BALAJI INSTITUTE OF I.T AND MANAGEMENT KADAPA

4TH SEM

INTERNATIONAL FINANCIAL MANAGEMENT
(1-2.5 Units)

ICET CODE: **BIMK**

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(17E00407)INTERNATIONAL FINANCIAL MANAGEMENT

(Elective VI)

Objective: The objective of the course is to provide students with a broad view of International Monetary Systems and its understanding to enable a global manager to do business in a global setting. The prerequisite for the course is Financial Accounting and Analysis and Financial Management.

1. **Introduction to International Financial management: IFM meaning, Difference between FM & IFM, Nature ,Scope, Importance.**
2. **Foreign Exchange Market**: Functions and Structure of the Forex markets, major participants, types of transactions and settlements, Foreign exchange quotations, .
3. **Management of foreign exchange exposure and risk:** Types of Exposure, Economic Exposure, Transaction Exposure, Operating Exposure.
4. **Cross-border Investment Decisions:** Capital budgeting, Approaches to Project Evaluation, Risk in Cross-border Investment Decisions.
5. **Financing Decisions of MNC`s & Working Capital Management:** Introduction, the cost of capital, capital structure, Cash management, management of receivables, Inventory management.

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- International Financial Management, Sharan5th Edition, PHI.
- International Financial Management, MadhuVij: Excel, .
- International Financial Management, V. A Avadhani, Himalaya .

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UNIT-1

INTRODUCTION TO INTERNATIONAL FINANCIAL MANAGEMENT

1.1 MEANING OF IFM

International financial management is concerned with the management of international business related financial functions commonly known as the international financial functions. The commonly stated goal of a firm is to maximize its value and thereby maximize shareholder wealth. This goal is applicable not only to firms that focus on domestic business but also to firms that focus on international business.

In fact, many firms have expanded their international business as a means of enhancing their value. Since foreign markets can be distinctly different from local markets they create opportunity for improving the firm's cash flows.

1.2.DIFFERENCE BETWEEN DOMESTIC FINANCIAL MANAGEMENT AND INTERNATIONAL FINANCIAL MANAGEMENT

There are similarities between domestic financial management and the international financial management of an international business. Objectives of financial management i.e., profit maximization and wealth maximization are same whether the firm serves on the domestic market or does its business in overseas markets. The major decisions a finance manager needs to make remain the same notwithstanding whether the business is domestic or international. The key decisions of financial management are investment financing and asset management. The third important decision of the firm is the asset management decision. Once assets have been acquired and appropriate financing provided these assets must be managed efficiently. The financial manager of a domestic business or international business is required to make all the three decisions judiciously.

There are dissimilarities however between domestic financial management and international financial management.

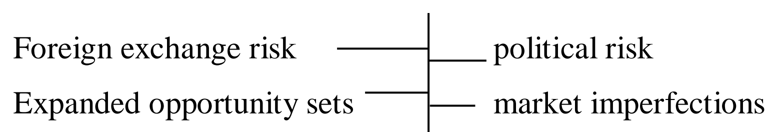
INTERNATIONAL FINANCIAL MANAGEMENT	DOMESTIC FINANCIAL MANAGEMENT
Main object is to earn excess return on investment	Normal returns are expected
Attempts to maximize returns are often thwarted by several constraints.	Enjoys relative freedom
Historical cultural and institutional environment obtaining in each host country impacts the way financial decisions are made and implemented. Decisions need to vary from one country to another.	Impact is country specific
Financial management requires an understanding of unique risks	Domestic financial management is free from such risks.

1.3 NATURE OF INTERNATIONAL FINANCIAL MANAGEMENT

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

1. **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. In fact this variability of exchange rates is widely regarded as the most serious international financial problem facing corporate managers and policy makers.

   Features of international financial management

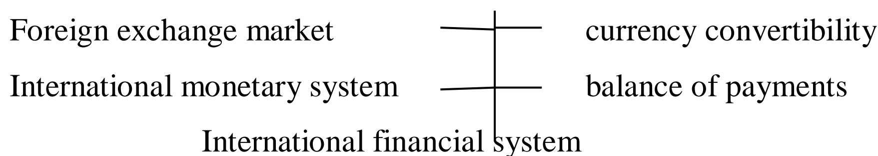


2. **POLITICAL RISK:** another risk that firms may encounter in international finance is political risk. Political risk ranges from the risk of loss from unforeseen government actions or other events of a political character such as acts of terrorism to outright expropriation of assets held by foreigners. MNC must assess the political risk not only in countries where it is currently doing business but also where it expects to establish subsidiaries.
3. **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 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.
4. **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 nation's 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 this market imperfection they also offer managers of international firm abundant opportunities.

1.4 SCOPE OF INTERNATIONAL FINANCIAL MANAGEMENT

International finance is subject to several external forces. The more important of them namely foreign exchange markets currency convertibility international monetary system balance of payments and international financial system.

Scope of IFM



1. **FOREIGN EXCHANGE MARKET**: the foreign exchange market is the place where money denominated in one currency is bought and sold with money denominated in another currency.
2. **CURRENCY CONVERTIBILITY**: the discussion of the foreign exchange market was based on the assumption that the currencies. This assumption is not valid. Many

countries result the ability of residents and non residents to convert the local currency into foreign currency making international business more difficult.

A countries currency is said to be freely convertible when the country's government allows north residents and non residents to purchase unlimited amounts of foreign currencies with the local currency. A currency is non convertible when neither residents nor non residents are allowed to convert local into a foreign currency.

3. **INTERNATIONAL MONETARY SYSTEM:** every country needs to have its own monetary system and an authority to maintain order in the system. Monetary system facilitates trade and investment. India has its own monetary policy that is administered by the reserve bank of India. Primarily RBI aims at controlling inflation and money supply and maintaining an interest rate regime that is helpful to economic growth.
4. **BALANCE OF PAYMENTS:** balance of payments is a statistics statement that systematically summarizes for a specified period time the monetary transactions of an economy with the rest of the world. BOP data help measure financial transitions between residents of the country and residents of all other countries. Transactions include exports and imports of goods and services income flows capital and gifts and similar one sided transfer payments.
5. **INTERNATIONAL FINANCIAL SYSTEM:** the international financial system consists of the numerous rules customs instruments facilities markets and organization that enable international payments to be made and funds to flow across borders. In recent years the international financial system has experienced tremendous growth. New financial instruments have been created and the volume of transactions has exploded. The dramatic metamorphosis of international financial markets is driven by technological changes the growth in world trade and the breakdown of barriers to financial flows.

