International Financial Management

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Abstract

Why do we need to study "international" financial management? The answer to this question is straightforward: We are now living in a highly globalized and integrated world economy. American consumers, for example, routinely purchase oil imported from Saudi Arabia and Nigeria, TV sets and camcorders from Japan, Italy, and wine from France. Foreigners, in turn, purchase American-made aircraft, software, movies, jeans, wheat, and other products. Continued liberalization of international trade is certain to further internationalize consumption patterns around the world.

Keywords: Foreign exchange risk, Political risk and Market imperfections.

INTRODUCTION:

Financial management is mainly concerned with how to optimally make various corporate financial decisions, such as those pertaining to investment, capital structure, dividend policy, and working capital management, with a view to achieving a set of given corporate objectives. In Anglo-American countries as well as in many advanced countries with well-developed capital markets, maximizing shareholder wealth is generally considered the most important corporate objective.

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Recently, financial markets have also become highly integrated. This development allows investors to diversify their investment portfolios internationally. In the words of a recent Wall Street Journal article, "Over the past decade, US investors have poured buckets of money into overseas markets, in the form of international mutual funds. At the same time, Japanese investors are investing heavily in US and other foreign financial markets in efforts to recycle their economous trade surpluses. In addition, many major corporations of the world, such as IBM, DaimlerBenz (now, Daimler Chrysler), and Sony, have their shares cross-listed on foreign stock exchanges, thereby rendering their shares internationally tradable and gaining access to foreign capital as well. Consequently, Daimler-Benz's venture, say, in China can be financed partly by American investors who purchase Daimler-Benz shares traded on the New York Stock Exchange.

During last few decades a rapid internationalization of business has occurred. With the increase in demand of goods and services due to opening of borders of countries around world, the requirement of capital, 3 machinery and technological know-how has reached to the topmost level. Now no single country can boast of self-sufficiency because in a global village a vast population of multidimensional tastes, preferences and demand exists. Undoubtedly, we are now living in a world where all the major economic functions- consumption, production, and investment– are highly globalized. It is thus essential for financial managers to fully understand vital international dimensions of financial management. In order to cater to needs/demand of huge world population, a country can engage itself in multi trading activities among various nations. In the post WTO regime (after 1999 onwards), it has became pertinent to note that MNCs (Multinational corporations) with their world-wide production and distribution activities have gained momentum. An understanding of international financial management is quite important in the light of changes in international environment, innovative instruments and institutions to facilitate the international trading activities. Classical theory of trade assumes that countries differ enough from one another in terms of resources endowments and economic skills for these differences to be at the centre of any analysis of corporate competitiveness.

Now there is free mobility of funds, resources, knowledge and technology which has made international trade more dynamic and complex. Capital moves around the world in huge amount; corporations are free to access different markets for raising finance. There exists an international competitiveness in different areas of trade and commerce. The enormous opportunities of investments, savings, consumption and market accessibility have given rise to big institutions, financial instruments and financial markets. Now a days an investor in USA would like to take investment opportunity in offshore markets. The trade off between risk of investing in global markets and return from 4 these investments is focussed to achieve wealth maximisation of the stakeholders. It is important to note that in international financial management, stakeholders are spread all over the world.

NATURE AND SCOPE OF INTERNATIONAL FINANCIAL MANAGEMENT

Like any finance function, international finance, the finance function of a multinational firm has two functions namely, treasury and control. The treasurer is responsible for financial planning analysis, fund acquisition, investment financing, cash management, investment decision and risk management. On the other hand, controller deals with the functions related to external reporting, tax planning and management, management information system, financial and management accounting, budget planning and control, and accounts receivables etc.

For maximising the returns from investment and to minimise the cost of finance, the firms has to take portfolio decision based on analytical skills required for this purpose. Since the firm has to raise funds from different financial markets of the world, which needs to actively exploit market imperfections and the firm's superior forecasting ability to generate purely financial gains. The complex nature of managing international finance is due to the fact that a wide variety of financial instruments, products, funding options and investment vehicles are available for both reactive and proactive management of corporate finance.

