International Financial Management
Paper Code: MS 509
Topic: Introduction to International Financial Management

Unit - 1: Introduction to International Financial Management

Structure of Unit

1.0 Objectives

After completing this unit, you would be able to:

- Develop an understanding of the term "International Financial Management".
- Describe the scope of international finance;
- Function of International financial management.

1.1 Introduction to International Financial Management

International financial management (IFM) is a term that grew out of the need for individuals and organizations to consider the implications of financial decisions due to cross-border transactions prevalent in the world economy. Thus, international financial management is the study and application of financial strategy that takes into account the differences and complexities involved in cross border transactions. The term accounts for such topics as raising capital, making acquisitions, investment strategy, managing risk, organizational restructuring, and overall financial policy in global context. Finance managers of such international activities are concerned with aspects like exchange rates, rules regarding taxation, legal complexities and regulations, and risk factors associated with doing business in another nation. Familiarity with international trade agreements is an important part of the topic as well.

Currency exchange rates and differing methods to determine price of assets can have a major impact on the bottom line in international financial management. As such, the topic accounts for the structure of the currency exchange system and how to determine asset prices in a global setting. In addition, IFM is also concerned with how different currencies impact the prices on stock markets. Decision making in international financial management must account for potential

impacts related to various capital structures, approaches to risk management, and how to best leverage taxation systems. IFM will examine how a firm may take advantage of local partnerships in other countries or how to capitalize on international subsidies that are available. Taking into account taxation and exposure to exchange rates, IFM managers will research and decide how to best hedge those exposures and responsibilities. Valuation and policies for obtaining financing internationally are usually modified when a dealing cross-border investment. International finance management will consider the cost of placing operations in other nations and discern how to best value investments in developing nations. Other areas of concern include penetrating markets and sustaining a presence in those markets effectively. Additionally, international financial management accounts for differing institutional arrangements, whether formal or informal, that reflect decision making. Differences in legalities, such as protection of creditors and shareholders, impacts both investment and restructuring decisions. This means IMF requires excellent communication skills and building relationships in order to get the job done correctly. Overall, the main goal of international financial management is to create the most wealth possible for shareholders. Stakeholders also are important for IFM managers. They include suppliers, vendors, employees and end customers who all must be observed from a financial perspective when considering cross-border transactions.

1.2 International Finance - Meaning

The term simply means managing the finance of a firm. The functions performed by a finance manager include sourcing of funds, investing optimally the funds procured and distributing the rewards to the people from whom he has procured funds. The process of procuring funds is known as financing function, investing activities are known as investment function and the distribution function is known as dividend function. The objective of managing finance was earlier to maximize profit. Gradually, firms felt the importance of value maximization and are functioning nowadays in order to achieve this objective.

The term International finance is simply understood as **finance across national borders**. It has synonyms like multinational finance, global finance etc. Though all the three are considered synonymous, they differ as they are defined contextually. It is named Multinational Finance or Multinational Financial Management when it deals with the financial management strategies of Multinationals. Similarly when the financial strategies of firms operating at global level are discussed, it is named global finance. In other words, the word differs when the level of internationalization differs according to the operations of the firms involved.

1.3 Scope of International Finance

The scope of International finance is broader than the basic domestic finance. It includes all the financing and investment options available at the global level. A firm has limited access to funds when it operates within a country. When it extends its operations; it also gains access to many more options. A manager has to consider all the alternatives before selecting a particular or a set of source of finance. Similarly, the opportunities for investment available are also plenty at the global level. A firm, can select from an exhaustive list of alternatives like franchising, licensing, outsourcing etc. apart from direct investment. Thus, decisions on managing finance tend to be optimum, only when it is dealt with global perspective. For example, decisions on cost control normally end up with substituting the raw material or changing the supplier. But in the parlance of international finance, it extends to even shifting the production facility to other locations where the factors of production are cheaper. As International Finance discusses all these aspects, it is more global in its outlook.

1.3.1 Foreign Exchange

The most important feature of International Finance is the use of different currencies for the transfer of funds between different countries. This involves the exchange of foreign currency for home currency and vice versa. These exchanges are affected by the exchange rate between the different currencies. Exchange rate is defined as the rate at which one currency is exchanged for the other. If 60 INR (Indian Rupee) is required to buy 1USD (US Dollar) then the exchange rate between INR and USD is Rs.60.