1.4.1 FUNCTIONS OF INTERNATIONAL FINANCIAL MANAGEMENT

IFM refers to the financial function of an overseas business. Specifically the finance function of an international business deals with the following points.

Functions of IFM

Investment decisions — international working capital decisions

Financial decisions ―――――― international accounting & taxation decisions

1. **INVESTMENT DECISIONS:** when a company innovate a specific technology and its product is mature in the markets abroad or when the company wants to reap the location to reap the location advantage in a foreign country it sets up an affiliate there. Whatever the motivation behind foreign investment or foreign manufacturing the company evaluates the cash inflow and outflow during the life of the project and makes investment only when the net present value of cash flows is positive.. IFM thus studies the different theories of oversees production the various strategies of investment capital budgeting decision and evaluation of foreign exchange and political risks pertaining to overseas investment.
2. **INTERANTIONAL WORKING CAPITAL DECISIONS:** when foreign operations begin the parent company evaluates different sources of working capital so that the cost of financing is the cheapest. In this context an international company maintains an edge over a domestic company insofar as it can easily reach the international financial market or can siphon resources from one subsidiary to another. IFM helps in taking correct decisions regarding the size of working capital and suggests a mechanism for its management. It also deals with how foreign trade is finished.
3. **FINANCIAL DECISIONS**: any investment needs rising of funds. The MNCs take advantage of the many innovations which have taken place in the international financial market and IFM guides them or how to take advantage of these. It deals with how different instruments are issued to raise funds and how swaps are used for minimizing the cost of funds. The nature and management of interest rate exposure to form a part of IFM.
4. **INTERNATIONAL ACCOUNTING AND TAXATION DECISIONS:** international accounting forms an integral part of IFM. It analyses the techniques for consolidation of financial statements of the various affiliates international audit international financial reporting and international taxation. Transfer pricing is an important area of international accounting as it is used lowering the overall burden of taxes and tariff as well as for working capital management. Similarly international tax system should be so designed that it fosters economic efficiency and does not come in the way of the cross border movement of goods and factors of production.

1.5 IMPORTANCE OF INTERNATIONAL FINANCIAL MANAGEMENT

IFM deals with the financial decision taken in the area of international business. The growth in international business is first of all evident in the form of highly inflated size of international trade. In the immediate post war years the generate agreement on the trade and tariffs was set up in order to boost trade. It axed the trade barriers significantly over the years as a result of which international trade grew manifold. All this required proper management of international flow of funds for which the study of IFM came to be indispensable.

Not unexpectedly the seconded half of the twentieth century witnessed the emergence and fast expansion of multinational corporations. Normally with the growth of international trade the products of the exporter become mature in the importing countries. They imported technology on a big scale and built up their own manufacturing base. As result the company went international. Thus multinational company's emergent not only in developed countries but also in the developing world and because of their operation the cross country flow of funds increased substantially. The two way flow of funds outward in the form of investment and inward in the form of repatriation divided royalty technical service fees etc., required proper management and so the study of international financial management become a real necessity. The need of international financial management has increased because of:

a. Increase in the volume of international trade
b. Globalization of business
c. Increase in movement of capital and labor with lesser restrictions
d. Increase in speed of communication and transport.
e. Emergence of international capital and money markets.

1.6 RISKS IN INTERNATIONAL FINANCIAL MANAGEMENT

Risk is a condition where there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for. The term risk may be defined as the possibility of adverse results flowing from any occurrence. Risk arises out of uncertainty. When risk is said to exist there must always be at least two possible outcomes. If it is known for certain that a loss will occur there is no risk and at least one of the possible outcomes is undesirable.

Following are the risk involved in international financial management.

1. **CURRENCY RISKS**: currency risk arises from a mismatch between the value of assets and that of capital and liabilities denominated in foreign currency or because of

mismatch between foreign receivables and foreign payable that are expressed in domestic currency. Such mismatches may exist between both principal and interest due. The currency risks can be divided into three different categories transaction risk transaction risk and economic risk.

2. **POLITICAL/COUNTRY RISKS**: the political risk or in other sources called country risk is explained ad risks related to either the country of a foreign buyer or borrower or to a third country which can cause the exporter financial or investor credit loss. Political risks also include restrictions on transfer of the credit currency rescheduling of debts expropriation and war or insurrection. The term political risk refers to all factors which influence the country's economy international relations and internal stability.
3. **FINANCIAL RISKS**: financial risk in accompany is associated with the method through which it plans its financial structure. If the capital structure of a company tends to make earnings unstable the company may fail financially. How a company raises funds to finance its needs and growth will have an impact on its future earnings and consequently on the stability of earnings. Debt financing provides a low cost source of funds to a company at the same time providing financial leverage for the common stock holders. It is found that variation in returns for shareholders in levered firms is higher than in unlevered firms. The variance in return is the financial risk.
4. **INTEREST RATE RISK:** interest rate risk refers to possible changes in cash flow or into eh value of assets and liabilities resulting from changes in interest rate. In other words interest rate is the chance that an unexpected change in interest rates will negatively affect the value of an investment. A bank's main source of profit is converting the liabilities of deposits and borrowings into assets of loans and securities. It profits by paying a lower interest on its liabilities than it earns on its assets the difference in these rates is the net interest margin. Banks make money by borrowing at short term rates and lending at long term rates.
5. **COMMERCIAL RISKS**: typical commercial risks include the buyer's guarantors or borrower's unwillingness or insolvency to pay its debts. This kind of risk can also be explained as a risk that arises if a customer or the other party of a financial instrument fails to meet its contractual obligation.
6. **LIQUIDITY RISK:** liquidity risk refers to the possibility of the company financial assets providing that they are insufficient to cover its business needs or a situation in which arranging such funding would result in additional cost.

UNIT-1–IMPORTANT QUESTIONS

1) **What is the IFM? Discuss its role in the world economy and various risks involved in IFM.**
2) **Discuss the nature, scope and significance of International Financial Management.**
3) **Globalization is no more a choice for any country. Domestic markets of the economy are forced to integrate with the global markets.**

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UNIT-2
FOREIGN EXCHANGE MARKET

1.1 MEANING AND DEFINITION OF FOREIGN EXCHANGE MARKET

Foreign exchange is currency other than the local currency which is used in settling international transactions also called foreign currency. It is a system of trading in and converting the currency of one country into that of another. Foreign exchange is the system or process of converting one national currency into another and of transferring the ownership of money from one country to another country.

Foreign exchange as defined by section 2 of FEMA 1999

Foreign currency means any currency other than Indian currency.