Multinational finance is multidisciplinary in nature, while an understanding of economic theories and principles is necessary to estimate and model financial decisions, financial accounting and management accounting help in decision making in financial management at multinational level.

Because of changing nature of environment at international level, the knowledge of latest changes in forex rates, volatility in capital market, interest rate fluctuations, macro level charges, micro level economic indicators, savings, consumption pattern, interest preference, investment behaviour of investors, export and import trends, competition, banking sector performance, inflationary trends, demand and supply conditions etc. is required by the practitioners of international financial management.

Distinguishing features of international finance

International Finance is a distinct field of study and certain features set it apart from other fields. The important distinguishing features of international finance from domestic financial management are discussed below:

- **Foreign exchange risk**

An understanding of foreign exchange risk is essential for managers and investors in the modern day environment of unforeseen changes in foreign exchange rates. In a domestic economy this risk is generally ignored because a single national currency serves as the main medium of exchange within a country. When different national currencies are exchanged for each other, there is a definite risk of volatility in foreign exchange rates. The present International Monetary System set up is characterised by a mix of floating and managed exchange rate policies adopted by each nation keeping in view its interests. In fact, this variability of exchange rates is widely regarded as the most serious international financial problem facing corporate managers and policy makers.

At present, the exchange rates among some major currencies such as the US dollar, British pound, Japanese yen and the euro fluctuate in a totally 6 unpredictable manner. Exchange rates have fluctuated since the 1970s after the fixed exchange rates were abandoned. Exchange rate variation affect the profitability of firms and all firms must understand foreign exchange risks in order to anticipate increased competition from imports or to value increased opportunities for exports.

- **Political risk**

Another risk that firms may encounter in international finance is political risk. Political risk ranges from the risk of loss (or gain) from unforeseen government actions or other events of a political character such as acts of terrorism to outright expropriation of assets held by foreigners. MNCs must assess the political risk not only in countries where it is currently doing business but also where it expects to establish subsidiaries. The extreme form of political risk is when the sovereign country changes the ‘rules of the game’ and the affected parties have no alternatives open to them. For example, in 1992, Enron Development Corporation, a subsidiary of a Houston based energy company, signed a contract to build India’s longest power plant. Unfortunately, the project got cancelled in 1995 by the politicians in Maharashtra who argued that India did not require the power plant. The company had

spent nearly $ 300 million on the project. The Enron episode highlights the problems involved in enforcing contracts in foreign countries. Thus, episode highlights the problems involved in enforcing contracts in foreign countries. Thus, political risk associated with international operations is generally greater than that associated with domestic operations and is generally more complicated.

- **Expanded opportunity sets**

When firms go global, they also tend to benefit from expanded opportunities which are available now. They can raise funds in capital 7 markets where cost of capital is the lowest. In addition, firms can also gain from greater economies of scale when they operate on a global basis.

- **Market imperfections**

The final feature of international finance that distinguishes it from domestic finance is that world markets today are highly imperfect. There are profound differences among nations' laws, tax systems, business practices and general cultural environments. Imperfections in the world financial markets tend to restrict the extent to which investors can diversify their portfolio. Though there are risks and costs in coping with these market imperfections, they also offer managers of international firms abundant opportunities.

GOALS FOR INTERNATIONAL FINANCIAL MANAGEMENT

The foregoing discussion implies that understanding and managing foreign exchange and political risks and coping with market imperfections have become important parts of the financial manager's job. International Financial Management is designed to provide today's financial managers with an understanding of the fundamental concepts and the tools necessary to be effective global managers. Throughout, the text emphasizes how to deal with exchange risk and market imperfections, using the various instruments and tools that are available, while at the same time maximizing the benefits from an expanded global opportunity set.

Effective financial management, however, is more than the application of the newest business techniques or operating more efficiently. There must be an underlying goal. International Financial Management is written from the perspective that the fundamental goal of sound financial management is shareholder wealth maximization. Shareholder wealth 8 maximization means that the firm makes all business decisions and investments with an eye toward making the owners of the firm– the shareholders– better off financially, or more wealthy, than they were before.