Foreign currencies are bought and sold at the foreign exchange market (forex market). The distinct feature of this market is that it does not have any physical setup and is an **over the counter market (OTC)**. Another feature of this market is that it operates 24*7 as it connects all countries i.e. when one market closes the other market elsewhere opens. This makes the exchange rates very dynamic. Since there are only two currencies involved in the exchange it is not necessary that only two countries are involved. These currencies may also be traded in a third country and hence the third country perspective of the currency should also be dealt with. With the rising impact of globalization on all the markets in the world, the foreign exchange is very important and since international finance deals with all the nuances of the forex market.

International finance deals with exchange rate systems too. A country has a choice of either keeping its exchange rate with a foreign currency fixed or determined by the market forces. The former one is called as the fixed rate and the latter is called as the floating rate. Before fixing up an exchange rate system the authorities should analyse the economic condition of the world in comparison to that specific country. The rate of development of each country affects the position of the exchange rate. If the alignment of the exchange rate is not done with respect to the changing economic condition then it leads to an economic crisis. This can be witnessed in the Asian Crisis. The Asian crisis of 1997 started in Thailand and spread across other Asian countries like Indonesia and South Korea. This was because the Thai Bhatt was pegged to the US dollars and Thailand did not grow at the same rate as US. As they could not cope up their currency was over rated and thus leading to the crisis. An exhibit with the list of events that led to this crisis is presented at the end of this unit.

1.3.2 International Financial System

As discussed in the above paragraph it becomes imperative to understand the financial and economic conditions of other countries. The economic condition of a country can be understood by its macro and micro economic indicators like Gross Domestic Product (GDP), Inflation, Interest rates, Savings, Investment levels, Employment etc. The financial climate can be understood from the financial system, policies and the financial markets of a country. **Financial System is understood simply as a set of Individuals and institutions, both governmental and non-governmental which are governed by set of policies, rules, and regulations set by regulatory authorities**. When there are corporate, which are in need of funds for activities like expansion, R&D and other investments, there are households with surplus in the form of savings. The households have the option of either saving this money in the form of Savings; Fixed Deposits etc or invest them in financial markets. The term Investment means sacrificing a sum of money at present for a future benefit.

Savings: Regular Income (Interest)

Investment: Regular Income (Interest, Dividend) + Capital Gain

In the case of savings the investor gets only regular income in the form of interest whereas when the money is invested in the corporate they get an additional capital gain. Capital Gain is the difference in the prices of the investment like share; bond etc. at two different time periods. Financial markets have a galore of investment opportunities. But there is a risk factor involved when an investment is made in the corporate because of variation in prices of shares due to market conditions. With liberalization of trade and finance, an investor has an array of investment alternatives across the globe. Thus risks can be minimized by investing in a portfolio of companies and countries. International Finance deals with all the investment alternatives in detail.

1.3.3 International Monetary System

International business transactions or trade creates an obligation between countries that are involved. Each country has a different currency and different settling procedure. A common payment system is necessary for the settling the obligations. According to Kevin (2009), an International monetary system is a payment system for settling international financial obligations, involving different currencies, needed for the smooth functioning of global economic system. Different systems were evolved in the past namely bimetallism Classical gold standard, Inter war period, Brettonwoods system and flexible exchange rate regime as classified by Resnick (2011). The main objective of establishing an international monetary system is to maintain stability in the exchange rates and to promote free flow of international business and trade.

International transactions by the residents of a country result in cash outflows to other countries as well as cash inflows from other countries. The foreign currency inflow adds to the foreign exchange reserves of the country. These cross border flow of currencies are recorded in a statement known as the Balance of Payments (BOP) statement. Different types of transactions such as current account transaction and capital account transaction are recorded. It also shows the change in the foreign exchange reserves of the country. The statement helps to know if there is a deficit or surplus of international receipts. The statement also depicts the demand and supply of foreign currency. Thus study of Balance of payment is an important part of International finance.

1.3.4 International Accounting and Taxation

MNC's have subsidiaries in a number of countries. They need to consolidate their subsidiaries accounts for financial reporting. This requirement makes it essential for these companies to decide upon a policy as to the different exchange rates that are to be applied to convert the various categories of foreign currency denominated assets, liabilities, earnings or expenses into the domestic currency, and for the treatment of any exchange gains or losses that arises out of such a conversion. The formation of policy becomes important to make financial statements more transparent. They need to abide by the accounting rules and procedures applicable. The translation also has tax implications. International accounting and taxation are very complex and extensive topics due to multiplicity of rules in different countries in the world.

