INTERNATIONAL FINANCE

PART 3

SECTION 6

REVISED KASNEB STUDY TEXT

MARCH 2019

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to analyse and manage investments in the international financial market environment.

17.0 LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Evaluate the operations of international financial markets
- Analyse fixed versus flexible exchange rate regimes
- Apply risk management strategies in international markets
- Justify government intervention in international finance management and international debt crisis
- Assess the role of the multinational corporation in international financial and capital flows
- Analyse the various finance issues related to multinational corporations
- Advise on various ethical dilemmas faced by multinational corporations' managers
- Identify types of country risks and their measurement.

CONTENT

17.1 The environment of international finance

- International finance: Theory of comparative advantage, the theory of factors endowment, product life cycle, globalisation of the world economy, the multinational corporation
- Goals of international finance
- International flow of funds
- The balance of payments: current account, financial account; factors affecting the financial account
- Sources of international finance: rising funds in foreign markets and investments in foreign projects (short term, medium term and long term sources)
- Terms of payments in international trading

17.2 The foreign exchange market

- Function and structure of the foreign exchange market
- Mechanics of foreign exchange: The market for foreign exchange; exchange rates(direct and indirect quotations, cross-rate calculations, bid-ask quotes and spreads, cross-rate calculations with bid-ask spreads), exchange rate determination
- Parity relationship: interest rate parity, purchasing power parity;

international fisher effects

- Forecasting exchange rates
- Indices of currency movements and exchange rate speculation; efficient fundamental and technical approaches to forecasting; forecasting performance and market efficiency; currency betas and consistent forecasts; international arbitrage

17.3 The foreign exchange rates regimes

- Fixed or pegged exchange rate system
- Floating or flexible exchange rate system
- Managed floating exchange rate systems
- Government Intervention in the foreign exchange market
- Deficit finance and exchange rates

17.4 Managing foreign exchange exposure

- Transaction exposure: identification of transaction exposure; hedging (forward, money and options market hedges), limitations of hedging short term exposure, hedging long term exposure, techniques of reducing transaction exposure
- Economic exposure: Measuring economic exposure, managing operating exposures (selecting low cost production sites, flexible sourcing policy, research and development and product differentiation, financial hedging, and diversification of the market)
- Translation exposure: Translation methods, financial accounting standards, hedging translation exposure

17.5 International financial markets

- Motives for world trade and foreign investment
- International financial institutions, the international monetary system, multilateral financial institutions, bilateral financial institution, trade-related investment measures (TRIMS),trading blocks
- International banking and money market: International banking services; capital adequacy standards; banking regulations among countries; international money markets
- International bond and equity markets: Long term financing decisions, foreign bonds, types of instruments, dual currency bonds, bond market credit ratings, market capitalisation (developed and developing countries), market structures, trading practices and costs, equity market benchmarks, trading in international equities

17.6 International financial crisis

- The debt crisis

- Causes and remedies of the international debt crises
- Bank management of loan exposure
- Bank assessment of country risk
- Basel I,II and III requirements

17.7 Foreign direct investments (FDIs)

- Definition of FDI
- Classification of FDI
- Motives for FDI
- Foreign market entry strategies, factors favouring FDI, complexities of FDI, Imperfect markets and foreign direct investments FDI's, benefits of international diversification, the direct foreign investment decision, political risks and foreign direct investments FDI's

17.8 International capital structures and the cost of capital

- Cost of Capital
- Cost of Capital in segmented versus integrated markets
- Comparisons of capital structure across countries
- Cross-border listings of stocks
- Capital asset pricing model (CAPM) under cross-listings
- The effect of foreign equity ownership restrictions
- The financial structure of subsidiaries

17.9 International capital budgeting

- Subsidiary versus parent perspective: translation
- Foreign investment decision process
- Factors to consider in multinational capital budgeting
- The adjusted present value model
- Risk adjustment in capital budgeting analysis
- Divesture analysis; international acquisitions, reducing exposure to host government takeovers

17.10 Multinational cash management

- The size of cash balances, choice of currency
- Cash management systems in practice: bilateral and multilateral netting of internal and external net cash flow
- Transfer pricing and related issues
- Blocked funds, methods used in moving blocked funds
- Factors influencing financing in foreign currencies
- Cash flow analysis for parent/subsidiary, optimisation of cash flows and distortion of subsidiary performance, reduction in precautionary cash

balances, financing with a portfolio of currencies

17.11 The international tax environment

- The objectives of taxation: tax neutrality, tax equity
- Types of taxation: income tax, withholding tax, value-added tax
- National tax environment: worldwide taxation, territorial taxation, foreign tax credit
- Organisational structures for reducing tax liabilities: branch and subsidiary income, tax havens, controlled foreign corporation
- Use of transfer pricing to reduce taxes
- Corporate behaviour and international tax laws
- Multinational corporate policy