Whereas shareholder wealth maximization is generally accepted as the ultimate goal of financial management in 'Anglo-Saxon' countries, such as Australia, Canada, the United Kingdom, and especially the United States, it is not as widely embraced a goal in other parts of the world. In countries like France and Germany, for example, shareholders are generally viewed as one of the 'stakeholders' of the firm, others being employees, customers, suppliers, banks, and so forth. European managers tend to consider the promotion of the firm's stakeholders' overall welfare as the most important corporate goal. In Japan, on the other hand, many companies form a small number of interlocking business groups called keiretsu, such as Mitsubishi, Mitsui, and Sumitomo, which arose from consolidation of family- owned business

empires. Japanese managers tend to regard the prosperity and growth of their keiretsu as the critical goal; for instance, they tend to strive to maximize market share, rather than shareholder wealth

Obviously, the firm could pursue other goals. This does not mean, however, that the goal of shareholder wealth maximization is merely an alternative, or that the firm should enter into a debate as to its appropriate fundamental goal. Quite the contrary. If the firm seeks to maximize shareholder wealth, it will most likely simultaneously be accomplishing other legitimate goals that are perceived as worthwhile. Share-holder wealth maximization is a long-run goal. A firm cannot stay in business to maximize shareholder wealth if it treats employees poorly, produces shoddy merchandise, wastes raw materials and natural resources, operates inefficiently, or fails to satisfy customers. Only a wellmanaged business firm that profitably produces what is demanded in an 9 efficient manner can expect to stay in business in the long run and thereby provide employment opportunities.

Shareholders are the owners of the business; it is their capital that is at risk. It is only equitable that they receive a fair return on their investment. Private capital may not have been forthcoming for the business firm if it had intended to accomplish any other objective.

EMERGENCE OF GLOBALIZED FINANCIAL MARKETS AND MNCS

The 1980s and 90s saw a rapid integration of international capital and financial markets. The impetus for globalized financial markets initially came from the governments of major countries that had begun to deregulate their foreign exchange and capital markets. For example, in 1980 Japan deregulated its foreign exchange market, and in 1985 the Tokyo Stock Exchange admitted as members a limited number of foreign brokerage firms. Additionally, the London Stock Exchange (LSE) began admitting foreign firms as full members in February, 1986.

Perhaps the most celebrated deregulation, however, occurred in London on October 27, 1986, and is known as the "Big Bang." On that date, as on "May Day" in 1975 in the United States, the London Stock Exchange eliminated fixed brokerage commissions. Additionally, the regulation separating the order-taking function from the market-making function was eliminated. In Europe, financial institutions are allowed to perform both investment-banking and commercial-banking; functions. Hence, the London affiliates of foreign commercial banks were eligible for member-ship on the LSE. These changes were designed to give London the most open and competitive capital markets in the world. It has worked, and today the competition in London is especially fierce among the world's major financial centers. The United States recently repealed the Glass-Steagall Act, which restricted commercial banks from 10 investment banking activities (such as underwriting corporate securities), fur-ther promoting competition among financial institutions. Even developing countries such as Chile, Mexico, and Korea began to liberalize by allowing foreigners to directly invest in their financial markets.

Deregulated financial markets and heightened competition in financial services provided a natural environment for financial innovations that resulted in the intro-duction of various instruments. Examples of these innovative instruments include, currency futures and options, multicurrency bonds, international mutual funds, country funds, and foreign stock index futures and options. Corporations also

played an active role in integrating the world financial markets by listing their shares across national treasury hard-currency foreign reserves. The sale proceeds are often used to pay down sovereign debt that has weighed heavily on the economy. Additionally, privatization is often seen as a cure for bureaucratic inefficiency and waste; some economists estimate that privatization improves efficiency and reduces operating costs by as much as 20 per cent. The International Finance in Practice box on pages 12-13 further describes the privatization process.

