

International financial management

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Preprint / Preprint

Arbeitspapier / working paper

Empfohlene Zitierung / Suggested Citation:

Arif, M. (2008). *International financial management*. . <https://nbn-resolving.org/urn:nbn:de:0168-ssoar-34187>

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INTERNATIONAL FINANCIAL MANAGEMENT

A Business grow, so does their awareness of opportunities is foreign market, initially, they may merely attempt to export a product to a particular country or import supplier from a foreign manufacturer.

An understanding of International Financial Management is crucial to not only the large MNCs with numerous foreign subsidiaries, but also to the small business engaged in Exporting or Importing. Seventy Eight percent of the 43,300 U.S. firms that Export have been then 100 employees. International business is even important to companies that have no intention of engaging in International Business.

Which companies must recognized how their foreign competition will affected by movements in Exchange Rates, Foreign Interest rates, Labour Costs, and Inflation. Such economic characteristics can affect to foreign competitors cost of production and pricing policy.

MNCs have significant foreign operation driving a high percentage of their sales overseas financial manages of MNCs must understanding the complexities of International finance so that they can make sound financial and Investment decision.

" Managing working capital, financing the business, assessing control of foreign Exchange and political risks and evaluating foreign direct Investment."

INTERNATIONAL FINANCIAL MANAGEMENT DIFFERENT
FROM THE DOMESTIC FINANCIAL MANAGEMENT

- 1- The worldwide scale of operations makes the information requirements greater.
- 2- The Communications, planning, control and coordination needs are also greater.
- 3- Different currencies are involved and their relationship change with changing economic, financial and political developments.
- 4- The cultural, social and political factors are different in various countries of the world; adoption to their different Environments requires that firms have different rules for different parts of their operation.
- 5- The problems of measurement of performances are complicated by the different circumstances of Individual foreign subsidiaries.
- 6- The terms and conditions of financial and Its availability are subject to continuous change, presenting new opportunities and risks.
- 7- The proper balance between centralization and decentralization of strategies, policies and operation is more difficult to achieve in International operation.

BALANCE OF PAYMENTS

A Country's balance of payments is commonly defined as the record of transaction between residents and foreign residents over a specific period. Each transaction is recorded in accordance with the principles of double entry bookkeeping, meaning that the amount involved in each transaction is interned on each of the two sides of the balance of payment account. Consequently the sum of the two sides of the complete balance of the payments accounts should always be the same. And in their sense the balance of payment always balance.

"The Balance of payments is measurement of all transaction between domestic and foreign residents over a specified period of time. The use of word "all transaction" can be some what misleading, since transaction may be estimated the recorded transaction is done by double entry book-keeping."

However, there is no keeping requirement that the sums of the two sides of a selected numbers of balance of payments accounts should be the same, and It happens that the (IM) balance shown by certain combination of accounts are considerable interest to analyst and government officials. It is those balances that are often referred to as "surplus" or "deficit" in the Balance of payments.

COMPONENTS OF THE BALANCE OF PAYMENTS

The BOP is a collection of accounts conventionally grouped into three main categories with subdivisions in each. The three main categories are :-

- (A) **The Current Account** : Under this are included import and exports of goods and services and unilateral transfer of goods and services.
- (B) **The Capital Account** : Under this are grouped transaction leading to changes in foreign financial assets and liabilities of the country.
- (C) **The Reserve Account** : In principles this no different from the capital Account and such as It also relates to financial assets and liabilities. However, In this categories only " Reserve Assets" are included those are assets which the monetary authority of the country uses to settle the deficits and surplus that arise on the other two categories taken together.

GLOBAL FINANCIAL MARKET

The last two decades have witnessed the emergence of a vast financial Market Stranding national boundaries enabling massive cross-border Capital flows from those who have surplus funds and are in search of high returns to those seeking low cost funding.

Due to growth in International Business over the last 30 years, various International financial Market have been developed. The five widely used International financial markets are :-

- 1- Eurocurrency Market.
- 2- Eurocredit Market
- 3- Eurobond Market
- 4- International Stock Market
- 5- Foreign Exchange Market

- 1- **EUROCURRENCY MARKET** : The Eurocurrency market is composed of several large bank (sometimes referred to as Euro banks) that accepted deposit and provide loan in various currencies. Countries within the organization of Petroleum Exporting countries (OPEC) also use the Eurocurrency market to deposit a portion of their Petroleum revenues. The deposit usually have been denominated in U.S. Dollar, since OPEC generally requires payment for Oil in dollar. Those dollar deposit by OPEC countries are sometimes referred to as Petro dollars.