17.12 Ethics in the international financial environment

- Ethical dilemmas for multinational corporations (MNC) and its manager
- The Green movement

17.13 Country risk analysis

17.13.1 Country risk characteristics

- Political risk characteristics
- Economic risk characteristics
- Financial risk characteristics

17.13.2 Measuring country risk/ country risk profiling

- Methods or techniques of measuring country risk
- Derivation of country risk rating
- Comparison of country risk rating among different countries
- Decision making process from country risk rating

17.14 Emerging issues and trends

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CHAPTER ONE

THE ENVIRONMENT OF INTERNATIONAL FINANCE

THEORY OF COMPARATIVE ADVANTAGE

The theory of comparative advantage holds that a country has a comparative advantage over another in producing particular goods if it can produce that good at a lower relative opportunity costs.

The theory has the following assumptions:

1. There are no transport costs
2. There are only two economies
3. The two economies are producing only two goods
4. The market is perfect
5. There are no tariffs or trade barriers
6. The factors of production are assumed to be perfectly mobile

FACTOR ENDOWMENT THEORY

The theory holds that countries are likely to be abundant in different types of resources. Countries should strive economically to produce goods and services that require resources they are heavily endowed with e.g. a country with a high ratio of capital to labor will be more efficient at producing computers than it would produce corn.

ASSUMPTIONS

1. There are two countries

2. There are two factors of production: Labor and capital
3. There are no transport costs
4. The demand conditions in both countries are identical
5. There are two goods which are either labor intensive or capital intensive.
6. There is completion in both commodity and factor market

THEORY OF PRODUCT LIFE CYCLE

It consists of the following stages:

a) **Introduction stage**-New product is made at the local market and sold at local market. When there is saturation, it is exported.
b) **Growth stage**-Other people are also producing your product; there are competitors and the product is known all over the world.
c) **Maturity stage**- Industry contracts and concentrates. The lowest cost producer wins
d) **Saturation stage**-A period when the sales of a product both at home and away reach a peak and there is no further possibility of increase .Marketers try to develop new and alternative uses of the product.
e) **Decline stage**- Poor countries constitute the only markets for the products. They act as dumping sites.

AASUMPTIONS

1. The product completes the 5 stages of its life
2. The duration of each stage is fixed or equal
3. There is no reintroduction of the product
4. The product passes through the stages in a chronological order.

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CHAPTER TWO

THE FOREIGN EXCHANGE MARKETS

Physical and institutional structure through which money of one country is exchanged for the other

Foreign exchange means money or foreign currency.

FOREIGN EXCHANGE MARKET PARTICIPANTS

i. Foreign exchange dealers
ii. Speculators
iii. Central banks and Treasuries
iv. Brokers

FUNCTIONS OF FOREIGN EXCHANGE MARKET

1) Exists to provide credit
2) Transfer of purchasing power-Enabling another to have ownership e.g. foreigner buy equity into another country.
3) Acts as a guard against foreign exchange losses

FOREIGN EXCHANGE TRANSACTIONS

a) SPOT

Purchase of foreign exchange with delivery and payment between parties taking place immediately or on the second business day.

Date of transaction is called **value date**

CHAPTER THREE

THE FOREIGN EXCHANGE RATES REGIME

i. Fixed or pegged exchange system
ii. Floating or flexible exchange rate system.
iii. Managing floating rate system.
iv. Government intervention.
v. Deficit finance and exchange rate.

Exchange rates are determined by **demand and supply** of currencies but governments can influence these rates in various ways. The extent and nature of government involvement in the currency market defined alternative ways of exchange rates.

Factors influencing exchange rates

I. Inflation
II. Interest rates
III. Current account/ trade balance
IV. Public debt
V. Political factors.

1. Fixed exchange rate

Rates are held constant and allowed to fluctuate through very narrow ban.

If the rate changes too much, the government through CBK steps to change the rate.

Assume there're are two countries in the world US and UK also assume a fixed exchange rate sy6 and this country trade frequently with each other.

If US experiences higher inflation rate than UK, US consumers should buy more of UK goods while UK goods consumers will reduce their imports of US goods. This reaction could force US production to decrease while unemployment will increase. This would also cause higher inflation in UK due to ***excessive demand of UK goods*** Relative to supply and demand.

