GLOBAL FINANCIAL MANAGEMENT

UNIT-I

**Globalization :**

* Globalization refers to the growing unification of financial markets across the world.
* It reflects growing links between emerging and developed financial markets.

**Implications of globalization:**

1. The impact of globalization on democracy also has been both positive and negative.
2. Globalization has contributed to the spread of democracy but it has also limited the scope of democracy by narrowing the sphere of public decisions.
3. The argument that market democracy is more genuine (and less exclusive) is not convincing.
4. Market democracy, in which voting rests on a base of purchasing power, is inherently oligarchic in an economic system that is characterized by inequality—as capitalism is.
5. Globalization's economic vision, including deregulation of labor and the retrenchment of the welfare state, has also increased inequality and relative (if not absolute) poverty.
6. Various aspects of workers' rights have been rolled back in order to bolster the bottom line of corporations.

**Goals of international financial management**:

**1. Profit Maximization**

* [Profit maximization](https://www.mbaknol.com/financial-management/objectives-of-financial-management/) is a stated goal of financial management. Profit is the excess of revenue over expenses.
* Profit maximization is therefore maximizing revenue given the expenses, or minimizing expenses given the revenue or a simultaneous maximization of revenue and minimization of expenses.

### ****2. Profitability Maximization****

* Profit as an absolute figure conveys less and conceals more. Profit must be related to either sales, capacity utilization, production or capital invested.
* Profit when expressed in relation to the above size or scale factors it acquires greater meaning.

### ****3. EPS Maximization****

* Maximization [Earnings Per Share](https://www.mbaknol.com/investment-management/classification-of-equity-shares-in-terms-of-anticipated-earnings/) (EPS) involves maximizing earnings after tax given the number of outstanding equity shares.
* This goal is similar to profitability maximization in respect of merits and demands.

### ****4. Liquidity Maximization****

* Liquidity refers to the ability of a business to honor its short-term liabilities as and when these become due.
* This ability depends on the ratio of current assets to current liabilities, the maturity patterns of currents assets and ‘the current liabilities, the composition of current assets, the quality of non-cash current assets; the relations with the short-term creditors; the relations with bankers and the like.

**Scope of international finance:**

* Increasing Interdependence in the Global Economy
* Financial management of a company is a complex process, involving its own methods and procedures.
* It is made even more complex because of the globalization taking place, which is making the world’s financial and commodity markets more and more integrated.
* The integration is both across countries as well as markets. Not only the markets, but even the companies are becoming international in their operations and approach.
* This changing scenario makes it imperative for a student of finance to study international finance.
* When a firm operates only in the domestic market, both for procuring inputs as well as selling its output, it needs to deal only in the domestic currency.

**International monetary system: bimetallism- Gold standard**

**Meaning:**

The international monetary system refers to the operating system of the financial environment, which consists of financial institutions, [multinational corporations](https://www.sciencedirect.com/topics/economics-econometrics-and-finance/transnational-corporation), and investors.

#### (i)The Bimetallism:

* Before 1870, the international monetary system consisted of bimetallism, where both gold and silver coins were used as the international modes of payment.
* The exchange rates among currencies were determined by their gold or silver contents. Some countries were either on a gold or a silver standard.

#### (ii)Gold standard

* The international gold standard prevailed from 1875 to 1914. In a gold standard system, gold alone is assured of unrestricted coinage.
* There was a two-way [convertibility](https://www.sciencedirect.com/topics/economics-econometrics-and-finance/convertibility) between gold and national currencies at a stable ratio

**(iii)Gold exchange standard**

* The [Bretton Woods System](https://www.sciencedirect.com/topics/economics-econometrics-and-finance/bretton-woods-system) was established after World War II and was in existence during the period 1945-1972.
* In 1944, representatives of 44 nations met at Bretton Woods, New Hampshire, and designed a new postwar international monetary system.

**(iv)Flexible exchange rate regime**

* European and Japanese currencies became free-floating currencies in 1973.
* The flexible exchange rate regime was formally ratified in 1976 by IMF members through the Jamaica Agreement.