The foreign exchange currency or FOREX or FX market refers to the market for currencies. Transactions in this market typically involve one party purchasing a quantity of one currency in exchange for paying a quantity of another. The FX market is the largest and most liquid financial market in the world and includes trading between large banks central banks currency speculators corporate government and other institutions.

According to KNDLEBERGER foreign exchange market is a place where foreign moneys are bought and sold. Foreign exchange market is an institutional arrangement for buying and selling of foreign currencies. Exporters sell the foreign currencies and importers buy them. Foreign exchange market is merely a part of the money market in the financial centers. It is a place where foreign moneys are bought and sold. The buyers and sellers of claim on foreign money and intermediaries together constitute a foreign exchange market. It is not restricted to any given country or a geographical area.

Thus the foreign exchange market is the market for a national currency anywhere in the world as the financial centre of world is united in a single market.

1.2 NATURE OF FOREIGN EXCHANGE MARKET

Some of the important of a foreign exchange market are follows.

1. **ELECTRONIC MARKET**: foreign exchange market does not have physical place. It is a market whereby trading in foreign currency takes place through the electronically linked network of banks foreign exchange brokers and dealers whose function is to bring together buyers and sellers of foreign exchange.
2. **GEOGRAPHICAL DISPERSAL**: A redeeming feature of the foreign exchange market is that it is not to be found in one place. The market is vastly dispersed throughout the leading financial centers of the world such as London New York Paris Zurich Amsterdam, Tokyo, Hong Kong Toronto Frankfurt, Milan and other cities.
3. **TRANSFER OF PURCHASING POWER**: foreign exchange market aims at permitting the transfer of purchasing power denominated in one currency to another whereby one currency is traded for another currency. For example, an Indian exporter sells software to a U.S. firm for dollars and a U.S. firm sells super computers to an Indian company for rupees. In these transactions firms of respective countries would like to have their payments settled in their currencies i.e., Indian firm in rupees and U.S. firm in U.S. dollar it is the foreign exchange market which facilities such a settlement between countries in their respective currency units.
4. **INTERMEDIARY:** foreign exchange market provides a convenient way of converting the currencies earned into currencies wanted of their respective countries. For this purpose the market acts as an intermediary between buyers and sellers of foreign exchange.
5. **VOLUME**: A special features of the foreign exchange market is that out of the total trading transactions that take place in the foreign exchange market around 95percent takes the form of cross border purchase and sale of assets i.e., international capital flows. Only around 5% relates to the export and import activities.
6. **PROVISION OF CREDIT**: a foreign exchange market provider's credit through specialized instruments such as banks acceptances and letters of credit. The credit thus provided is of much help to the traders and businessmen in the international market.

1.3 FUNCTIONS OF FOREX MARKET

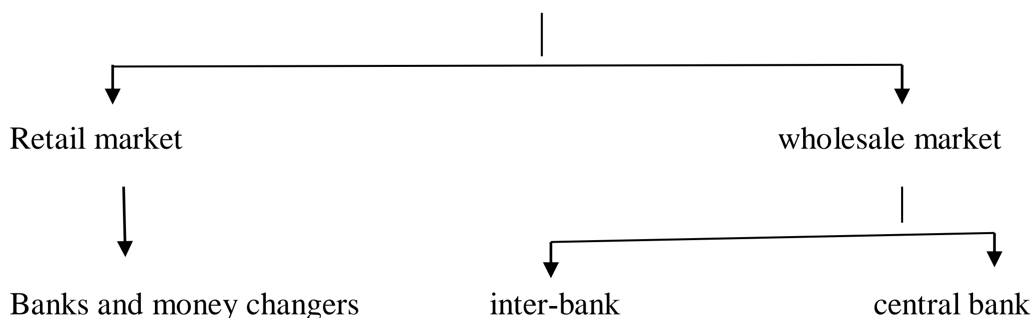
A forex market performs three important functions.

1. **TRANSFER OF PURCHASING POWER**: the primary function of foreign exchange market is to transfer of purchasing power from one country to another and from one currency to another. The international clearing function performed by foreign exchange markets plays a very important role in facilitating international trade and capital movements.
2. **PROVISION OF CREDIT**: the credit function performed by foreign exchange markets also plays a very important role in the growth of foreign trade for international trade depends to a great extent on credit facilities. Exporters may get pre shipment and post shipment credit. Credit facilities are available also for importers. The euro dollar market has emerged as major international credit market.
3. **PROVISION OF HEDGING FAcilities**: the other importer function of the foreign exchange market is to provide hedging facilities. Hedging refers to covering of export risks and it provides a mechanism to exporters and importers to guard themselves against losses arising from fluctuations in exchange rates.

1.4 STRUCTURE OF FOREX MARKET

1. **RETAIL MARKET:** the exchange of bank notes bank drafts currency ordinary and traveler's cheques between private customers' tourists and banks takes place in the retail market. The RBI has granted two types of money changer licenses to certain established firms hotels shops and other organization to deal in currency notes coins and traveler cheques to a limited extent. While the full fledged money changers can undertake both purchase and sales transactions with the public restricted money changers can only purchase foreign currency from the foreign tourists.

   Structure of forex market



(Currencies, bank notes, cheques) (bank accounts/deposits)

2. **WHOLESALE MARKET;** the wholesale market is primarily an interbank trade in currencies held in different currency dominated bank accounts i.e. they transfer bank deposited from sellers to buyers accounts. This market is far larger than the bank notes market. Only the head offices and regional offices of the major commercial banks are the market makers in the wholesale market. Most of the small banks and the local offices of even the major banks do not deal directly in the interbank market.

(i) **Interbank market**: The interbank market can thus be said to have two parts.

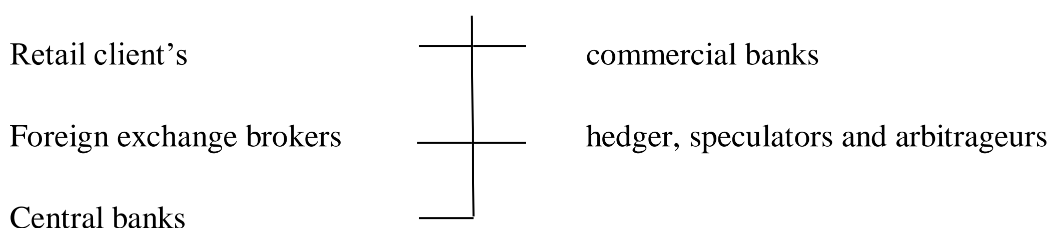
a. **Direct market**: In the direct market banks quote buying and selling prices directly to each other and all participating banks are market makers. It has been sometimes characterized as a decentralized continuous open bid double auction market.

b. **Indirect market**: in the indirect market the banks put orders with brokers who put them on books and try to match purchases and sales orders for different currencies. They charge commission to both the buyers and sellers. This market is characterized as quasi centralized continuous limit book single auction market.

c. **Central banks**: normally the monetary authorities of a country are not indifferent to changes in the external value of their currency and even though exchange rates of the major industrialized nations have been left to fluctuate freely since 1973 central banks frequently intervene to buy and sell their currencies in a bid to influence the rate at which their currency is traded. Under a fixed exchange rate system the authorities are obliged to purchase their currencies when there is excess supply and sell the currency when there is excess demand.