NB: This high inflation in US causes high inflation in UK.

Types of fixed exchange rate

1. Crawling peg

The exchange e rate is adjusted periodically according to a set of indicators. The rate of the crew can be set at a pre-announced fixed rate or bellow projected inflation rate.

2. Pegged Within Bands.

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CHAPTER FOUR

MANAGING FOREIGN EXCHANGE EXPOSURE

EXPOSURE

Refers to the degree to which a company is affected by exchange rate.

Exchange rate risk is defined as the variability of a firm value due to uncertain changes in the exchange rate.

TYPES OF EXPOSURE

1. Transaction exposure
2. Translation Accounting exposure
3. Economic exposure
4. Tax exposure

TRANSACTION EXPOSURE

It stems from the possibility of incurring exchange gains/losses on transaction already entered into and denominated in a foreign currency.

E.g. the value of firms cash flow received in various currencies will be affected by the respective exchange rate of these currencies when converted into the home currencies. The degree to which the value of cash transaction can be affected by exchange rate is known as **Transaction Exposure (TE)**

Characteristics of TE

1. Involve real exchange gains/losses

2. Short-term in nature

TE arises because of:

a) Purchasing or selling on credit goods or services nominated in foreign currency.

b) Borrowing or lending funds with repayment made in foreign currency

When TE exists multinational companies faces 3 major tasks;

1. Identify the degree of transaction exposure
2. Decide whether to hedge the exposure
3. Choose a hedging technique

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CHAPTER FIVE

INTERNATIONAL FINANCIAL MARKETS (IFM)

INTRODUCTION

A financial market is where people trade financial securities, commodities and other items of value at low transaction cost and prices that reflect demand and supply.

Financial securities include stocks and bonds while commodities include precious metals and agricultural products.

The term market is sometimes used for what are strictly changes and organization that facilitate trade in financial security e.g. stock or commodity exchange

The markets for financial assets are prevented from complete integration by barriers such as tax differentials, tariffs, labor immobility, and culture difference among others.

MOTIVE OF USING IFM

The motives depend on the parties involved in international financial transactions.

1. Investors-invest in foreign market to take advantage of favorable economic conditions and to reap benefits of international diversification.
2. Creditors – Provide credit in foreign markets, to capitalize on high foreign interest rate and reap the benefits of international diversification
3. Borrowers – borrow in foreign markets to capitalize in lower interest rate and when they expect foreign currencies to depreciate against their own.

International Financial Institutions (IFI) can be defined as institutions that have been established or charted by more than one country hence a subject to international laws.

CHAPTER SIX

INTERNATIONAL FINANCIAL CRISIS

Financial crisis (FC) is a banking crisis, exchange crisis or combination of the two.

It occurs when the banking system is unable to perform its role of intermediation and normal lending.

An exchange rate crisis occurs when there is a sudden ort collapse in the value of a countries currency.

Two sources of financial crisis

1. Crisis caused by macro-economic imbalances such as large budgets
2. Crisis caused by volatile flows of capital in and out of a country.

FC causes a considerable slowdown in the economy of a country.

DEBT CRISIS

It is a general term for a massive public debt relative to tax revenues. Borrowed money is used to finance budget and in some instances enrich a few individuals.

In other cases, the money is used for legit purposes but the financial conditions are beyond government control making loan repayment impossible.

Causes of debt Crisis

1. Continued legacy of colonialism

Third world debt is a history of massive siphoning off by international financial institution of the resources of the most deprived people.

CHAPTER SEVEN

DIRECT FOREIGN INVESTMENT

Direct Foreign Investment (DFI) is an investment made by a company based in one country into a company based in another country.

DFI differ from indirect investments such as portfolio flows where overseas institutions invest in equities listed in a countries stock exchange.

Entities making DFI have significant degree of influence and control over the company into which the investment is made.

Open economies with skilled work forces and good growth prospects, tend to attract large amounts of direct investments.

TYPES OF DFI

1. Horizontal

Occurs if a firm invests in the same industry abroad, in which it operates domestically. E.g. Toyota Japan builds an auto manufacturing in Kenya.

2. Vertical

Occurs if a firm invests in a supply industry abroad where different stages of activities are added abroad.eg Toyota acquiring a tyre manufacture in Kenya.

3. Conglomerate

Occurs where unrelated business is added abroad. It is the most unusual form of DFI as it is attempt to involve two barriers simultaneously i.e. entering a foreign country under new industry .e.g. Toyota Japan producing Unga in Kenya.

