Importance of international finance assignment

Business

I acknowledge Allah Almighty for granting me the health and ability to make this project on time. Then, I give my heartfelt appreciation to my parents who made studying here a possibility by bearing my tuition fees and my teacher who guided me in understanding this topic well enough to make a project on it. In the completion of the project, I owe a heavy debt to my brother Rash Monsoon for helping me with the making of the graphs and charts. Finally, my friends had a huge hand in this for they assisted me in researching the material for it. Preface

This project covers the fundamentals of International Finance, the very basics that a student of Finance should be aware of. It starts with a brief introduction, touches Multinational corporations, defining them and telling their advantages. The project then progresses to Exchange Rates, their different quotation techniques and Foreign Exchange Markets. Futures market, options exchanges and cross rates have been discussed briefly. Further, the main Exchange Rate theories have been described, with their equations and graphs where necessary for a better explanation.

These include; Purchasing Power Parity Theory, Interest Rate Parity, Unbiased Forward Rates and International Fisher Effect. Two methods of international capital budgeting are then highlighted. Subsequently, the sources of international finance have been described and risk is defined. Risk is further classified into short run, long run and translation exposure. Six methods of managing Exchange Rate risk are then included. Then, political and cultural risks, two very significant issues facing firms with international operations, especially Macs, are explained. The means to deal touched upon.

The project includes a glossary and appendices for key equations and some other supplementary concepts to explain a few theories in a better manner. Acronyms ; PEPS: Earnings per Share ; RE: Exchange Rate ; EX.: European Union ; Examining: Export- Import Bank ; FAST: Financial Accounting Standards Board ; FEE: Foreign Exchange ; LAIR: Long Run ; NC: Multinational Company ; SIR: Short Run ; SWIFT: Society for Worldwide Interbrain Financial Telecommunication ; BE: Business finance by Person and Bird ; MM: Fundamentals of Corporate Finance by Bradley, Myers and Marcus Financial management by Timothy J. Gallagher and Joseph D.

Andrew, Jar International Finance by Keith Pliable ; ‘ FM: Introduction to financial management by Charles P. Jones Multinational Finance by Adrian Buckley ; MFC: Multinational financial management by Alan C. Shapiro Fundamentals of Corporate Finance by Stephen A Ross, Randolph W Westfield and Bradford D Jordan Introduction International investments are affected by the same factors that influence domestic investments, with the exception that fluctuating exchange rates leave their mark on the former only. Along with this, language differences, politics and cultures re important determinants in the decision to invest abroad.

International finance explores the influences on international investments, their potential risks and benefits, managing risk, international trade agreements and their effect on business. However, the primary objective of the company is still raising cash by incurring the lowest cost and capital budgeting so that the value of the venture exceeds its cost. Today, we live in a global economy where world trade has increased dramatically, Foreign

Direct Investment plays an important role in the growth of industry in all economies of the world.

It is the development of a new business or acquisition of at least 10 percent interest in a domestic company or tangible asset, by a foreign From a societal viewpoint, it is crucial for the survival of firms to company. [l] streamline themselves enough to be competitive internationally. Otherwise, their business will go to foreign firms offering cheaper output. Learning about the intricacies of international finance is essential to keep a firm from falling prey to takeover bids. Any firm having international dealings, even if it is not a NC, needs to concern itself with international financial management.

International Financial Management is unique primarily because the firm must deal in more than its own currency. [2] A multinational is a corporation that has operations in more than one country. [3] It is also called an International Corporation. It ordinarily consists of 1 parent company and about 6 foreign subsidiaries, typically with a high degree of strategic intervention between them. E. G. The Coca Cola Company is a multinational company, selling in more than 200 countries and having net sales of $7169 million in the 1st quarter of 2009. 4] Financial advantages of foreign operations An overseas market provides a larger market and thus, a potential increase in the sales of the firm’s products. For some corporations, it might mean a fall in production costs if their opening a subsidiary in a country that offers cheap labor, raw materials or machinery. Also, instead of only exporting goods to other nations, once an NC starts operations in another country, the risk of detrimental laws restricting the sales of their

products as well as an increase in the tax on their products, decreases considerably.