Eurocurrency market transaction normally represent large deposits and loans, often the equivalent of \$ 1 million or more large financial transaction such as these can reduce operating expense for bank. This is another reason why Euro banks can offer attractive rates on deposit and loans. Because the deposit and loan size is large, the Eurocurrency market is primary used by government and large firms.

When a currency is deposited in or loaned from a Eurobank, It is often described with a "Euro" prefix attached to it for example a loan in Swiss Francs by a Eurobank is referred to as a "Euro - Swiss Franc" loan, while a deposit of Japanese Yen in Euro Bank is called a "Euroyen" deposit. One Eurocurrency is somewhat representative of that currency's rates in its home country. That is the Eurodollar loan rate may be slightly less than a similar dollar in the U.S.

- 2- **EUROCREDIT MARKET** : Loans of one years or longer extended by the Eurobanks are commonly called Eurocredit or Eurocredit Loans. Such loans in the Eurocredit Market have become popular since corporations and government agencies often desire to borrow for a terms exceeding one year and a common maturity for Eurocredit loan is five years. Eurobanks now commonly use floating rates Eurocredit loans. The loans rates floats in accordance with the movement of some market interest rate, such as London Interbank

offer rate (LIBOR), which is the rate commonly charged for loans between Eurobanks.

- 3- **EUROBOND MARKET** : While the Eurocurrency and Eurocredit loan help accommodate short and medium term borrower, International bond markets accommodate the long term borrowers . International bond are typically classified as either foreign bonds or Eurobonds. A Foreign bond is issued by a borrower foreign to the country where the bond is placed.

Eurobonds are sold in countries other than the country represented by the currency denominating them.

Eurobonds are underwritten by Multinational syndicate of Investment Bank and simultaneously placed in many countries, providing a wide spectrum of fund source to tap. Eurobonds have several distinguish feature. They usually are issued in bearer form, and coupon payment are made yearly.

- 4- **INTERNATIONAL STOCK MARKET** : New Issue of stock are increasingly being floated in International markets for a variety of reasons. Non U.S. corporations that need large amounts of funds will sometime issue the stock in the United States due to the liquidity of the new issue market there. That is a foreign corporation may be more likely to sell on entire issue of stock in the U.S. market, whereas in other, smaller markets, the entire issue may not necessarily sell.

While the value of new stock issued in the United States by foreign corporations is still somewhat small. It could become much large over time.

The locations of the MNC's operation can influence the decision of where to place stock, as the MMCs may desire a country where It is likely to generate enough future cash flow to cover dividend. The stock of some U.S. based MNCs are widely traded on numerous stock exchange of some the world.

For Exm. : The stock of Coca Cola Company is traded on six stock exchange in United States, the German Exchange in Frankfurt and four stock exchange in Switzerland.

What " Foreign Exchange" Means

"Foreign Exchange" refers to money denominated in the currency of another nation or group of nations. Any person who exchange money denominated in his own nation's currency for money denominated in another nation's currency acquires foreign exchange.

Foreign Exchange Market

The foreign exchange market is the market in which currencies are bought and sold against each other. It is the largest market in the world. The most recent study of BIS States that over USD \$ 1.8 trillion turnover a day.

The U.S. Govt. securities market to worlds second largest market. Turnover is equivalent to more than \$ 200 in foreign exchange market transaction.

The Quoted price change as often as 20 times a minutes. It has estimated that the worlds most active exchange rates can change up to 18000 times during a single day.

INSTRUMENT OF FOREIGN EXCHANGE MARKET

Different types of Instrument usage in foreign exchange market for transaction of currencies, these are :-

- (1) Spot Transaction
- (2) Forward Transaction
- (3) Future Transaction
- (4) Swap Transaction
- (5) Option Transaction

1- **SPOT TRANSACTION** : A Spot transaction is most common types of foreign exchange transaction is for immediately exchange at the so called Spot rate.