**Bretton woods system:**

Financial-economic agreement reached in 1944

* The **Bretton Woods system** of monetary management established the rules for commercial and financial relations among the [United States](https://en.wikipedia.org/wiki/United_States), [Canada](https://en.wikipedia.org/wiki/Canada), Western European countries, Australia, and [Japan](https://en.wikipedia.org/wiki/Japan) after the 1944 Bretton Woods Agreement.
* The Bretton Woods system was the first example of a fully [negotiated](https://en.wikipedia.org/wiki/Representative_money) monetary order intended to govern monetary relations among independent states.
* Also, there was a need to address the lack of cooperation among other countries and to prevent competitive devaluation of the currencies as well.
* Preparing to rebuild the international economic system while [World War II](https://en.wikipedia.org/wiki/World_War_II) was still raging,
* 730 delegates from all 44 Allied nations gathered at the Mount Washington Hotel in Bretton Woods, New Hampshire, United States, for the United Nations Monetary and Financial Conference, also known as the Bretton Woods Conference.

**Floating exchange rate regime:**

* Flexible exchange rates can be defined as [*exchange rates*](https://www.policonomics.com/exchange-rate/) determined by global [*supply and demand*](https://www.policonomics.com/supply-and-demand) of currency.
* In other words, they are prices of foreign exchange determined by the market, that can rapidly change due to supply and demand, and are not pegged nor controlled by central banks.

Two types of flexible exchange rates:

1. [**pure floating regimes**](https://www.policonomics.com/free-float/)
2. [**managed floating regimes**](https://www.policonomics.com/managed-float/).

Pure floating regimes:

Pure floating regimes exist when, in a flexible exchange rate regime, there are absolutely no official purchases or sales of currency.

Managed floating rates:

Managed (also called dirty) floating regimes, are those flexible exchange rate regimes where at least some official intervention happens.

* Flexible exchange rate regimes were rare before the late twentieth century. Prior to World War II, governments used to purchase and sell foreign and domestic currency in order to maintain a desirable exchange rate, especially in accordance with each country’s [trade policy](https://www.policonomics.com/international-trade/).

**European monetary system:**

## Meaning:

* The European Monetary System (EMS) was an adjustable [exchange rate](https://www.investopedia.com/terms/e/exchangerate.asp) arrangement set up in 1979 to foster closer [monetary policy](https://www.investopedia.com/terms/m/monetarypolicy.asp) co-operation between members of the [European Community](https://www.investopedia.com/terms/e/european-community.asp) (EC).
* The European Monetary System (EMS) was later succeeded by the [European Economic and Monetary Union](https://www.investopedia.com/terms/e/emu.asp) (EMU), which established a common currency called the [euro](https://www.investopedia.com/terms/e/euro.asp).

## Criticism of the European Monetary System (EMS)

* Under the European Monetary System (EMS), exchange rates could only be changed if both member countries and the European Commission were in agreement.
* This was an unprecedented move that attracted a lot of criticism.
* With the[global economic crisis of 2008-2009](https://www.investopedia.com/terms/g/great-recession.asp)  and the ensuing economic aftermath, significant problems in the foundational European Monetary System (EMS) policy became evident.

**IMF:**

## International Monetary Fund:

The International Monetary Fund (IMF) is an international organization that aims to promote global [economic growth](https://www.investopedia.com/terms/e/economicgrowth.asp) and financial stability, encourage international trade, and reduce poverty.

**IMF Activities:**

### Surveillance

The IMF collects massive amounts of data on national economies, [international trade](https://www.investopedia.com/insights/what-is-international-trade/), and the global economy in aggregate, as well as providing regularly updated economic forecasts at the national and international levels

### Capacity Building

The IMF provides technical assistance, training, and policy advice to member countries through its capacity building programs.

### Lending

The IMF makes [loans](https://www.investopedia.com/terms/l/loan.asp) to countries that are experiencing economic distress in order to prevent or mitigate financial crises.

**WTO:**

**Meaning:**

* World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations .
* The goal is to ensure that trade flows as smoothly, predictably and freely as possible.

## Decision-making

* **[Organization chart](https://www.wto.org/english/thewto_e/whatis_e/tif_e/org2_e.htm)**  
  The WTO's top decision-making body is the Ministerial Conference. Below this is the General Council and various other councils and committees.  
  [Current WTO chairpersons](https://www.wto.org/english/thewto_e/secre_e/current_chairs_e.htm)

* **[Ministerial conferences](https://www.wto.org/english/thewto_e/minist_e/minist_e.htm)**  
  Ministerial conferences usually take place every two years.

