors beforehand.

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Equity financing

Equity financing is the process of raising capital through the sale of shares. Companies raise money because they might have a short-term need to pay bills or they might have a long-term goal and require funds to invest in their growth. By selling shares, they sell ownership in their company in return for cash, like stock financing.

Equity financing comes from many sources; for example, an entrepreneur's friends and family, investors, or an initial public offering (IPO).

Equity risk is "the financial risk involved in holding equity in a particular investment".

The measure of risk used in the equity markets is typically the standard deviation of a security's price over a number of periods.

Bond financing

Bond financing is a type of long-term borrowing that state and local governments frequently use to raise money, primarily for long-lived infrastructure assets. They obtain this money by selling bonds to investors. In exchange, they promise to repay this money, with interest, according to specified schedules.

International bonds

International bonds are debt instruments that are issued by a non-domestic company in order to raise money from international investors and are usually denominated in the currency of the issuing country with the primary objective to attract more investors on a large scale.

Types Of International Bonds

1)Foreign bonds and Euro bonds: Bond where foreign company issues bond denominated in the currency denomination of the foreign country.

In Euro bond, a foreign company issues a bond denominated in a currency which is not the home currency of the investors

2) Global bonds : Global bonds can have following differences among issuer, denomination and the country in which it is being issued:

Issuer (Issuing company's nationality)

What is the denomination of bonds (currency) and for which country this currency is local?

The country in which it is being issued

3) Straight Bonds : A bond that pays interest at regular intervals, and at maturity pays back the principal that was originally invested.

Types of straight bonds:

a) Bullet –redemption bond

A bullet bond is a debt instrument whose entire principal value is paid all at once on the maturity date, as opposed to amortizing the bond over its lifetime.

b) Rising coupon bond

A bond with interest coupons that change to preset levels on specific dates. the bond pays a given coupon for a specific period of time, then its coupon is stepped up in regular periods until maturity. This bond is also known as a dual-coupon/stepped-coupon/step-up coupon bond,

c)Zero-coupon bond: is a debt security that does not pay interest but instead trades at a deep discount, rendering a profit at maturity, when the bond is redeemed for its full face value.
d) Bonds with currency option: The investor possesses the right for receiving the payments in a currency except the currency of issue
e) Bull and bear bonds: A bull bond is a term used to refer to a bond that is likely to increase in value in a bull market. Most bonds tend to increase in value when interest rates decline, but bull bonds refer to types of bonds that do especially well in this environment.
A bull market is a financial market marked by optimism and investor confidence. The term bull market, associated with trading in the stock market, can also apply to anything traded, such as bonds, currencies, and commodities.

5)Floating-rate Bonds: Floating rate bonds pay coupon based on some reference interest rate, such as LIBOR. Unlike coupon bonds, floating rate notes do not carry a fixed nominal interest rate.

The coupon payments are linked to the movement in a reference interest rate (frequently money market rates, such as the LIBOR) to which they are adjusted at specific intervals, typically on each coupon date for the next coupon period.

A floating rate note (FRN) is a debt instrument whose coupon rate is tied to a benchmark rate such as LIBOR or the US Treasury Bill rate. Thus, the coupon rate on a floating rate note is variable. It is typically composed of a variable benchmark rate + a fixed spread

FRNs are present in various forms:

•Perpetual FRNs
•Minimax FRNs
•Drop Lock FRNs\Flip-flop FRN
•Flip-flop FRN
•Mismatch FRN

6) Convertible bonds :

Convertible bonds are corporate bonds that can be converted by the holder into the common stock of the issuing company. A convertible bond gives the holder the option to convert or exchange it for a predetermined number of shares in the issuing company.

7) Cocktail bonds:

Composite currency bonds are denominated in a currency basket, such as SDRs or ECUs, instead of a single currency. They are typically straight fixed-rate bonds/cocktail bonds

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Parallel Loans

Parallel loan is a four-party agreement in which two parent companies in different countries borrow money in their local currencies, then lend that money to the other's local subsidiary.

The purpose of a parallel loan is to avoid borrowing money across country lines with possible restrictions and fees.

Each company can certainly go directly to the foreign exchange market (forex) to secure their funds in the proper currency, but they then would face exchange risk.

International Cash Management

Cash on hand refers to notes, coins, and deposits held on demand by government institutional units with a bank or another financial institution. Cash equivalents are defined to be highly liquid investments that are readily convertible to cash on hand.

Cash management is necessary because there are mismatches between the timing of payments and the availability of cash.

Storkey (2003) provides the following definition: “cash management is having the right amount of money in the right place and time to meet the government’s obligations in the most cost-effective way.”