1.5 MAJOR PARTICIPANTS IN FOREIGN EXCHANGE MARKET

Participants in foreign exchange market



1. **RETAIL CLIENTS**: these are made up of business international inventors multinational corporations and the like who need foreign exchange for the purpose of operating their business. Normally they do not directly purchase or sell foreign currencies themselves rather they operate by placing buy sell with commercial banks.
2. **COMMERCIAL BANKS:** the commercial banks carry out buy/sell orders from their retail clients and buy sell currencies on their own account so as to alter the structure of their assets and liabilities in different currencies. The banks deal either directly with other banks of through foreign exchange brokers.
3. **FOREIGN EXCHANGE BROKERS:** offer banks do not trade directly with one another rather they offer to buy and sell currencies via foreign exchange brokers. Operating through such brokers is advantageous because they collect buy and sell quotations for most currencies from many banks so that the most favorable quotation is obtained quickly and at very low cost. Each financial centre normally has just a handful of authorized brakes through which commercial banks conduct their exchange.
4. **HEDGER SPECULATORS AND ARBITRAGEURS:** Traders buying and selling foreign exchange can take the role of hedgers or speculators or arbitrageurs. Hedgers are traders who undertake forex trading because they have assets or liability in foreign currency. For example when an importer requiring foreseeing currency sells domestic currency to buy foreign currency he is termed as a hedger. All these are examples of heeding. Hedgers use the foreign currency market to hedge the risk associated with volatility in foreign exchange market.

   SPECULATORS: are traders who essentially buy and sell foreign currency to make profit from the expected futures movement of the currency. These traders to not have any genuine requirement for trading foreign currency. They do not hold any cash position in the currency.

   ARBITRAGEURS buy and sell the same currency at two different markets whenever there is price discrepancy. The principal of law of one price governs the arbitrage principle. Arbitrageurs ensure that market prices move to rational or normal levels. With the proliferation on internet cross currency cross currency arbitrage possibility has increased significantly.
5. **CENTRAL BANKS:** Normally the monetary authorities of a country are not indifferent to changes in the external value of their currency and even though exchange rates of the major industrialized nations have been left to fluctuate freely

since 1973, central banks frequently intervene to buy and sell their currencies in a bid to influence the rate at which their currency is traded. Under a fixed exchange rate system the authorities are obliged to purchase their currencies when there is excess supply and sell the currency when there is excess demand.

1.5.1 FACTORS INFLUENCING FOREIGN EXCHANGE MARKET

1. **ECONOMIC FACTORS**: these include economic policy disseminated by government agencies and central banks economic conditions generally revealed through economic reports and other economic indicators. Economic policy comprises government fiscal policy and monetary policy (the means by which a government central bank influences the supply and cost of money which is reflected by the level of interest rates.) Economic conditions include.
   a. **Government budget deficits or surpluses**: the market usually reacts negatively to widening government budget deficits and positively to narrowing budget definite. The impact is reflected in the value of a country currency.
   b. **Balance of trade levels and trends**: the trade flow between countries illustrates the demand for goods and services which in turn indicates demand for a country currency to conduct trade. Example, trade deficits may have a negative impact on a nation currency.
   c. **Inflation levels and trends**: typically a currency will lose value if there is a high level of inflation in the country of if inflation levels are perceived to be rising. This is because inflation erodes purchasing power thus demand for that particular currency. However a currency may sometimes strengthen when inflation rises because of expectations that the central bank will raise short term interest rates to combat rising inflation.
   d. **Economic growth and health:** reports such as gross domestic product employment levels retail sales capacity utilization and others detail the levels of a country's economic growth and health. Generally the more healthy and robust a country economy the better its currency will perform and the more demand for it there will be.
2. **POLITICAL CONDITIONS**: internal regional and international political conditions and events can have a profound effect on currency markets. For example, political upheaval and instability can have a negative impact on a nation's economy.

3. **MARKET PSYCHOLOGY**: largest psychology and trader perceptions influence the foreign exchange in a variety of ways.
   a. **Flights to quality**: Unsettling international events can lead to a flight to quality with investors seeking a safe haven. There will be a greater demand thus higher price for currencies perceived as stronger over their relatively weaker counterparts. The Swiss franc has been a traditional safe haven during times of political or economic uncertainly.
   b. **Long term trends**: currency markets often move in visible long term trends. Although currencies do not have an annual growing season like physical commodities business cycles do make themselves felt. Cycle analysis looks at longer term price trends what may raise from economic or political trends.
   c. **Buy the rumor sell the fact**: This market truism can apply to many currently situations. It is the tendency for the price of a currency to reflect the impact of particular action before it occurs and when the anticipated event comes to pass read in exactly the opposite direction. This may also be referred to as a market being oversold or overbought. To buy the rumor or sell the fact can also be an example of the cognitive bias known as anchoring when investors focus too much on the relevance of outside events to currently prices.
   d. **Economic numbers**: while numbers can certainly reflect economic policy some reports and numbers take on a talisman like affect the number it becomes important to market psychology and may have an immediate impact on short term market moves.
   e. **Technical trading considerations**: as in other markets the accumulated price movements in a currency pair such as EUR/USD can form apparent patterns that traders may attempts to use. Many traders study price charts in order to identify such patterns.
   f. **Balance of payment**: balance of payments of a country will cause the exchange rate of its domestic currency to fluctuate. The balance of payments is a summary of all economic and financial transactions between the country and the rest of the world. The balance of payments can affect the supply and demand for foreign currencies as well as their exchange rates.
   g. **Interest rates**: when a country key interest rate rises higher or falls lower than that of another country the currency of the nation with lower interest rate will be sold and the other currency will be bought so as to achieve higher returns. Given

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this increase in demand for the currency with higher interest rate the value of that currency will rise against other currencies.

h. **Speculation:** speculation by major market operators is another crucial factor that influences exchange rates. In the forex market the proportion of transactions that are directly related to international trade activities is relatively low. Conversely if the market expects a drop in value of a certain currency people will start selling it away and the currency will depreciate.

