Mohamed Khaider University, Biskra

Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: International Finance

Branch: International Trade
Level: Third year Bachelor

Lecture 02: International Finance; Meaning, Features, Importance, Goals

Unit 01: Introduction to International Finance

Unit Overview

This Unit offers a primer on International Finance

Learning Outcomes

When you have completed your Study of this unit and its readings, you will be able to:

- explain the meaning of international finance
- determine scope of international finance
- distinguish between domestic and international financial transactions and identify the main characteristics of international financial contracts

1- Concept and Scope of International Finance

a- Concept

International finance focuses on managing financial resources in a global business environment. It explores the principles of trading in international markets, foreign currency exchange, and profit generation through such activities. As a key aspect of financial economics, international finance addresses monetary interactions between two or more countries. It covers topics such as currency exchange rates, global monetary systems, foreign direct investment (FDI), and other critical aspects of international financial management.

b-Scope

International finance has traditionally been associated with managing multinational corporations (MNCs) engaged in global business. A company is considered international when over 20% of its sales come from foreign markets. MNCs continuously seek strategies to enhance cash flow and shareholder wealth, leveraging market expansion opportunities facilitated by reduced trade barriers and liberal policies. Free trade promotes specialization, efficient resource allocation, and overall economic welfare.

Companies expand internationally in stages, starting with exports or imports before establishing foreign subsidiaries. Over the past three decades, political, technological, and economic changes have significantly shaped international business activities. Advancements in technology, particularly wireless and computing, have enhanced global mobility for companies.

Foreign direct investment (FDI) is a key approach for accessing international markets, with major economies like the USA, Germany, the UK, Japan, and European nations relying increasingly on domestic and foreign-based corporations. In 2004, India recorded 3.4% of GDP as inward FDI and 1.4% as outward FDI, while global FDI stood at 7.5% (inward) and 8.7% (outward). The rise of outward investment has been influenced by the opening of former communist economies, particularly China.

2- Features of International Finance

Some of the features of international financing management are listed below as international finance management has some certain distinguished features when compared with domestic finance managing. They are:

-Foreign exchange risks

-Political risks

-Market imperfections

-Expanded Opportunity

a-Foreign exchange risks: Exchange rate fluctuations can significantly impact businesses and individuals engaged in international transactions. A sharp depreciation of a local currency, such as the Mexican peso in 1994 or the Asian currency crisis of 1997, can make foreign products more expensive, reducing export competitiveness. Similarly, individuals borrowing in foreign currencies, like Hungarians taking euro or Swiss franc mortgages, can face increased repayment burdens if their local currency weakens, leading to financial distress.

Since the abandonment of fixed exchange rates in the early 1970s, major currencies like the U.S. dollar, Japanese yen, British pound, and euro have experienced continuous and unpredictable fluctuations. This exchange rate volatility affects key economic activities, including consumption, production, and investment, making foreign exchange risk a critical factor for both businesses and households in integrated financial markets.

b-Political risks

Political risk is a significant concern for firms and individuals operating internationally, as governments can change regulations or even expropriate foreign assets without effective recourse. This risk ranges from tax policy changes to the outright seizure of property.

For example, Enron Development Corporation invested nearly $300 million in an Indian power plant project, only for it to be canceled by local politicians in 1995, demonstrating the difficulty of enforcing contracts abroad. Similarly, the Russian government's actions against Yukos, including its forced bankruptcy and asset seizure following politically motivated charges against its owner, resulted in massive losses for international investors.

These cases highlight the vulnerability of businesses in countries lacking strong legal protections for property rights, making political risk a critical factor in international investment decisions.

c-Market imperfections: Despite increased global economic integration, barriers such as legal restrictions, high transaction and transportation costs, information asymmetry, and discriminatory taxation continue to hinder the free movement of people, goods, services, and capital. These market imperfections create frictions that motivate multinational corporations (MNCs) to establish overseas operations. For instance, Honda set up production in Ohio to bypass trade barriers.

