

Quadrant II - Notes

Course Code: COG 140

Module Name: International Financial Management Meaning, forms of Financial Capital.

Module No: 06

INTERNATIONAL FINANCIAL MANAGEMENT

The main objective of international financial management is to maximise shareholder wealth. This would require making sound investment and financing decisions that would result in adding value to the firm. One of the main reasons for focusing on shareholder wealth is that the companies who do not do so may be taken over by others. If the shareholder wealth is maximized or, in other words, if share price is made to go up hostile takeover becomes difficult and costly. Also, it becomes easier for a company to attract additional capital from the investors if it cares for increasing shareholder wealth. Companies which create more value will have more money to distribute to all stakeholders not only shareholders-be they employees, managers or other beneficiaries in the society. It has been argued, and very rightly so, that maximizing shareholder wealth is not the best way but the only way to benefit all stakeholders.

Traditionally financial management is separated into two basic functions. The first is concerned with acquisition of funds, also known as financing decision. This function involves generating funds from internal as well as external sources.

The effort is to get funds at the lowest cost possible. The second, that is, investment decision is concerned with deployment of the acquired funds in a manner so as to maximize shareholder wealth. Other decisions relate to dividend payment, working capital and capital structure etc. In addition, risk management involves both financing and investment decision.

A finance manager in an MNC faces many challenges that his counterpart in a domestic firm does not encounter. These challenges include political risks leading to expropriation or confiscation of assets, exchange rate risk, control on repatriation of profits, different tax laws, multiple money markets and different interest rates etc. MNCs and their financial managers have to be abreast with the changes taking place all the time and develop ways to take advantages of the changes while reducing risks that these changes create. They have operations in different countries. This gives them opportunity to access segmented capital markets to lower their overall cost of capital. They can shift profits to lower the tax outflows. They have ability to move people, money and material on a global basis to derive the maximum advantage out of these resources- They are able to practise the economic adage, "do not put all your eggs in one basket". International diversification of markets and production facilities reduces their risk. Operating globally gives MNCs continuous access to information on the latest process technologies and latest R&D activities of their competitors. They are able to access world's capital markets and thus diversify their funding sources.

International finance manager has to analyze and balance international risks and advantages. Some of the key challenges he must be prepared to face are listed here under:

- (i) To understand the interrelationship between environmental changes and corporate response. For example, how will the credit conditions be impacted by stock market crash? How will defaults by some debtor countries affect funding ability in the international capital market?
- (ii) To understand the development and use of new instruments such as options, forwards futures and swaps for effective management.
- (iii) To develop ways to minimize risks through internal and external techniques.
- (iv) To take a balanced view of successes and failures, treating them as experiences to learn from. Decisions such as taking loan in a currency that has started appreciating fast, taking a fixed rate financing when rates have started going down will have an adverse impact and impel finance manager to contain the damage to the extent possible.

International financial management will involve the study of

- (a) exchange rate and currency markets,
- (b) theory and practice of estimating future exchange rate,
- (c) various risks such as political/country risk, exchange rate risk and interest rate risk,
- (d) various risk management techniques,
- (e) cost of capital and capital budgeting in international context,
- (t) working capital management,
- (g) balance of payment, and
- (h) international financial institutions etc.

FINANCIAL FLOWS TO DEVELOPING COUNTRIES

Different type of capital flows to the developing countries are as follows:

Bond finance: The developing countries government can issue bonds to foreign investors with a guaranteed rate of interest depending on maturity date of the bond and the currency in which it is denominated. If the bond is in domestic currency it entails an 'Inflation risk' and if it is in foreign currency the "default risk is associated with the bond."

Bank finance: Developing countries government can borrow from commercial banks in form of syndicated loans at variable as fixed rate of interest. The reference interest rate is (\$ LIBOR), this is the rate at which banks in London lend dollar to one another. Loans to developing countries are normally expressed as margin over dollar LIBOR.

Foreign Direct Investment: Developing countries can also increase capital flows through Foreign Direct Investment. Foreign direct investment can be either in form of green field project, brown field acquisition, merger and amalgamations etc.

