Mohamed Khaider University, Biskra

Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: International Finance

Branch: International Trade
Level: Third year Bachelor

Lecture 02: International Finance; Meaning, Features, importance

Unit 01: Introduction to International Finance

Unit Overview

This Unit offers a primer on International Finance

Learning Outcomes

When you have completed your Study of this unit and its readings, you will be able to:

- explain the meaning of international finance

- determine scope of international finance

- distinguish between domestic and international financial transactions and identify the main characteristics of international financial contracts

1- Concept and Scope of International Finance

a- Concept

International Finance deals with the management of finances in a global business. It explains how to trade in international markets and how to exchange foreign currency, and earn profit through such activities. In fact, international Finance is an important part of financial economics. It mainly discusses the issues related with monetary interactions of at least two or more countries. International finance is concerned with subjects such as exchange rates of currencies, monetary systems of the world, foreign direct investment (FDI), and other important issues associated with international financial management.

b-Scope

Traditionally, international finance has been viewed as management of MNCs that engage in some form of international business. (A business firm is considered an international player according to Fortune Magazine, when its international sales exceed 20% of total). These MNCs continuously devise strategies to improve their cash flows and enhance shareholder wealth. Penetration of foreign market creates opportunities for improving the company's cash flows. The dismantling of barriers to entry encourage companies to pursue international business. Liberal trade is the principal driver of internationalisation which encompasses unimpeded flows of capital labour and technology across national boundaries. Free trade is always beneficial because it encourages nations to specialise in the products they are best at and import those they are less good at. This results in efficient allocation of resources and maximisation of welfare. Corporates go through different stages in this pursuit, export products or import supplies from foreign manufacturer initially to establishing subsidiaries in foreign countries. The extent, pattern and modes of international companies' activity have been greatly influenced by the political, technological and economic events in the last three decades. The mobility aided by computer technologies and wireless is offering international companies' wider options in respect of both the creation and use of these assets and products. The data on stock of outward foreign direct investment by large companies and inbound foreign investments by major host countries, show that foreign based activities of international companies, is the method for serving foreign markets. In all major economies, viz., USA, Germany, U.K., Japan and European countries, the role of domestic and/or foreign based companies is increasing. Inwards FDI in 2004 was, 3.4% of GDP in India and 1.4% of outward FDIs of GDP. While the world as a whole, the percentage share in 2004 was 7.5% of inward FDI as against 8.7% of outward FDIs Outward direct investment has been influenced by the opening up of erstwhile communist countries especially China.

2- Features of International Finance

Some of the features of international financing management are listed below as international finance management has some certain distinguished features when compared with domestic finance managing. They are:

-Foreign exchange risks

-Political risks

-Market imperfections

-Expanded Opportunity

a-Foreign exchange risks: When institutions and individuals are engaged in cross-border transactions, they are potentially exposed to *foreign exchange risk* that they would not normally encounter in purely domestic transactions. In depth, the foreign exchange risk is a financial risk that occurs when a cross-border transaction is designated in a Currency Other than that of the base Currency Of The institutions and individuals.

Eg; Suppose Mexico is a major export market for your company and the Mexican peso depreciates drastically against the U.S. dollar, as it did in December 1994. This means that your company's products can be priced out of the Mexican market, as the peso price of American imports will rise following the peso's fall. If such countries as Indonesia, Thailand, and Korea are major export markets, your company would have faced the same difficult situation in the wake of the Asian currency crisis of 1997.

b-Political risks

Multinational firms, individuals, companies and investors should be particularly aware of *political risk* that may encounter in an international setting. It arises from the fact that a sovereign country can change the "rules of the game" and the affected parties may not have effective recourse. It is important to understand that the property rights of shareholders and investors are not universally respected due to unexpected changes in tax rules, expropriation of assets held by foreigners or investing in those countries without a tradition of the rule of law.

Eg; In 1992, Eron development corporation signed a contract to build India's longest power plant , but it was later cancelled in 1995 by politicians in Maharashtra, who argued that India does not need power plant . The company spent nearly $300million on that project.

c-Market imperfections: refers to various disagreements and impediments preventing markets from functioning perfectly, play an important role in motivating multinational corporations to locate production overseas. These are a variety of barriers that include legal restrictions, excessive transaction and transportation costs, information asymmetry, and discriminatory taxation. They still hamper free movements of people, goods, services, and capital across national boundaries.

d- Expanded Opportunity: Investors can benefit greatly if they invest internationally rather than domestically. Firms can also locate production in any country or region of the world to maximize their performance and raise funds in any capital market where the cost of capital is the lowest. In addition, firms can gain from greater economies of scale when their tangible and intangible assets are deployed on a global basis.

Eg: Suppose you have a given amount of money to invest in stocks. You may invest the entire amount in U.S. (domestic) stocks. Alternatively, you may allocate the funds across domestic and foreign stocks. If you diversify internationally, the resulting international portfolio may have a lower risk or a higher return (or both) than a purely domestic portfolio.

3-The importance of International Finance:

a- Expansion of production capacities: Some of the domestic firms expanded their production capacities more than the demand for the product in the domestic countries. These firms in such cases, are forced to sell their excess production in foreign
developed countries.

b- Nearness to raw materials: The source of highly qualitative raw materials and bulk raw materials is a major factor for attracting the firms from various foreign countries. Most of the US based and European based firms located their manufacturing facilities in Saudi Arabia, Bahrain, Qatar, Iran etc. due to availability of petroleum.

c- Higher rate of profits: International firms search for foreign markets that hold promise for higher rate of profits. Thus, the objective of profit affects and motivates the business to expand its operations to foreign countries

d- Availability of technology and skilled human resources: Availability of advanced technology and competent human resources, in some countries act as pulling factors for international companies.

e- Calculate exchange rates: They are very important in international finance, as they let us determine the relative values of currencies. International finance helps in calculating these rates

f- Higher growth rate of economic development: International firms help the governments to achieve higher growth rate of the economy, increase the total and per capita GDP, industrial growth, employment and income levels

g- Tariffs and import quotas: To avoid high tariffs and quotas firms prefer direct investments to go globally. For example, firms like Sony, Honda and Toyota preferred direct foreign investment in various countries by establishing subsidiaries or through joint ventures.

4-Glossary:

Cash Management: The handling of cash within a firm such as the investment a firm has in transaction balances, funds tied up in precautionary cash balances, investment of excess funds at the most favorable rate, and borrowing at the lowest rate when there is a temporary cash shortage.

Corporate Governance: The economic, legal, and institutional framework in which corporate control and cash flow rights
are distributed among shareholders, managers, and other stakeholders of the company

Counterparty: One of the two parties involved in financial contracts who agrees to exchange cash flows on particular terms.

Countertrade: Transactions in which parties exchange goods or services. If these transactions do not involve an exchange
of money, they are a type of barter

Euro: The common European currency introduced in 1999 of the 11 countries of the EU that make up the EMU

Foreign Branch: An overseas affiliate of a MNC which is not an independently incorporated firm but is rather an extension of the parent.

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Market Imperfections: Various frictions, such as transaction costs and legal restrictions, that prevent the markets from
functioning perfectly

Multinational Corporation (MNC): Refers to a firm that has business activities and interests in multiple countries.

Political Risk: Potential losses to the parent firm resulting from adverse political developments in the host country.