There is no one single way to privatize state-owned operations. The objectives of the country seem to be the prevailing guide. For the Czech Republic, speed was the overriding factor. To accomplish privatization en masse, the Czech government essentially gave away its businesses to the Czech people. For a nominal fee, vouchers were sold that allowed Czech citizens to bid on businesses as they went on the auction block. From 1991 to 1995, more than 1,700 companies were turned over to private hands. Moreover, three-quarters of the Czech citizens became stockholders in these newly privatized firms.

In Russia, there has been an 'irreversible' shift to private ownership, according to the World Bank. More than 80 per cent of the country's non- 11 farm workers are now employed in the private sector. Eleven million apartment units have been privatized, as have half of the country's 240,000 other business firms. Additionally, via a Czech-style voucher system, 40 million Russians now own stock in over 15,000 medium- to large-size corporations that recently became privatized through mass auctions of state-owned enterprises.

International financial management is related to managing finance of MNCs. There are five methods by which firms conduct international business activities– licensing, franchising, joint ventures, management contracts and establishing new foreign subsidiaries.

- **Licensing:** A firm in one country licenses the use of some or all of its intellectual property (patents, trademarks, copyrights, brand names) to a firm of some other country in exchange for fees or some royalty payment. Licensing enables a firm to use its technology in foreign markets without a substantial investment in foreign countries.

- **Franchising:** A firm in one country authorising a firm in another country to utilise its brand names, logos etc. in return for royalty payment.

- **Joint ventures:** A corporate entity or partnership that is jointly owned and operated by two or more firms is known as a joint venture. Joint ventures allow two firms to apply their respective comparative advantage in a given project.

- **Establishing new foreign subsidiaries:** A firm can also penetrate foreign markets by establishing new operations in foreign countries to produce and sell their products. The advantage here is that the working and operation of the firm can be tailored exactly to the firms needs. However, a large amount of investment is required in this method.
- **Management contracts:** A firms in one country agrees to operate facilities or provide other management services to a firm in another country for an agreed upon fee.

FOREIGN INVESTMENT FLOWS TO INDIA AND OTHER DEVELOPING COUNTRIES

In the last two decades there has been a rapid growth in international financial flows to both India and other emerging economies. There are two types of foreign investment flows. One is foreign direct investment (FDI) and other is called indirect investment (portfolio investment). If we look at FDI trends in India then during last decade the following pattern has emerged

Year	Direct investment		Portfolio investment		Total	
	Rs. Crore	US $ million	Rs. Crore	US $ million	Rs. Crore	US $ million
2001-02	174	97	11	6	185	103
2002-03	316	129	10	4	326	133
2003-04	965	315	748	244	1713	559
2004-05	1838	586	11188	3567	13026	4153
2005-06	4126	1314	12007	3824	16133	5138
2006-07	7172	2144	9192	2748	16364	4892
2007-08	10015	2821	11758	3312	21773	6133
2008-09	13220	3557	6696	1828	19916	5385
2009-10	10358	2462	-257	-61	10101	2401
2010-11	9338	2155	13112	3026	22450	5181
2011-12	10686	2339	12609	2760	23295	5099
2012-13	-	5035	-	979	-	6014
2013-14	-	4673	-	5035	-	9708
2014-15	-	5536	-	8909	-	14445

Conclusion:

In view of globalization and its impact on the economy of the world, it is pertinent to note that financial management of multinational companies, has adapted to changes in the environment. The theory and practice of international financial management is in consonance with the tax environment, legal obligations, foreign exchange rates, interest rate fluctuation, capital market movements, inflationary trends, political risk and country risk, micro and macro economic environment changes, ethical constraints etc. The objective of wealth maximization can be achieved if financial manager has the knowledge of economics, investment climate, tax implications and strategies in multinational settings. Further the scope of multinational finance has widened its horizon with the emergence of innovative financial instruments and mechanism supported by multilateral trade agencies like WTO- and regional blocks like ASEAN, NAFTA, SAPTA etc. There are various challenges from the environment and accordingly the scope and 17 relevance of multinational financial management has increased in recent past.

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