Official flows: Apart from private flows the capital flows can occur through official channels also in the form of grants, aids and loans from IMF, world bank and other multilateral donor agencies. The world gross domestic product (GDP) grew by an estimated 3.8 percent in 2004. The long term interest rates are low in most advanced and developing countries. The GDP growth of developing countries was 6.6 percent in 2004 (much higher than the global average). Some of the major highlights of capital flows to the developing countries in recent years are as follows.

i.) The increase in capital flows to the developing countries over the past few years. coincide with the developing countries improvement in their current account balances. Developing countries continue to export capital (mostly to the United States) in the form of rapidly growing accumulation of foreign reserves,

ii.) Foreign direct investment to developing countries have become increasingly concentrated, whereas FDI outflows from developing countries have increased.

iii.) Most developing countries have restructured their debts.

iv.) Strong private capital flows have enabled developing countries to repay loans taken from bilateral and multilateral creditors picture of financial flows to developing countries.

v.) Official flows (Credit by World Bank, IMF) has been gradually shifting from loans to grants.

FORMS OF INTERNATIONAL FINANCIAL FLOWS:

The various types of transactions leading to international financial flows need some discussion here. Trade flows, invisibles, foreign direct and portfolio investment, external assistance and external commercial borrowings and some short-term flows

Merchandise Trade Flows

Trade may be related to goods. Alternatively, it may be related to services. The merchandise trade has two sides. While one is export, the other is import. If India exports various goods, it will get convertible currencies and that will be an inflow of funds. On the contrary, it has to make payments in convertible currencies for the imports it makes. Thus export and import of goods lead to international financial flows.

Invisibles

Invisible include, broadly, trade in services, investment income and unilateral transfers. If an Indian shipping company carries goods of a

foreign exporter/importer and gets the freight charges, it will be treated as inflow of funds on account of trade in services. Similarly, if a foreign shipping company carries goods of an Indian exporter, there will be outflow of funds in form of freight charges. There are many examples of international flow of funds on account of trade in services. Investment income relates to the receipt and payment of dividend, technical service, fees, royalty, interest on loan, etc. A foreign company operating in India remits dividend, etc. to its home country that will represent an outflow of funds. Similarly, an Indian company operating abroad remits to India the dividend and other fees that will represent inflow of funds. Likewise, payment of interest on foreign borrowings represents outflow of funds. Any receipt of interest manifests in inflow of funds.

Unilateral transfers are unidirectional. They represent international financial flows without any services rendered. If an Indian makes a gift to his/her friend in England, it will be a case of outflow of funds on account of unilateral transfer. Similarly, a large number of Indians living abroad remit a part of their income to their family members living in India. This is a case of inflow of funds on account of unilateral transfer.

Foreign Investment

Foreign investment may be of two kinds. While one is direct, the other is portfolio. Foreign direct investment (FDI) occurs when a firm moves abroad for the production of goods or provision of services and participates in the management of that company located abroad. On the contrary, foreign portfolio investment (FPI) is not at all concerned with the production of goods and rendering of services. The sole purpose of a foreign portfolio investor is to earn a return through investment in foreign securities without any intention of grabbing the voting power in

the company whose securities it purchases. In case of FDI too, an investor invests in the shares of a foreign company, but the sole objective is to enjoy the voting power and thereby a say in the management of the foreign company. Thus, it is primarily the voting right that differentiates between FDI and FPI. Whatever the forms may be, inflow of funds occurs when a foreign investor makes investment in the country. On the contrary, outflow of funds occurs when the domestic investor invests in a foreign country.

External Assistance and External Commercial Borrowings

External assistance and external commercial borrowings are different in the sense that while the former flows normally from an official institution -bilateral or multilateral, the latter flows from international banks or other private lenders. The rate of interest in the former is usually low along with a longer maturity period. The latter carries market rate of interest and a shorter maturity. Last but not least, external assistance is manifest often in outright grant that does not require repayment of principal/interest payment.

Whatever may be the difference between the two, any borrowing from abroad is treated as inflow of funds. Lending abroad, on the other hand, represents outflow of funds. However, repayment of loans is treated just the other way,

Short-term Flow of funds

Normally loans and foreign direct investment are meant for a period exceeding one year but there are financial flows that occur for less than a year. Movement of funds relating to banking channels, euro notes, speculative and arbitrage activities, etc. are the examples of short-term funds that move across countries.