Exchange rates and their effects An exchange rate is the expression of the value of one currency in terms of another amounts currency. [5] There are two ways of expressing this value: 1. Direct quotation: Domestic Currency / Foreign Currency 2. Indirect quotation: Foreign Currency/ Domestic currency The two methods are different ways of expressing the same thing. Throughout the project, RE is quoted in direct quotation. Banks in most countries use a system of Foreign Exchange Market and its Fluctuations The volume of international transactions has grown considerably in the past 50-70 years.

Trade and investment of this magnitude would be impossible without the ability to buy and sell currencies. The latter must be done for one currency is not the acceptable means of payment in all countries engaged in trade. The foreign exchange market is one of the largest in the world which facilitates the buying and selling of currencies, whose price is determined by the RE. The market is over-the- counter, I. E. Trade is carried out using computer terminals, telephones, telecoms devices and SWIFT; an international banking communications network that electronically links brokers and traders.

It is not confined to any one country but is dispersed throughout the leading financial centre of the world. Participants The major participants are large commercial banks that trade with one another, channeling most currency transactions through the worldwide interbrain market. Their transactions are conducted through foreign exchange brokers, who specialize in matching net

supplier and demander banks. The brokers charge a brokerage fee and in return, offer anonymity to both parties and minimize the contact of banks with other traders.

Small banks and local offices of major banks have lines of credit with large banks or with the home office. Customers deal with the bank, which then makes use of the line of credit. Other players are brokers, international money centre banks, central banks of many countries, portfolio managers, foreign exchange brokers, hedgers, traders and speculators. Another actor in the market is the arbitrageur, who seeks to earn risk-free profit by taking advantage of difference in interest rates between countries and make use of forward contracts to eliminate RE risk.

If the value of home currency A decreases relative to the value of currency B, A is a weakening or depreciating currency and B is a strengthening or appreciating currency. RE quoted indirectly will fall. For the importers of country A, ore of their home currency is required to purchase goods of country B. The vice versa is true for country B. Therefore, the attractiveness of a country’s goods and services abroad is Judged by the relative values of the currencies of the importing and exporting countries. Types of Transactions 1 .

This eliminates the risk of an unfavorable shift in the RE for it locks in the RE today. In both the spot and the forward markets, quotes are given in pairs for a dealer is unaware of whether a person is in the market for buying or selling currency. The first rate is the buy, or bid price; the second is the sell, or ask, or offer rate. The bid-ask parade or the transaction cost, is the spread

between bid and ask rates for a currency. The less heavily traded currencies, and currencies having greater volatility, have greater spreads.

Also, the forward currency spreads are usually larger than spot spreads. If it is more expensive to buy currency A with currency B in the forward market than it is in the spot market, it is selling at a premium relative to currency B. The latter is selling at a discount. Currency A has appreciated relative to the spot rate and is the stronger currency. The forward premium, if RE is quoted as (Currency A/ Currency B) is: Spot Rate – Forward Rate Forward Rate Futures Market It is an organized market for future delivery of currencies.

Futures contracts are highly standardized versions of forward contracts. [9] Their advantage to both parties is that they are low cost. If one buys a forward or futures contract, he/ she is committed to taking delivery of the currency. There are however, some important differences between futures and forward contracts. The futures market is regulated and that for forward contracts is self-regulatory. Also, forward contracts maybe designed as to time and amount, but futures, which are generally smaller, are denaturized, not offering such flexibility.

Another important distinction is the daily curbs on the price variations of futures, which is not the case for forward contacts. Also futures are denominated only in the major currencies. Options Exchanges In these exchanges, standardized options are traded. An option is the right, but not the obligation, to buy (for a call option) or sell (for a put option) a specific amount of a given currency at a specified price (the strike price) during a

specified period of time. [10] As protection, options can guard against price fluctuations in the near term