* **[General Council](https://www.wto.org/english/thewto_e/gcounc_e/gcounc_e.htm)**  
  The General Council is the top day-to-day decision-making body. It meets a number of times a year in Geneva.

## Membership

* [**Members and observers**](https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm)    
  The WTO has over 160 members representing 98 per cent of world trade. Over 20 countries are seeking to join the WTO.

* **[Accessions](https://www.wto.org/english/thewto_e/acc_e/acc_e.htm)**    
  To join the WTO, a government has to bring its economic and trade policies in line with WTO rules and negotiate its terms of entry with the WTO membership.

**GATT:**

## General Agreement on Tariffs and Trade (GATT):

The General Agreement on Tariffs and Trade (GATT), signed on Oct. 30, 1947, by 23 countries, was a legal agreement [minimizing barriers to international trade](https://www.investopedia.com/articles/economics/08/tariff-trade-barrier-basics.asp) by eliminating or reducing [quotas](https://www.investopedia.com/terms/q/quota.asp), [tariffs](https://www.investopedia.com/terms/t/tariff.asp), and [subsidies](https://www.investopedia.com/terms/s/subsidy.asp) while preserving significant regulations.

* The General Agreement on Tariffs and Trade (GATT) was signed by 23 countries in October 1947, after World War II, and became law on Jan. 1, 1948.
* The GATT’s purpose was to make international trade easier.
* The GATT held eight rounds in total from April 1947 to September 1986, each with significant achievements and outcomes.
* In 1995 the GATT was absorbed into the World Trade Organization (WTO), which extended it.

UNIT-II

**Balance of payment:**

**Meaning:**

The balance of payments (BOP) is the record of all international financial transactions made by the residents of a country.

There are three main categories of BOP:

The current account,

The capital account, and

The financial account.

**The Current Account:**

Within the current account are credits and debits on the trade of merchandise, which includes goods such as raw materials and manufactured goods that are bought, sold, or given away (possibly in the form of aid).

**The Capital Account**

* The capital account is where all international capital transfers are recorded.
* This refers to the [acquisition](https://www.investopedia.com/terms/a/acquisition.asp) or disposal of non-financial assets (for example, a physical asset such as land) and non-produced assets,.

## The Financial Account

* In the financial account, international monetary flows related to investment in business, real estate, bonds, and stocks are documented.
* Also included are government-owned assets such as foreign reserves, gold, special drawing rights (SDRs) held with the International Monetary Fund (IMF).

**Significance of BOP:**

* The balance of payments data is important to a lot of users.
* Investment managers, government policymakers, the central bank, businessmen, etc., all make use of the BOP data to make important decisions.
* The BOP data is affected by vital macroeconomic variables such as exchange rate, price levels, interest rates, employment, and GDP.
* Monetary and fiscal policies are formed in a way to achieve very specific objectives, which generally exert a significant impact on the balance of payments.
* Policies can be formed with the objectives to induce or curb foreign inflows or outflows.
* Businesses use BOP to analyze the market potential of a country, especially in the short term.
* A country with a large trade deficit is not as likely to import as much as a country with a trade surplus.
* If there is a large trade deficit, the government may adopt a policy of trade restrictions, such as quotas or tariffs.

**Bop account of india:**

* Bop is the oldest and the most important statistical statement for any country.
* In a nutshell BOP of a country is “a systematic record of all economic transactions between the residents of one country with the residents of the other country in a financial year”.
* Economic Transactions include all the foreign receipts and payments made by a country during a given financial year.
* The Foreign receipts include all the earnings and borrowings by a country from the other countries.