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Approaches of Centralized Cash Management:

- **Netting:** If all the resulting cash flows are executed on a bilateral, pair wise basis, a large number of currency conversions would be involved with substantial transaction costs. With a centralized system, netting is possible whereby the cash management center (CMC) nets out receivables against payables, and only the net cash flows are settled among different units of the corporate family.
- **Cash Pooling:** Cash pooling will also reduce overall cash needs since cash requirements of individual units will not be synchronous.
- **Collection and Disbursement of Funds:** Accelerating collections both within a foreign country and across borders is a key element of international cash management. Management of disbursements requires knowledge of individual country and supplier policies and the different payment instruments and banking services.

Accounts Receivables management

The receivables out of the credit sales crunch the availability of the resources to meet the day today requirements. The acute competition requires the firm to sustain among the other competitors through more volume of credit sales and in the intention of retaining the existing customers. This requires the firm to sell more through credit sales only in order to encourage the buyers to grab the opportunities unlike the other competitors they offer in the market.

Objectives of Accounts Receivables

- Achieving the growth in the volume of sales
- Increasing the volume of profits
- Meeting the acute competition

Factors Affecting the Accounts Receivables

- Cash discount
- Level of sales
- Credit policies
- Lenient credit policy
- Stringent credit policy
- Terms of trade
- Credit period

Management of Accounts Payable/Financing the Resources is more important at par with the management of receivable, in order to avail the short term resources for the smooth conduct of the firm.

Inventory management

Inventory management refers to the process of ordering, storing, and using a company's inventory. These include the management of raw materials, components, and finished products, as well as warehousing and processing such items.

For companies with complex supply chains and manufacturing processes, balancing the risks of inventory gluts and shortages is especially difficult.

To achieve these balances, firms have developed two major methods for inventory management: just-in-time and materials requirement planning: just-in-time (JIT) and materials requirement planning (MRP).

The objectives of inventory management

The objectives of inventory management are to provide the desired level of customer service, to allow cost-efficient operations, and to minimize the inventory investment.

Customer Service

Customer service is a company's ability to satisfy the needs of its customers. When we talk about customer service in inventory management, we mean whether or not a product is available for the customer when the customer wants it. In this sense, customer service measures the effectiveness of the company's inventory management. Customers can be either external or internal: any entity in the supply chain is considered a customer.

A customer service measure appropriate when customer orders vary in number of line items ordered.

Methods of Payment in International Trade

there are five primary methods of payment for international transactions.

1)Cash-in-Advance

With cash-in-advance payment terms, an exporter can avoid credit risk because payment is received before the ownership of the goods is transferred. For international sales, wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters.

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ii) Letters of Credit

Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents.

iii) Documentary Collections

A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents that its buyer needs to the importer’s bank (collecting bank), with instructions to release the documents to the buyer for payment.

iv) Open Account

An open account transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60 or 90 days. Obviously, this is one of the most advantageous options to the importer in terms of cash flow and cost, but it is consequently one of the highest risk options for an exporter.

v) Consignment

Consignment in international trade is a variation of open account in which payment is sent to the exporter only after the goods have been sold by the foreign distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold.

Letter Of Credit

When a buyer or importer wants to purchase goods from an unknown seller or exporter. He can take assistance of bank in such buying or importing transactions.

Types Of Letter Of Credit (LC)

There are various types of letter of credit (LC) in the trade transactions:

- Drafts
- commercial invoice
- Bill Of Lading

Trade Finance Methods

The most popular trade financing methods are the following –

- Accounts Receivable Financing
- Factoring
- Letters of Credit
- Banker’s Acceptance
- Working Capital Finance
- Forfeiting
- Barter
- Countertrade

Export and Import Bank of India (EXIM)

- The Export and Import Bank of India, popularly known as the EXIM Bank was set up in 1982. It is the principal financial institution in India for foreign and international trade.
- It was previously a branch of the IDBI, but as the foreign trade sector grew, it was made into an independent body.

The main function of the Export and Import Bank of India:

- to provide financial and other assistance to importers and exporters of the country.
- it oversees and coordinates the working of other institutions that work in the import-export sector.
- The ultimate aim is to promote foreign trade activities in the country.

Functions of the EXIM Bank

Some of the main functions of Export and Import Bank of India are:

- Finances import and export of goods and services from India
- It also finances the import and export of goods and services from countries other than India.
- It finances the import or export of machines and machinery on lease or hires purchase basis as well.
- Provides refinancing services to banks and other financial institutes for their financing of foreign trade
- EXIM bank will also provide financial assistance to businesses joining a joint venture in a foreign country.
- Will offer short-term loans or lines of credit to foreign banks and governments.
- Undertakes functions of a merchant bank for the importer or exporter in transactions of foreign trade.

Highlight of Exim Policy 2002 – 07

Hardware/Software
Service Exports
Status Holders
Gem & Jeweler Sector
Removal of Quantitative Restrictions
Special Economic Zones Scheme EOU Scheme
EPCG Scheme (Export Promotion Capital Goods Scheme)
DEPB Scheme (Duty Entitlement Pass Book)
DFRC Scheme (Duty Free Replenishment Certificate scheme

Thank you