THEORY OF HORIZONTAL DFI

Consider a situation of a firm that is deciding how to best service a foreign market. Options:

1. Produce the goods domestically and export in foreign country.
2. Engage in horizontal DFI and produce the goods directly in the foreign country.

Exporting will have the advantage that the form will exploit its planned level economies of scale in its domestic plant.

Horizontal DFI has the advantage that the firm can save on trade cost such as transport or tariffs.

According to this theory, exporting should become more important if they are large economies of scale and less important if there are large trading costs.

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CHAPTER EIGHT

INTERNATIONAL CAPITAL STRUCTURES AND COST OF CAPITAL

COST OF CAPITAL

COC is the cost of funds used for financing a business. It depends on the mode of financing used. It can be referred to as the cost of equity (K_e) if the business is financed solely through equity or the cost of debt (K_d) if the business is financed solely through debt.

Many companies use a combination of debt and equity to finance their business. For such a company their overall cost of capital is derived from a weighted average of all capital.

Weighted average cost of capital (WACC) = $W_e K_e + W_d (1\text{-}t) Kd$

W_e –weight of equity

W_d –weight of debt

T – Tax rate

The COC is the minimum rate of return on investment project must generate in order to pay its financing costs.

WACC is used to represent financing costs for a levered firm.

A firm’s capital consists of equity (retained earnings and funds obtained by issuing stock and debt). The cost of equity reflects the opportunity cost of using retained earnings while the cost of debt reflected in interest expenses.

NB: Firm's want a capital structure that will minimize the cost of capital and hence the required rate of return of projects.

Capital structure decision of subsidiary is influenced by both corporate and country characteristics;

Corporate characteristic

1. Stability of CFs-MNC with more stable CFs can handle more debt
2. Credit risk- MNC that have lower CR have more access to credit
3. Access to retained earnings
4. Guarantee on debt
5. Agency problems

Country characteristics

1. Stock restrictions
2. Interest rates
3. Strength of currencies
4. Country risk
5. Tax laws

COST OF CAPITAL FOR MNC

The cost of capital of MNC differs from that of domestic firms because of the following:

1. Size of the firm

Because of their size, MNC are often given preferential treatment by creditors. This means that they can get more debt at lower interest rates hence low cost of debt.

2. Access to international capital markets

MNC are normally able to obtain funds through international capital markets where the cost of funds may be lower.

3. International diversification

MNC may have more stable cash inflows due to international diversification such that there probability of bankruptcy may be lower.

4. Exposure to exchange rate risk

MNC may be more exposed to exchange rate fluctuations such that their cash flows may be uncertain and their probability of bankruptcy higher.

5. Exposure to country risk

MNC that have a higher percentage of assets invested in foreign countries are more exposed. The capital asset pricing model (CAPM) can be used to assess how rates of return of MNC differ from those of purely domestic firms. According to CAPM

$K_e = R_f + \beta (R_m - R_f)$

K_e – required return on a stock

R_f –Risk free rate

R_m – Market rate

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CHAPTER NINE

INTERNATIONAL CAPITAL BUDGETING

Many large MNC have followed development strategies based on direct investment in foreign countries.

There are various reasons for this;

1. Cost of labor
2. Transport cost
3. Diversification

The efficient allocation of capital is one of the most important functions of finance. It involves decision to commit the firm's long-term funds to long-term investments.

Capital budgeting (CB) involves the allocation of scarce resources (capital and management skills in the most efficient use).Hence maximum returns to investors.

MNC CB focuses on CFs in and out associated with long-term projects.

NOTE

1. Almost any project should earn a cash return equal to the yield available on host government security (bond)
2. MNC should invest only if they can earn a risk adjusted return greater than locally based competitor can earn on the same project.
3. If MNC are unable to earn superior returns on foreign projects their stakeholders will be better buying shares in local firms.

Most firms evaluate foreign projects from both parent and subsidiary view point. Should the CB of a MNC projects be conducted from the view point of the subsidiary that will administer the project or the parent that will provide most of the financing.

The result may vary with the perspective taken because the net after tax CFs in to the parent can differ substantially from those of the subsidiary.

Net CFs difference can be due to;

1. Tax differentials

The parent company needs to consider how earnings remitted from the subsidiary will be taxed in the home country. If the home country levies higher taxes, the projects may seem viable from the subsidiary point of view.

2. Restricted remittances

Consider a subsidiary operating in a country where the government requires that a percentage of earnings remain in the country. Since the parent may never have access, these funds the project will not seem attractive to the parent company. Although it may be attractive to subsidiary.