Market imperfections also affect financial markets, limiting investors' ability to diversify. A notable example is Nestlé, which previously issued two classes of stock—bearer shares for foreigners and registered shares for Swiss residents. Foreigners had to pay nearly twice as much for bearer shares due to these restrictions. When Nestlé lifted these limitations in 1988, the price disparity quickly disappeared, causing a wealth shift from foreign to domestic shareholders. This case highlights both the role of market imperfections in international finance and the risks of political decisions affecting foreign investors, even in politically stable countries.

d- Expanded Opportunity: Expanding into global markets provides firms with a broader opportunity set, allowing them to optimize production locations, access cheaper capital, and achieve economies of scale by leveraging tangible and intangible assets worldwide. A prime example is General Electric, which utilized the global bond and swap markets to secure funding in French francs and convert it into U.S. dollars, saving $400,000 annually on a nine-year deal.

Individual investors also benefit from international diversification. Investing across multiple countries can reduce risk and potentially increase returns, as stock returns tend to be less correlated across nations than within a single country. By embracing global investment opportunities, both firms and investors can maximize gains while carefully managing currency risks, political uncertainties, and market imperfections.

3-The importance of International Finance:

a- **Expansion of production capacity:** Some domestic firms increase their production beyond local demand, leading them to sell surplus output in foreign developed markets.

b- **Proximity to raw materials:** Access to high-quality and bulk raw materials is a key factor attracting firms to foreign locations. Many U.S. and European companies have established manufacturing units in Saudi Arabia, Bahrain, Qatar, and Iran due to their abundant petroleum resources.

c- **Higher profit potential:** International firms seek foreign markets that offer greater profit opportunities, driving them to expand operations beyond their home countries.

d- **Access to technology and skilled workforce:** The presence of advanced technology and highly skilled labor in certain countries serves as a major incentive for international companies to invest there.

e- **Exchange rate determination:** Exchange rates play a crucial role in international finance, helping assess the relative value of different currencies. International finance facilitates the calculation of these rates.

f- **Boost to economic growth:** International firms contribute to economic development by enhancing GDP growth, increasing industrial output, creating jobs, and raising income levels.

g- **Avoiding tariffs and import restrictions:** To bypass high tariffs and import quotas, firms opt for direct foreign investment. Companies like Sony, Honda, and Toyota have expanded globally by setting up subsidiaries or forming joint ventures in various countries.

4-Goals for International Finance

International Finance is designed to provide today's financial managers with an understanding of the fundamental concepts and the tools necessary to be effective global managers.

- Shareholder wealth maximization; Effective financial management goes beyond simply adopting the latest business strategies or improving operational efficiency; it requires a clear objective. International Financial Management is based on the principle that the primary aim of sound financial management is to maximize shareholder wealth. This means that all business decisions and investments should be made with the goal of enhancing the financial well-being of the firm's owners—its shareholders—by increasing their overall wealth.

- Corporate governance, Following these corporate crises that have shaken confidence in the free market system, society has come to recognize the critical role of corporate governance—the financial and legal framework that defines the relationship between a company's management and its shareholders. This issue is not limited to the United States; in many regions, particularly emerging and transitioning economies like Indonesia, Korea, China, and Russia, weak or nonexistent legal protections for shareholders make corporate governance challenges even more severe.

5-Key Terms:

Cash Management: The handling of cash within a firm such as the investment a firm has in transaction balances, funds tied up in precautionary cash balances, investment of excess funds at the most favorable rate, and borrowing at the lowest rate when there is a temporary cash shortage.

Corporate Governance: The economic, legal, and institutional framework in which corporate control and cash flow rights
are distributed among shareholders, managers, and other stakeholders of the company

Counterparty: One of the two parties involved in financial contracts who agrees to exchange cash flows on particular terms.

Countertrade: Transactions in which parties exchange goods or services. If these transactions do not involve an exchange
of money, they are a type of barter

Euro: The common European currency introduced in 1999 of the 11 countries of the EU that make up the EMU

Foreign Branch: An overseas affiliate of a MNC which is not an independently incorporated firm but is rather an extension of the parent.

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Market Imperfections: Various frictions, such as transaction costs and legal restrictions, that prevent the markets from
functioning perfectly

Multinational Corporation (MNC): Refers to a firm that has business activities and interests in multiple countries.

Political Risk: Potential losses to the parent firm resulting from adverse political developments in the host country.