1.6 TYPES OF TRANSACTION & TRANSACTIONS OF FOREIGN EXCHANGE MARKET

A foreign exchange transaction is an agreement between two parities to exchange one currency for another at an agreed exchange rate on an agreed date. It also provides protection against unfavorable exchange rates.

A foreign exchange transaction may be useful in managing the currency risk associated with exporting or importing gods denominated in foreign currency inviting or borrowing overseas repatriating profits convert in foreign currency denominated dividends or settling other foreign currency contractual arrangement.

There are different types of foreign exchange transaction

1. **SPOT MARKET TRANSACTIONS**: the spot market refers to that segment of the foreign exchange market in which sale and purchase transactions are settled within two days of the deal. The spot sale and purchase of foreign exchange makes the spot market is called the spot exchange rate. For all practical purposes the spot rate is the prevailing exchange rate.

   TYPES OF SPOT MARKET**:** The spot can be of two types.

   a. **Organization**: an exchange is a highly organization market where tradable security commodities foreign exchange are sold and bought.
   b. **Over-the counter (OTC):** over the counter or off exchange trading is to trade financial instruments such as stock body commodities or derivatives directly between two parties. It contrasted with exchange trading which occurs wave facilities constructed for the purpose of trading.

2. FORWARD MARKET TRANSACTIONS: the forward exchange market refers to foreign exchange deals for sale and purchase of foreign currency at some future date, normally after 90days of the deal when buyers and sellers enter an agreement to buy and sell foreign currency after 90days of the deal at the agreed relate exchange it is called forward transaction. The forward exchange rate settled between the buyers and sellers for forward sale and purchase of currencies is called forward exchange rate.

TYPES OF FORWARD EXCHANGE CONTRACTS

Forwards contracts in India area broadly governed by the forward contracts act, 1952. According to this act forward contracts are of the following three major categories.

1. **Fixed term and optimal term forward contract:** both buying and selling forward exchange contracts may be either fixed or optimal term contracts.

a. **Fixed term contracts:** fixed term contracts allow the customer to specify the date when the delivery of the overseas currency will occur. Earlier delivery is usually an option however a marginal adjustment to the forward contract rate may be required.

b. **Optional term contracts:** optional term contracts allow the customer to enter in to an agreement for a specific period where the customer declares a certain period within which they would like the delivery to be made e.g., customer may enter a contract for a six month period while having the option of receiving a delivery anytime during the final week.

c. **Hedge contracts**: there are freely transferable contracts which do not require specification of a particular lot size quality or delivery standards for the underlying assets. Most of these are necessary to be settling through delivery of underlying assets.

d. **Transferable specific delivery forward contracts**: apart from being freely transferable between parties concerned these forward contracts refer to a specific and predetermined lot size and variety of the underlying asset. It is compulsory for delivery of the underlying assets to take place at expiration of contract.

e. **Non transferrable specific delivery forward contracts:** These contracts are normally exempted from the provision of regulation under forward contract act, 1952 but the central government reserves the right to bring them back under the act when it feels necessary. These are contracts which cannot be transferable to another party.

f. **Other forward contracts:** it includes

a. **Forward rate agreements**: forward contracts are commonly arranged on domestic interest rate bearing instruments as well as on foreign currencies. In forward rate agreement no actual lending or borrowing is affected. Only it fixes the rate of interest for a futures transaction.

b. **Range forwards**: these instruments area very much popular in foreign exchange markets. Under this instrument instead of quoting a single forward rate a quotation is given in terms of a range i.e., a range may be quoted for Indian rupee against US dollar at ₹47 to ₹49 has been quoted. This is also known as flexible forward contracts.

3.SWAPS TRANSACTIONS: Swap is any agreement to a future exchange of one asset for another one liability for another or more specifically one strum of cash flows for another. A swap is a private agreement between two parities in which both parties are obligated to exchange some specified cash flows at periodic intervals multiple future points of exchange.

The cash flaws of swap may be fixed in advance or adjusted for each settlement date by reference to some specified interest rate such as MIBOR, LIBOR or other market yield. On the settlement date a difference cheque is paid by whichever party in the swap is obligated to pay more cash than is to be received at the student date.

For example, an investor realizing returns from an equity investment can swap those returns into less risky fixed income cash flows without having to liquidate the equates. A corporation will floating rate debt can swap that debt into a fixed rate obligated without having to retire and re-issue debt.

Types of swap: Following are the types of swap.

1. **Interest rate swaps**: a standard fixed to floating interest rate swap known in the market terminology as a plan vanilla coupon swap is an agreement between tow parties in which each contracts to make payments to the other on particular dates in the future till a specified termination date. One parry known as the fixed rate payer makes fixed payments all of which are determined at eh outset. The other party known as the floating rate payer will make payments the size of which depends upon the future evolution of a specified interest rate index (6 month MIBOR)

2. **Currency swaps:** swap contracts also can be arranged across currencies. Such contracts are known as currency swaps and can help to manage both interest rate and exchange rate risk. A currency swap is an agreement between two parties to exchange a given amount in one currency for another and to reply these currencies with interest in the future.
3. **Commodity swaps**: in commodity swaps the cash flows to be exchanged are linked to commodity prices. Commodities are physical assets such as metals energy stores and food including cattle. For exchange in a commodity swap a party may agree to exchange cash flows linked to prices of oil for fixed cash flows.

   <u>Commodity swaps are used for hedging against.</u>

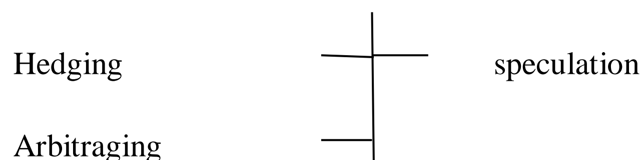
   a. Fluctuations in commodity prices or
   b. Fluctuations in spreads between final product and rate material prices e.g. cracking and refined product price significantly affect the margins of oil refineries.
4. **Equity swaps**: under an equity swap the shareholder effectively sells his holding to a bank promising to buy it back at market price at a future date. However he retains a voting right on the shares.

In equity swap at least one of the two steams of cash flow is determined by a stock price the value of portfolio or the level of stock index. The other stream of cash flow can be a fixed rate a floating rate such as MIBOR or it can be determined by the value of another stock, stock portfolio or stock index. In this manner an equity swap can substitute for trading for trading in an individual stock, stock portfolio or stock index.

<u>1.7 NATURE OF FOREIGN EXCHNGE TRANSCTIONS</u>

The nature of foreign exchange transactions are as follows.