|  |  |
| --- | --- |
| **UNIT- 3**  **1.International Financial Market:**  **Meaning**   * The International Financial Market is the place where financial wealth is traded between individuals (and between countries). * It can be seen as a wide set of rules and institutions where assets are traded between agents in surplus and agents in deficit and where institutions lay down the rules.   **Who are the participants of international financial market?**  The main participants in this market are retail customers, commercial banks, foreign exchange brokers, and central banks.  **What are the different types of financial markets?**  **#** Stock market.  **#** The stock market trades shares # of ownership of public companies. ...  **#** Bond market. ...  **#** Commodities market. ...  **#** Derivatives market. ...  **#** Puts savings into more productive use. ...  **#** Determines the price of securities. ...  **#** Makes financial assets liquid. ...  **#** Lowers the cost of transactions.  **What are the Functions of Financial Markets?**  **#** Price Determination.  **#** Funds Mobilization.  **#** Liquidity.  **#** Risk sharing.  **#** Easy Access.  **#** Reduction in transaction costs and provision of the Information.  **#** Capital Formation.  **Sources of International Finance :**  **#** Commercial Banks and Financial Institutions.  **#** Meaning, Nature and Significance of Business Finance.  **#** Retained Earning, Trade Credit and Factoring.  **#** Commercial Paper.  **#** Debentures.  **#** Equity Shares and Preference Shares.  **#** International Financing and Choice of Sources of Funds.  **#** Lease Finance and Public Deposits.  **Multilateral Development Banks:**  **Meaning:**  A multilateral development bank (MDB) is an institution, created by a group of countries, that provides financing and professional advising for the purpose of development.  MDBs have large memberships including both developed donor countries and developing borrower countries  **Types of Multilateral Development Banks**  **1.** Industrial Finance Corporation of India **(IFCI),** 1948  **2.**Industrial Credit and Investment Corporation of India **(ICICI),** 1955  **3.**Industrial Development of Bank of India **(IDBI)**, 1964  **4.**State Finance Corporation **(SFC),** 1951  **5.**Small Industries Development Bank of India (**SIDBI),** 1990  **6.**Export-Import Bank **(EXIM)**  **7.**Small Industries Development Corporation (**SIDCO)**  **8**.National Bank for Agriculture and Rural Development **(NABARD)**  **Govt Agencies:**  A government or state agency, sometimes an appointed commission, is a permanent or semi-permanent organization in the machinery of government that is responsible for the oversight and administration of specific functions, such as an administration. ... Agencies can be established by legislation or by executive powers.  **Roles of govt Agencies:**  Federal agencies are special government organizations set up for a specific purpose such as the management of resources, financial oversight of industries, or national security issues. These organizations are typically created by legislative action, but may initially be set up by presidential order as well.  **International financial-market-instruments**.  **#** International bonds  **#** Foreign bonds  **#** euro bonds  **#** Global bonds  **#** Straight bond  **#** Floating rate notes  **#** Convertible bonds  **#** Cocktail bonds  **1.Cash** Instruments.  **2.Derivative** Instruments.  **3.Debt-Based** Financial Instruments.  **4.Equity-Based** Financial Instruments.  **International Securities**  Exchange (ISE) is an electronic options exchange that was launched in 2000.  The exchange provides investors with greater liquidity and the ability to execute transactions at a much faster rate than the open-cry trading floor that has historically been the basis for options trading.  **#** debt securities (e.g., banknotes, bonds and debentures.  **#** equity securities (e.g., common stocks)  **#** derivatives (e.g., forwards, futures, options, and swaps).  **GDR'S:**  **global depository receipt**  A global depository receipt is a general name for a depositary receipt where a certificate issued by a depository bank, which purchases shares of foreign companies, creates a security on a local exchange backed by those shares.  **GDR'S Features:**  **1.** It is a negotiable instrument and can be traded freely like any other security.  **2.** Indian companies with sound financial track of three years are readily allowed to access international financial markets through GDR. However clearances are required from the Foreign Investment Promotion Board (FIPB) and the Ministry of Finance.  **3.** GDRs are issued to investors across the country. It is denominated in any  acceptable freely convertible currency.  **4.** GDR is denominated in any foreign currency but the underlying shares would be denominated in local currency of the issuer.  **5.** The holder is entitled to dividend and bonus on the value of shares underlying the GDR.  **6.** The investor can convert GDR into equity shares, and sell the shares mentioned in the GDR through a local custodian. This provision can be used after 45 days from the date of issue.  **7.** Under GDR, the issuing company transacts with only one entity for all its transactions.  **ADR'S**  **American depositary receipt**  An American depositary receipt (ADR) is a certificate issued by a U.S. bank that represents shares in foreign stock. ADRs trade on American stock exchanges. ADRs and their dividends are priced in U.S. dollars. ADRs represent an easy, liquid way for U.S. investors to own foreign stocks  **International money market:**  The international money market is a market where international currency  transactions between numerous central banks of countries are carried on. The transactions are mainly carried out using gold or in US dollar as a base  **Following are the types of Money Market Instruments:**  **1.Promissory** Note: A promissory note is one of the earliest type of bills. ...  **2.Bills** of exchange or commercial bills. ...  **3.Treasury** Bills (T-Bills)  **4.Call** and Notice Money. ...  **5.Inter-bank** Term Market. ...  **5.Commercial** Papers (CPs)  **6.Certificate** of Deposits ( CD's )  **7.Banker's** Acceptance  **Euro bonds:**  A eurobond is an international bond that is denominated in a currency not native to the country where it is issued. Also called external bond; "external bonds which, strictly, are neither eurobonds nor foreign bonds would also include: foreign currency denominated domestic bonds…"  **The main advantages of Eurobonds**  Increased liquidity of European bond markets (conditional on participation), protection from large market shocks and erratic market discipline, guaranteed funding for all Economic and Monetary Union (EMU) countries and an improvement in the international position of the Euro.  **Euro commercial paper :**  Euro Commercial Paper (ECP) is an unsecured, short-term debt instrument that is denominated in a currency differing from the domestic currency of the market where it is issued. The ECP works to be an attractive short-term financing tool for firms that wish to reduce forex market risk.  **Medium Term Notes :**  A medium-term note **(MTN)** is a debt note that usually matures (is paid back) in 5–10 years, but the term may be less than one year or as long as 100 years. They can be issuedon a fixed or floating coupon basis.  **Floating Rate Notes :**  Floating rate notes **(FRNs)** are bonds that have a variable coupon, equal to a money market reference rate, like LIBOR or federal funds rate, plus a quoted spread (also known as quoted margin). ... Almost all FRNs have quarterly coupons, i.e. they pay out interest every three months.  **Loan Syndicate:**  Loan syndication is the process of involving a group of lenders in funding various portions of a loan for a single borrower. Loan syndication most often occurs when a borrower requires an amount too large for a single lender to provide or when the loan is outside the scope of a lender's risk-exposure levels.  **Euro Deposit:**  A euro deposit is a deposit of foreign funds into a bank that operates within the European banking system. These banks function on the consolidated European currency—the euro.  When an external investor deposits foreign currency into one of these banks, they are effectively depositing in euros**.**  **Euro Issues in India:**  The Indian case is no exception. The significance of the euro issues is not limited to the primary market abroad. After the ADRs/GDRs of Indian firms are issued, they are also listed on the international stock exchanges and subsequently traded there. The trading brings in ample gains to the Indian company.  Euro Issue Guidelines. A scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipts Mechanism) was notified by the Government of India in November, 1993. Revisions/modifications in the operative guidelines for EuroIssues are announced from time to time. |  |
|  |  |