1.4 Functions of International Financial Management

International finance performs certain special functions other than what domestic finance performs. The functions of International finance are:

1.4.1 Financing function

Through this function, the finance department is expected to look out for alternate methods of financing the firm. Simply speaking, Financing function is the sum total of the liability side of the Balance sheet. Traditionally, equity and debt were considered as the major sources of finance. By optimizing the mix of sources, the finance manager is expected to reduce the cost of capital. If finance, viewed from a single country perspective, it deals only with debt and equity. But international finance brings out the entire gamut of sources that are available in all the countries across the globe. Firms are permitted to borrow in other currencies as well. This decision is prudent only when it results in reducing the cost of capital.

1.4.2 Investment Function

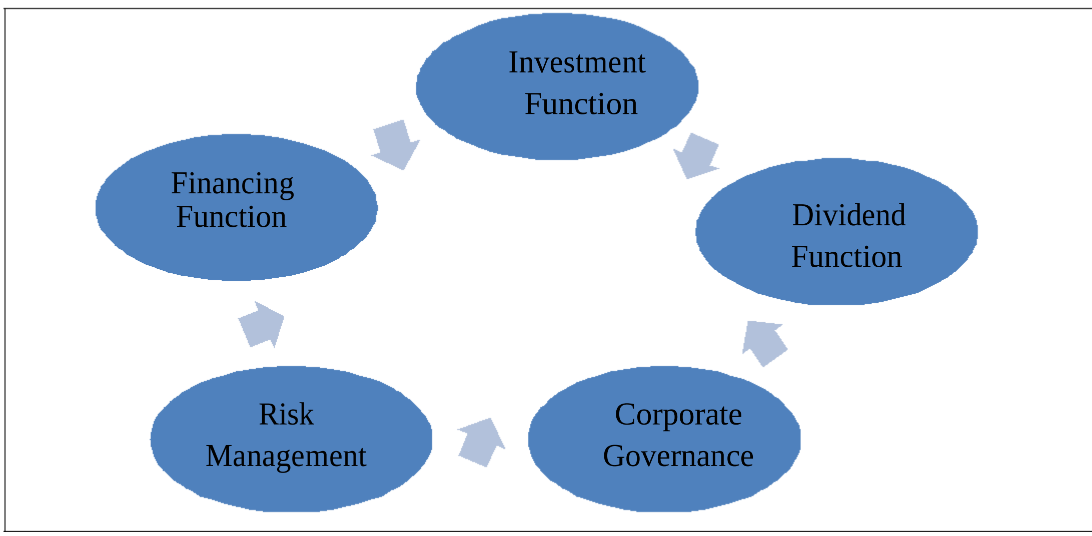
The finance department is also responsible for allocating the funds procured for various activities of the firm. This is known as investment function. In other words, the asset side of the Balance Sheet represents the investment function. The conflicting alternatives here are fixed assets and Current Assets. Generally manufacturing concerns have more investments in current assets than trading firms. Apart from fixed assets, firms that are operating in Pharmaceutical and Informational Technology industries have to invest more in Intangible assets like patents etc. The decision is taken normally to maximize profit in the short run, and to maximize wealth of the investors in the long run.

1.4.3 Dividend Function

This function deals with the distribution of rewards among the investors. The conflicting alternatives are to distribute or to reinvest in to the business. The firm has the choice of either distributing the profits as dividends, bonus shares etc. or to reinvest in to the business. By retaining the profits, the firm can save a lot of cost by not going for equityissues for subsequent fund requirements. There are contradicting theories on the relevance and irrelevance of this decision on the value of the firm.

The functions of International Finance are depicted in the following figure:

Figure 1.3 International Financial Function



In the figure 1.3, the top three functions relate to basic financial management. The extended functions of risk management and corporate governance relate to International Finance. It is undoubtedly important to include corporate governance as a function under domestic, but it becomes all the more important when the firms expand geographically to other countries. The consequences of not adhering to the rules of the land are more severe in case of firms operating at the global level. In other words, corporate governance started receiving extended attention since countries started integrating themselves more in trade and finance.