Nature of foreign exchange transactions



1. **HEDGING:** It is an important feature of the forward exchange market. When exporters and importers enter an agreement to sell and buy goods at some future date at current prices and exchange rate it is called hedging.
   Hedging i.e., the forward foreign exchange transaction takes place through the banks. The banks dealing in forward purchase and sale of foreign exchange provide the hedging facility to the exports and importers.
2. **SPECULATION:** Speculation transactions in foreign exchange are opposite of hedging. In hedging the buyers and sellers try to avoid rink if any due to fluctuation in the exchange rate whereas speculation in foreign exchange is a deliberate attempt under the condition of risk to make profits from the fluctuations in the exchange rate.
   On the other hand bulls of the market expect the exchange rate to increase. Since bears expect foreign exchange to decrease in future they sell their currency holding to avoid loss. The bulls on the other hand expect exchange rate to increase and hence they buy the foreign currency with a view selling it when exchange rate increases in future. Whether bulls and bears gain or lose depends on how correct they are in their expectations.
3. **ARBITRAGING:** Arbitrage is the act of simultaneously buying a currency in one market and selling it in another to make a profit by taking advantage of price exchange rate difference in the two markets. If the arbitrage operations are confined to two markets only they will be known as two point arbitrage.

   a. International arbitrage reviles around taking advantages of price difference between goods and securities in different countries. While this is a common practice among many types of investor's arbitrage separates itself because the buying and selling happen nearly simultaneously. When the broker is purchasing an item in one market they are selling that same item in a different market. International arbitrage is widely seen as a little to no risk investment, as the initiate purchase doesn't take place unless the profit is available right then.

1.8 SETTLEMENT DATE

In finance4 a contract settle when one or both parties perform on an obligation under that contract. The term is commonly used in trading and derivatives markets.

In trading a trade settles when the instrument being traded actually changes hands and/or is paid for. Both events typically occur on the same date which is called the settlement date.

Because of mistakes or events beyond the control of counterparties transactions sometimes fail to settle on the intended date. For this reason it is useful to distinguish between a transaction settlement date and its value date.

1.8 TYPES OF SETTLEMENTS: Investors trade in foreign exchange markets in different settlements dates by using different types of instruments i.e.,

1. **SPOT TRANSACTIONS:** here transaction takes place on T + 2 basis i.e. in spot exchange transactions settlement usually takes two working days. Spot word implies immediate however spot rate means the rate on which transaction has taken place and whose settlement occurs within 2 working days.
   When a person goes to monad changer/bank and buys one currency but paying another currency is an example of spot transaction and the rate quoted by the money changer/bank is the spot rate. For example, in India some hotels buy or sell foreign currency over the counter. Normally the hotel/antique shops will have a display board mentioning different INR rates for different currency.
2. **READY OR CASH TRANSCTIONS**: in these types of contract transaction is settle on same day i.e. the trade date. With the advancement of technology it becomes possible to make settlement on trade date.
   Settling a trade using the cash transaction method differs from settling a contract on the settlement date which in some case involves agreeing on a price on the trade date but transferring payment on some date in the future (known as the settlement date). A cash transaction requires all aspects of a trade including delivery of payment to be finalized on the trade date.
3. **TOM TRANSACTIONS**: in these types of contracts delivery/settlement of underlying is to be done on the next day i.e., next day of the trade date. In many countries the actual settlement takes place very next business day.
   Many a time’s settlement for spot/tom transactions may not happen on the T+1 OR T+2 but gets rolled over. In a typical spot/tom transaction, actual delivery of one currency and receipt of other currency happens between two parties. Howe ever most forex trade are speculators.

4. **FUTURE OR FORWARD CONTRACTS**: in both future and forward contracts contract is entered on given day to settle the transaction on specific future date at fixed price. In these contracts settlement date is decided by both the parties and on that specific day actual settlement takes place.
   Term of forward operation may vary from 3days till 3years but most common are 1, 3, 6 and 12 months periods. It is worth mentioning that forward prices are relatively stable for period lesser than 6 months for longer period market is very volatile and even single transaction could cause significant price fluctuations

SUMMARY

TERM	DEFINITION	FOR EXAMPLE
Cash date or trade date	The tom of the transaction, say today	If today is 25-06-12, then cash date is 25-06-12.
Spot date	Second wording day from the cash date or day after tomorrow	27-06-12
Tom date	Tom is short for tomorrow and is the next working day from the cash date.	26-06-12
Spot rate	The rate quoted and transacted today for settlement on the spot date.	Say the rate is 55.95. This is the rate normally seen heard and been talk about.
Cash rate	The rate applicable for settlement today itself on the cash date.	This is usually lower than the spot rate. Since the spot rate is 55.95 the cash rate may be 55.93. the difference between the two rates is known as the cash spot rate or cash spot difference
Tom rate	The rate quoted and transacted today for settlement tomorrow on the tom date.	This is lower than the spot rate but higher than the cash rate. Since the spot rate is 55.95 the tom rate may be

		55.94
Forward/future contract	These contracts are settle on a specific future date at fixed price.	Term of forward operation vary from 3days to 3 years

1.9 FOREIGN EXCHANGE QUOTATIONS & TYPES OF EXCHANGE RATE QUOTATIONS

Foreign exchange quotations can be confusing because currencies are quoted in terms of other currencies. It means exchange rate is relative price. In other words foreign exchange quotation is the amount of currency that is exchanged for a unit of another currency. For example the exchange rates of rupees in India may be quoted in terms of dollar e.g., ₹/ = ₹ 44/. It means that 1 is worth ₹44.

A change in price of one currency implies therefore a change in price of the other currency that appears in the quote. For example if the price of ₹ against the moves from ₹44/ to ₹43.5/ one can say that ₹ has depreciated relative to the rupee.

Following are the foreign exchange rate quotations as shown in figure below.

Types of foreign exchange rate quotations

Bid and ask prices	indirect rates/quotes
Direct rates/quote	cross currency rates
Spot rates	forward rates
Inter-bank quotations	% speed/cost of transaction

A.BID AND ASK PRICES

A quotation is the amount of a currency necessary to buy or sell a unit of another currency.

When it is expressed in currency terms it is called outright rate e.g., s (₹/S) = ₹ 35.980 is an outright rate between rupees and dollar.

The quotes are usually made in the form of buy and sell or bid and ask rates.

B.DIRECT RATES: In the case of direct rates a unit of foreign currency is quoted in terms of domestic currency.