A Spot Transaction is a straight forward (or "outright") exchange of one currency for another.

A Spot rate is the current market price, the benchmark price.

2- **FORWARD TRANSACTION** : Forward contract for the purchasing or selling of currencies in future periods when MNCs anticipated future need or future receipt of a foreign currency they can set up forward contract to lock the rate at which they can purchase or sell a particular currency.

3- **FUTURE TRANSACTION** : Are contract specifying standard value of a particular currency to be exchange on a specific settlement date. They are similar to forward contract in that they allow one to lock in

the price to be paid for given currency at a future point in time. Yet their characteristics different from forward rate. They are traded face to face transaction require a trading floor. Which is provided by International Money Market.

4- **SWAP TRANSACTION** : Swap means trades of assets and liabilities in different currencies or interest rate structure to loosen risks or lower costs. It is another market, one currency is swapped for another for a period of time and then swapped back, creating an exchange and re-exchanging.

5- **OPTION TRANSACTION** : A Foreign Exchange or currency option contract given the buyer the right, but not obligation to buy or (sell) a specified amount of one currency for another at specified price on a specified date. There are two types option contract.

A "Call" Option is the right but not obligation to buy the underlying currency and "Put" option is the right but not obligation to sell the underlying currency.

FOREIGN EXCHANGE RATE DETERMINATION

Firms that conduct International business must continuously monitor exchange rates because their cash flow are highly depended on them.

In simple terms, It is the Interaction of supply and demand factor for two currencies in the market that determines the rate at which they trade. But what factors influence the many thousand of decision made each day to buy or sell a currency.

Some Approaches to Exchange rate Determination

The condition under which the actual rate of exchange between the two currencies to determined vary widely under different monetary system. The important theories which explain as to how the exchange rate determination are :

- 1- Mint par theory
 - 2- Balance of trade theory
 - 3- Balance of payment theory
 - 4- Purchasing Power parity theory
- (1) **MINT PAR THEORY** : It two countries are on gold standard, the rate of exchange will determine by the "Mint Par" i.e. the gold contract of two currencies. A country is said to be on gold standard.
- (i) It Its monetary authority, usually the central bank is committed to a policy of buying all gold offered to I and selling all gold demanded from It is unlimited quantities at a specified rate.

- (ii) When there is a no restriction the export and import of gold and
- (iii) Its currency consist of gold coins is fully convertible into gold.

The Mint Par of exchange can be calculated by comparing the metallic content or the currencies of two currencies in other words.

The rate of exchange depends on the quantity and purity of gold contained in each currency.

- (2) **BALANCE OF TRADE THEORY** : The rate of Exchange is of one currency in terms of another like other price, the rate of exchange also depends on demand and supply of currency in terms of another. In actual practice.

- (3) **BALANCE OF PAYMENT THEORY** : The trade of exchange is not only influenced by the imports and exports of goods. There are invisible items such as services, tourist, traffic etc. which must also be considered to determine the supply and demand of foreign currency. All payments made by foreign to resident of the country are known or "Credit" and all the payment made by the residents to the foreigners are known are "debits". The different between total debits and total credit over a given period is known as balance of payment.

- (4) **PURCHASING POWER PARITY THEORY (PPP)** : According to Gustav Cassel, the rate of Exchange, when exchange rates are free to fluctuates, between two currencies in the long run, will be determined by them respective purchasing power. It can also be taken

as the exchange rate between one currency and another is in equilibrium. Where their domestic purchasing power at the rate of exchange are equivalent.

For Exm. assume a particular items of goods in India costs Rs. 44.50 and that the same in the U.S.A cost \$ 1. The exchange rate will be in equilibrium, if It is \$ 1 = Rs. 44.50. Then It is depends upon on exchange relatively inflation.

It there is a change in the price (i.e. the purchasing power of the currencies), the new equilibrium rate of exchange may be determine with the help of the following formula :-

$$E_R = E_r \times \frac{P_d}{P_f}$$

Where ,

E_R = Equilibrium exchange rates

E_r = Exchange rates in the reference period

P_d = Domestic price Index

P_f = Foreign country's price Index.

Information :

This paper is only my personal occasional educational paper. If any correction or fault on this paper then contact me.

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