1.4.4 Corporate Risk management

The term risk is understood as the probability of unexpected events. The money equivalent of the assets and liabilities, revenue etc. that are exposed to risk when quantified is come to be known as exposure. The art of managing the exposure from the risks is known as risk management. Risks are omnipresent as far as international business is concerned. Risks are defined depending on their origin or source. Every country has the right to issue and use currencies of its own. All of its transactions shall be, hence denominated in the same currency. The firm that is into trading relations with the host country shall be only in the host currency. But the transacting firm would be denominating all the transactions in its home currency. Since all the global markets have switched over to flexible exchange rate system, where the exchange rate between two currencies is determined by market conditions, the exchange rate keeps changing day to day. Any change in the exchange rate would impact the revenues and costs of the transacting firm**.** Variability in the revenues or position of a firm due to the change in the exchange rate is known as currency or foreign exchange risk. Any change in the market conditions too will have an impact on the global firms. It would affect their revenues and position. Any variability in the earnings or financial position of a firm due to changes in the demand and supply conditions is known as market risk. Political risk arises due to the impact of change in the political system on the revenues and position of the firm. Country risk arises when the geographical and demographical set up of the country impacts the revenue and position of the firm.

Table 1.2 Forms and Sources of Risk

Type of Risk	**Source of Risk**
Foreign exchange risk / Currency risk	Volatility in exchange rates of currencies
Market risk	Demand and supply factors
Political risk	Political system
Country risk	Demographic profile of the country
Economy risk	Economic factors like interest rates, inflation rates, capital formation etc.

Economy risk arises due to the impact of the economic factors like inflation, interest rates etc on the firms revenue. Of all these foreign currency risk would be the major concern for a finance officer, as it directly affects the revenue. This is known as currency mismatch. Any mismatch has to be managed by converting the currency. Since the exchange rates change according to the demand and supply of that pair of currency, the realized amount on conversion too shall vary. This variation in revenue has to be managed both in long term as well as short term. In international finance parlance, foreign exchange risk thus becomes the major area of concern and focus.

1.4.5 Corporate Governance

According to **Eiteman, Moffett and Stonehill, "**Corporate governance is the process of maintaining a relationship among the stakeholders that is used to determine and control the strategic direction and performance of an organization". A private firm does not have to follow the mandatory requirement of disclosure and the objective of wealth maximization of shareholders. A privately held company does not go public to issue shares. A public company is widely owned ie, they are controlled by a group people who have invested in the company in the form of shares. These people are known as the shareholders. Apart from the shareholders, the firm has to network with its suppliers, customers, bankers and regulatory bodies. The second group of people is generally referred to as stakeholders. A publicly held firm has to strive to maximize the wealth of the shareholders.

1.5 International Financial Management in Indian context

International business started witnessing a sudden spurt in its growth at the global level. This necessitated the development of a robust settlement system. Thus all countries that started globalizing themselves, laid lot of emphasis on improving their financial systems. India's history presents a glorious picture of its astounding presence in the global market as an export-surplus country. However, with its wealth plundered, it had to remain dependent on imports heavily during the pre and post-independence eras. The post independent India saw its economic planning in terms of five year plans. When all these initiatives did not yield the expected results, India went for liberalizing its economy during the year 1991. With liberalizing its policies, India started participating in the global business actively. Due to this, Indian financial system too was restructured. The major reforms were globalization and making the businesses work on a regulated environment from a restrictive one. India's disposition to international trade could be analyzed under the following categories.

1.5.1 Foreign Exchange Market

A forex market becomes a significant factor for every country. India has an evolving foreign exchange market that caters to the needs of the participants. Though evolving, its presence is felt very much in the global arena as an active participant in all activities. Reserve Bank of India is the apex bank of India. The foreign exchange market operates in three tiers. The top tier consists of the RBI and its transactions with various commercial banks. These banks are the authorized dealers of forex market. The second tier consists of transactions across banks that are otherwise known as interbank deals. The third tier consists of transactions between commercial banks and other retailers. The money changers are of two types. Full-fledged money changers are given the powers to both buy and sell foreign exchange where as others are authorized only to buy. Indian export and import transactions are predominantly denominated in US Dollars. So the USD occupies more than 80% of the total foreign exchange transactions.

1.5.2. Balance of Payments

Balance of Payments is a summary of global transactions that have taken place during a particular period. The difference between receipts and payments is known as deficit. India has been witnessing continuous deficit.

1.5.3. Capital Flows

Any foreign individual or company has two options to invest in the Indian market. They can either invest in the company directly or they can invest in the shares of companies which are publicly listed. The former is called as FDI (Foreign Direct Investment or direct foreign investment) while the latter is called as FII (Foreign Institutional Investment or Portfolio Investment). These investors help in increasing the capital flow into the country and thus help in the growth of the country. However an increase in capital and growth of a country result in inflation and hence it is essential to formulate policies that would keep inflation at a check. Studies have shown that the entry of FDI and FII help in the growth of a country and hence it would be essential to have them with certain restrictions.