Direct quote: bid rate < ask rate

1. Bid rate: it is the rate at which an AD buyer is ready to buy the currency that is constant (Currency F)
2. Ask rate: it is rate at which an AD seller is ready to sell the currency that is constant (currency F)

C.INDIRECT RATES: An indirect rate is the price of one unit of home currency in terms of a foreign currency.

INDIRECT QUOTE: bid rate > ask rate.

1. Bid rate: it is the rate at which an AD buyer is ready to buy the currency that is constant (Currency H)

2. Ask rate: it is the rate at which an AD seller is ready to sell the currency that is constant (currency H)

D.SPOT RATE/QUOTES: Spot rate (spot exchange rate) is that exchange rate which applies to those sale/purchase transactions in foreign exchange for which payments and receipts are to be effected on the spot (in practice it normally means a specified short period say two working days or so.)

E.FORWARD RATE/QUOTES: A forward rate is the one which applies to a foreign exchange transaction to be effected on a specified future date. Both the buyer and seller of exchange in the forward agree that the forward rate will sell a stated amount of the foreign currency at an agreed exchange rate to the buyer one specified future date irrespective of the actual exchange rate that may prevail on the said future date. The deal also involves a corresponding payment in domestic currency by the buyer of foreign currency to the seller of it. Forward rates can be calculated from spot rates and interest rates.

The formula for calculating forward rate is as follows.

Spot (1+domestic interest rate) / (1+foreign interest rate)

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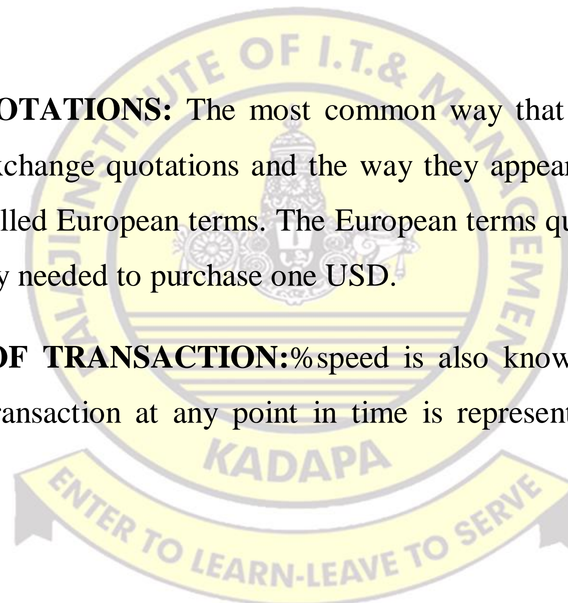
Where the spot is expressed as a direct rate (i.e. as the number of domestic currency units one unit of the foreign currency can buy)

F.CROSS CURRENCY RATES: It is the exchange rate between two inactively traded currencies usually involves the sue of a third widely traded currency the U.S. dollar.

For example, we have, **JANPANEESE YEN AND MEXICAN PESO:**

G.CROSS CURRENCY RATES FOR NON SYMMETRICAL PAIRINGS: When the USD is the base or the quote currencies for both pairings make flip one of them around in order to make the equation work. For example calculated EUR/GBP knows the bid price for EUR/USD and USD/GBP note that the letter does not follow the convention of GBP as base currency. When a currency pair is switched around in this way it is known as a reciprocal pairing.



H.INTER-BANK QUOTATIONS: The most common way that professional dealers and brokers state foreign exchange quotations and the way they appear on all computer trading screens worldwide is called European terms. The European terms quote shows the number of units of foreign currency needed to purchase one USD.

I.%SPREAD/COST OF TRANSACTION:%speed is also known as cost of transaction. The %spread/cost of transaction at any point in time is represented by the percentage of spread.

UNIT-2–**IMPORTANT QUESTIONS**

1) **What is foreign exchange market? Write briefly about Foreign Exchange Market:**
2) **Define forex market. Discuss the functions and the structure of forex market in India.**
3) **Elaborately discuss about the major participants and transactions in the foreign exchange market.**
4) **Short note on Forex market**
    a. **Transactions and settlements,**
    b. **Foreign exchange quotations,**

(17E00407)INTERNATIONAL FINANCIAL MANAGEMENT

(Elective VI)

Objective: The objective of the course is to provide students with a broad view of International Monetary Systems and its understanding to enable a global manager to do business in a global setting. The prerequisite for the course is Financial Accounting and Analysis and Financial Management.

1. **Introduction to International Financial management:** IFM meaning**,** Difference between FM & IFM, Nature ,Scope, Importance.
2. Foreign Exchange Market: Functions and Structure of the Forex markets, major participants, types of transactions and settlements, Foreign exchange quotations, .
3. **Management of foreign exchange exposure and risk: Types of Exposure, Economic Exposure, Transaction Exposure, Operating Exposure.**
4. **Cross-border Investment Decisions:** Capital budgeting, Approaches to Project Evaluation, Risk in Cross-border Investment Decisions.
5. **Financing Decisions of MNC`s & Working Capital Management:** Introduction, the cost of capital, capital structure, Cash management, management of receivables, Inventory management.

Text Books:

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UNIT-3

MANAGEMENT OF FOREIGN EXCHANGE EXPOSURE AND RISK

1.1 MEANING OF FOREIGN EXCHANGE RISK

Foreign exchange risk is the variability of domestic currency values of assets liabilities or operating incomes due to unanticipated change in exchange rate. This is measured by the variance of the values i.e., Var (V) where V is the value of the assets or liability and var = variance = (standard deviation)

Foreign exchange risk is the possibility of a gain or loss to a firm that occurs due to unanticipated changes in exchange rate. For example if an Indian firm imports goods and pays in foreign currency its outflow is in dollars thus it is exposed to foreign exchange risk. If the value of the foreign currency rises the Indian firm has to pay more domestic currency to get the required amount of foreign currency.

Foreign exchange risks is the risk that the domestic currency value of cash flows denominated in foreign currency may change because of the variation in the foreign exchange rate.

1.1.1 MEANING OF FOREIGN EXCHANGE EXPOSURE

The general concept of foreign exchange exposure refers to the degree to which a company is affected by the changes in the exchange rates. In other words foreign exchange exposure refers to the change in the exchange rate due to change in the value of the assets liability and operating income either through their direct relationships or through common underlying factors.

ACCORDING TO MICHEAL ADLER AND BERNARD DUMAS have defined foreign exchange exposure as the measure of the sensitivity of changes in the real domestic currency value of assets liabilities or operating incomes due to unanticipated change in exchange rates. Thus as per the definition

a. Exposure is a measure of the sensitivity of domestic currency values of foreign currency denominated assets or liabilities i.e. it measures the extent to which the value of something in terms of domestic currency is changed due to the unanticipated change in exchange rate.

b. Exposure concerns the real change in the value of assets liabilities or operating income i.e. inflation adjusted value.

