

# International finance: overview

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## True/False

1. Multinational financial management requires that financial analysts consider the effects of changing currency values.
2. Legal and economic differences among countries, although important, do NOT pose significant problems for most multinational corporations when they coordinate and control worldwide operations and subsidiaries. Comment: Legal and economic differences among countries do affect worldwide operations and subsidiaries.
3. When the value of the U. S. dollar appreciates against another country's currency, we may purchase more of the foreign currency with a dollar.
4. The United States and most other major industrialized nations currently operate under a system of floating exchange rates.
5. Exchange rate quotations consist solely of direct quotations. Comment: Exchange rate quotations consist of direct and indirect quotations.
6. Calculating a currency cross rate involves determining the exchange rate for two currencies by using a third currency as a base.
7. A Eurodollar is a U. S. dollar deposited in a bank outside the United States.
8. LIBOR is an acronym for the London Interbank Offer Rate, which is an average of interest rates offered by London banks to smaller U. S. corporations. Comment: LIBOR is the interest rate offered by the largest and strongest London-based banks on large deposits.

9. Exchange rate risk is the risk that the cash flows from a foreign project when converted to the parent company's currency, will be worth less than was originally projected because of exchange rate changes.
10. Because political risk is seldom negotiable, it cannot be explicitly addressed in multinational corporate financial analysis. Comment: Political risk refers to potential actions by a host government that would reduce the value of a company's investment. It includes at one extreme the expropriation without compensation of the subsidiary's assets, but it also includes less drastic actions that reduce the value of the parent firm's investment in the foreign subsidiary, including higher taxes, tighter repatriation or currency controls, and restrictions on prices charged.

However, companies can take several steps to reduce the potential loss from expropriation:

- (1) finance the subsidiary with local capital
  - (2) structure operations so that the subsidiary has value only as a part of the integrated corporate system
  - (3) obtain insurance against economic losses due to expropriation from a source such as the Overseas Private Investment Corporation
1. Individuals and corporations can buy or sell forward currencies to hedge their exchange rate exposure. Essentially, the process involves simultaneously selling the currency expected to appreciate in value and buying the currency expected to depreciate.

2. If an investor can obtain more foreign currency for a dollar in the forward market than in the spot market, then the forward currency is said to be selling at a discount to the spot rate.
3. If a dollar will buy fewer units of foreign currency in the forward market than in the spot market, then the forward currency is said to be selling at a premium to the spot rate.
4. Foreign currency will, on average, depreciate against the U. S. dollar at a percentage rate approximately equal to the amount by which its inflation rate exceeds that of the United States.
5. The cash flows relevant for foreign investment should, from the parent company's perspective, include the financial cash flows that the subsidiary can legally send back to the parent company plus the cash flows that must remain in the foreign country. Comment: From the perspective of the parent organization, the cash flows relevant for foreign investment analysis are the cash flows that the subsidiary is actually expected to send back to the parent.
6. The cost of capital may be different for a foreign project than for an equivalent domestic project because foreign projects may be more or less risky.
7. When considering the risk of foreign investment, a higher risk might arise from exchange rate risk and political risk while lower risk might result from international diversification.

### Multiple Choice

Which of the following are reasons why companies move into international operations?

- a. To take advantage of lower production costs in regions where labor costs are relatively low.
- b. To develop new markets for the firm's products.
- c. To better serve their primary customers.
- d. Because important raw materials are located abroad.
- e. All of the above.

Multinational financial management requires that

- a. The effects of changing currency values be included in financial analyses.
- b. Legal and economic differences need not be considered in financial decisions because these differences are insignificant.
- c. Political risk should be excluded from multinational corporate financial analyses.
- d. Traditional U. S. and European financial models incorporating the existence of a competitive marketplace not be recast when analyzing projects in other parts of the world.
- e. Cultural differences need not be accounted for when considering firm goals and employee management.

If the inflation rate in the United States is greater than the inflation rate in Britain, other things held constant, the British pound will

- a. Appreciate against the U. S. dollar.
- b. Depreciate against the U. S. dollar.
- c. Remain unchanged against the U. S. dollar.
- d. Appreciate against other major currencies.

- e. Appreciate against the dollar and other major currencies.

In Japan, 90-day securities have a 4% annualized return, and 180-day securities have a 5% annualized return. In the United States, 90-day securities have a 4% annualized return and 180-day securities have an annualized return of 4.5%. All securities are of equal risk, and Japanese securities are denominated in terms of the Japanese yen. Assuming that interest rate parity holds in all markets, which of the following statements is most CORRECT?

- a. The yen-dollar spot exchange rate equals the yen-dollar exchange rate in the 90-day forward market.
- b. the yen-dollar spot exchange rate equals the yen-dollar exchange rate in the 180-day forward market. |
- c. The yen-dollar exchange rate in the 90-day forward market equals the yen-dollar exchange rate in the 180-day forward | market.
- d. The yen-dollar exchange rate in the 180-day forward market equals the yen-dollar exchange rate in the 90-day spot market.
- e. The relationship between spot and forward interest rates cannot be inferred.

Which of the following statements is NOT CORRECT?

- a. Any bond sold outside the country of the borrower is called an international bond.
- b. Foreign bonds and Eurobonds are two important types of international bonds.

- c. Foreign bonds are bonds sold by a foreign borrower but denominated in the currency of the country in which the issue is sold.
- d. The term Eurobond applies only to foreign bonds denominated in U. S. currency.
- e. A Eurodollar is a U. S. dollar deposited in a bank outside the U. S.

23. Currently, a U. S. trader notes that in the 6-month forward market, the Japanese yen is selling at a premium (that is, you receive more dollars per yen in the forward market than you do in the spot market), while the British pound is selling at a discount. Which of the following statements is CORRECT?

- a. If interest rate parity holds, 6-month interest rates should be the same in the U. S., Britain, and Japan.
- b. If interest rate parity holds among the three countries, the United States should have the highest 6-month interest rates and Japan should have the lowest rates.
- c. If interest rate parity holds among the three countries, Britain should have the highest 6-month interest rates and Japan should have the lowest rates.
- d. If interest rate parity holds among the three countries, Japan should have the highest 6-month interest rates and Britain should have the lowest rates.
- e. If interest rate parity holds among the three countries, the United States should have the highest 6-month interest rates and Britain should have the lowest rates.

Today in the spot market  $\$1 = 1.82$  Swiss francs and  $\$1 = 130$  Japanese yen. In the 90-day forward market,  $\$1 = 1.84$  Swiss francs and  $\$1 = 127$

Japanese yen. Assume that interest rate parity holds worldwide. Which of the following statements is most CORRECT?

- a. Interest rates on 90-day risk-free U. S. securities are higher than the interest rates on 90-day risk-free Swiss securities.
- b. Interest rates on 90-day risk-free U. S. securities are higher than the interest rates on 90-day risk-free Japanese securities.
- c. Interest rates on 90-day risk-free U. S. securities equal the interest rates on 90-day risk-free Japanese securities.
- d. Since interest rate parity holds interest rates should be the same in all three countries.