3. Excessive remittances

INVESTMENT FOREIGN DECISION PROCESS

CB for foreign project uses the same theoretical framework as that of domestic CB. Basic steps are;

1. Identify the initial capital invested (I_o)
2. Estimate the CFs of the project overtime including terminal or salvage value
3. Identify the appropriate discount rate.
4. Apply traditional CB decision criteria such as net present value (NPV)

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CHAPTER TEN

MULTINATIONAL CASH MANAGEMENT

Cash levels are determined independently of the working capital management decision. Cash balances including marketable securities are held partly for day to day transaction and to protect against anticipated variations from budgeted CFs. These two motives are called transaction and precautionary motives.

The main goal is to minimize cash balances without reducing operations or reducing risks.

The optimal size of the cash balances depend upon;

1. Cost of keeping too much cash on hand i.e. opportunity cost of holding cash
2. Cost of not keeping enough cash on hand i.e. trading cost associated with having too little cash.
3. Variability of cash flows

Trading costs increase when the firm must sell securities to meet cash needs.

Multinational cash management (MCM) is a set of activities which consist of;

1. Cash planning –anticipating CFs of future days, weeks, months
2. Cash collection – getting cash into the firm as soon as possible
3. Cash mobilization – moving cash within the firm to the location where needed
4. Cash disbursement – Planning procedures for distributing cash
5. Covering cash shortages – managing anticipated shortages by borrowing locally
6. Investing surplus cash – managing anticipated surpluses by investing locally or controlling them centrally.

CHAPTER ELEVEN

INTERNATIONAL TAX ENVIRONMENT

Taxation is a system that the government uses to collect taxes from people and businesses, based on their income, assets or transaction values. It is administered on a company-by-company basis and calculated on individual subsidiaries' accounts. International taxation presents both threats and opportunities;

- ✓ Structuring of international transactions in the most tax efficient way
- ✓ Avoiding double taxation (double tax treaties)

GENERAL OBJECTIVES OF TAXATION

1. Raise revenue-The government raises revenue through taxation to meet huge public expenditure
2. Economic development – Economic development of any country is largely conditioned by growth of capital formation.
3. Full employment –Since the level of level of employment depends on effective demand, a country desirous of achieving the goal of full employment must cut down the rate of taxes.
4. Price stability –Taxes are regarded an as effective means of controlling inflation. By raising the rate of direct taxes, private spending can be controlled.
5. Reduction of BOP difficulties – Taxes like custom duties are also used to control imports of certain goods with the objective of reducing the intensity of balance of payments difficulties and encouraging domestic production of import substitutes.

Control of cyclical fluctuations –Periods of boom and depression is considered to be another objective of taxation .During depression; taxes are lowered down while during boom taxes are increased so that cyclical fluctuations are tamed.

CHAPTER 12

ETHICS AND ETHICAL DILLEMAS IN INTERNATIONAL BUSINESS

The broad dilemma which include;

i) Operating where ethical standard are weak

ii) Operating where ethical standard are strong

Setting strategies are different in different countries.

HOW MNC CAN DEAL WITH ETHICAL DILLEMAS

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CHAPTER 14

EMERGING ISSUES AND TRENDS

International finance is that branch of financial economics that deals with the monetary or the macroeconomic inter relations between two or more nation states. This field studies the relationships and dynamics that exist in the global financial systems or the international monetary system such as balance of payments, stock exchanges, exchange rates, foreign direct investment as well as international trade. Multi-national organizations hire the experts in international financial management to study the inter-play between the various elements of international finance and accordingly formulate strategies for international business for their organization. It is also referred to as multinational finance, international monetary economics or international macroeconomics.

International trade and related financial activities provide both opportunities and associated risks for investors, exporters and capitalists. By understanding the emerging trends in this field, they can learn how to invest fruitfully in today's environment. The field of international finance has seen a significant growth over the past decade. Some of the recent and emerging trends in this field are as below –

1. **Countries are Re-balancing Their Import Export Trade**
   This trend is visible in the way countries like China are trying to balance their import and export trade. The country's fast growth in the last decade was fueled by

its major dependence on its import and export trade. The country is known for large amounts of export of inexpensive goods all over the globe. This happened at a large scale which was not sustainable. Now China is importing goods in exchange for investment. It is now focusing on producing everything they need for domestic use. This puts the countries that relied on Chinese investment in a spot as they struggle to find comparable markets for their products. In addition, the tariffs imposed on China by US and EU have slowed down its trade and has provided benefits to domestic manufacturers.

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