1.2 TYPES OF EXPOSURE:

There are mainly following types of exchange risk/exposures are as follows

A. Translation exposure
B. Transaction exposure
C. Economic/operating exposure

A. TRANSACTION EXPOSURE: Transaction exposure can be defined as the sensitivity of realized domestic currency values of the firms contractual cash flows denominated in foreign currencies to unexpected exchange rate changes. In other words this exposure refers to the extent to which the future value of firm's domestic cash flow is affected by exchange rate fluctuations. It arises from the possibility of incurring foreign exchanges gains or losses on transaction already entered into and denominated in a foreign currency.

The degree of transaction exposure depends on the extent to which firms transactions are in foreign currency. For example, the transaction in exposure will be more if the firm has more transactions in foreign currency.

Now if in the next thirty days after which the machine is to arrive and the payment is required to be made the exchange rate moves to 1= ₹37.00 the importer will have to pay an extra amount of ₹2,00,000 (₹37.00   35.00)   1,00,000 extra because the exchange rate has moved adversely from 1=₹35.00 to 1=₹37.00. With this change in exchange rate i.e. the change in the price of dollar the importer has incurred a loss of ₹2,00,000 although the price of the machine in terms of dollars has remained the same i.e. 100,000.

B. TRANSLATION EXPOSURE: Translation exposure relates to the change in accounting income and balance sheet statements caused by the changes in exchange rates. These changes may take place by/at the time of finalization of accounts compared to the time when the asset was purchased or liability was assumed. In other words translation exposure results from the need to translate foreign currency assets or liabilities into the local currency at the time of finalizing accounts.

Alternatively translations loser may not be reflected in the income statement. They may be shown separately under the head of translation adjustment in the balance sheet without affecting accounting income. This translation loss adjustment is to he carried out in the owners' equity account.

On account of varying ways of dealing with translation losses or gains accounting practices vary in different countries and among business firms within a country. Whichever method is adopted to deal with translation losses gains a marked impact on both the income statement and the balance sheet.

C. **ECONOMIC/OPERATING EXPOSURE:** Economic exposure is also known as operating exposure operating exposure is a relatively broader conception of foreign exchange exposure. The prime feature of operating exposure is that it is essentially a long term multi transaction oriented way of looking at the foreign exchange exposure of a firm involved in international business. The standard definition of economic exposure is the degree to which fluctuations in exchange rates will affect the net present value of the future cash flows of a company.

Operating exposure is a particularly serious problem for multinational corporations with operations in several different countries. Most of these techniques rely on complex mathematical and statistical models that attempt to capture all the variables. Use of regression analysis and simulation of cash flow positions under different exchange rate scenarios are two examples of such techniques.

Operating exposure is the risk that a company cash flow foreign investments and earnings may suffer as a result of fluctuating foreign currency exchange rates.

Operating exposure refers to the changes in expected cash flow due to unexpected movement in the exchange rate. It refers to the extent to which the economic value of accompany can decline due to movement in the exchange rate.

1.2.1 MEASUREMENT OF FOREIGN EXCHANGE EXPOSURE AND RISK

Many methods are available to cover or hedge exposure to risk. Measurement and management of foreign exchange risk/exposure are as follows, Measurement of foreign exchange exposure and risk

1. MEASUREMENT OF TRANSACTION EXPOSURE: Transaction exposure measures gains or losses that arise from the settlement of existing financial obligation whose terms are stated in a foreign currency. Two steps are involved in measuring transaction exposure.

a. Determine the projected net amount of currency inflows or outflows in each foreign currency.

b. Determine the overall exposure to those currencies.

The first step in transaction exposure is the projecting of the consolidated net amount of currency inflows or outflows for all subsidiaries classified by currency subsidiary. Subsidiary a may have net inflows of 6,00,000 while subsidiary B way have net outflows of 7,00,000. The consolidated net inflows here would be 1, 00,000. If the other currency depreciates subsidiary A will be adversely affected while subsidiary B will be favorably affected. Thus while assessing the MNCs exposure it is advisable as a first step to determine the MNCs overall position in each currency.

2. MEASUREMENT OF TRANSLATION EXPOSURE: There are various methods of measuring translation exposure which are as follows,

a. **Monetary/non-monetary method:** This method distinguished between monetary assets and liabilities and non monetary assets and liabilities. Monetary items are cash accounts payables accounts receivables etc. are translated at current exchange rate and non monetary items such as inventory fixed assets long term investments are translated at historical rates.

   Income statement items are translated at average exchange rate during the period except current receivables and payables related to non monetary assets liabilities i.e. depreciation expenses and cost of goods sold are translated at the same rate as the corresponding balance sheet items. The basic advantage of this method is that foreign non Monterey assets are carried at their original cost in parent consolidated statement cost treatment of domestic assets of the parent firm.

b. **Temporal method**: the temporal method can be defined as a method of translating foreign currency through the use of exchange rates based on the time of acquisition of assets and liabilities. The exchange rate involved also depends on the valuation method being used. For assets and liabilities valued at current costs the current exchange rate is used. On the contrary the assets valued at historical costs involve the use of historical exchange rates.

c. **Current and non current method:** in this method all current assets and liabilities are translated into domestic currency at current exchange rate. Each non-current item is translated at historical exchange rate. Thus in this method the cash and working capital of a subsidiary after approbation of the parent's currency is going to give translation losses and its appreciation will provide translation profits.

d. **Current rate method:** the current rate method is the simple and the most popular method all over the world. Under this method all balance sheet and income items are translated at the current rate of exchange except for stockholders equity. The common stock account and paid in capital accounts are translated at historical rates. Further gains or losses caused by translation adjustment are not included in the net income but are reported separately and accumulated in a separate equity account known as cumulative.

e. **Translation adjustment (CTA)** thus CTA account helps in balancing the balance sheet balance since translation gains or losses are not adjusted through the income statement.

   The two main advantages of the current rate method are first the relative proportions of the individual balance sheet accounts remain the same and hence do not distort the various balance sheet ratios like the debt equity rate current ratio etc. second the variability in reported earnings due to foreign exchange gains or losses is eliminated as the translation gain loss is known in a separate account the CTA account. The main drawback of the current rate method is that various items in the balance sheet which are recorded at historical costs are translated back into dollars at a different rate.

UNIT-3-**IMPORTANT QUESTIONS**

1) **Explain different types of exposures in foreign exchange market.**
2) **What is transaction exposure? How is it calculated?**