**UNIT-IV**

**Currency risk management- Translation exposure- Operating exposure/ Economic exposure**

**Meaning of currency risk and exposure?**

**Currency risk:**

Currency risk is the potential risk of loss from fluctuating foreign exchange rates when an investor has exposure to foreign currency or in foreign-currency-traded investments.

Example:

If, interest rates are higher in Canada, the U.S dollar will probably drop in relative to the Canadian dollar.

**Exposure:**

## Exposure is the amount an investor stands to lose in investment should the investment fail.

## Example:

## The financial exposure involved in purchasing a car would be the initial investment amount minus the insured portion.

**Types of Currency Risks**

* Transaction exposure
* Translation exposure
* Economic exposure

**I. Transaction exposure:**

**(i)**Transaction exposure, defined as a type of foreign exchange risk faced by companies that engage in international trade, exists in any worldwide market.

**(ii)** It is also called transaction risk.

**II. Translation exposure**:

**(i)** Translation exposure ( also known as translation risk) is the risk that a company’s equities, assets, liabilities, or income will changes in value as a result of exchange rate changes.

**(ii)** It is also known as “accounting exposure”**.**

**III. Economic exposure:**

(i) Economic exposure is a type of foreign exchange exposure caused by the effect of unexpected currency fluctuations on a company’s future cash flows, foreign investments, and earnings.

(ii)It is also known as operating exposure.

**Measurement of currency risk?**

## Review your operating cycle:

(i) Review your business operating cycle to learn where FX risk exists.

(ii)This will help you determine your profit margin’s sensitivity to currency fluctuations.

## Measure and manage your exposure to currency risk:

(i) This should include the risk exposure before a deal, purchase or transaction is agreed upon and the actual risk that exists after a completed transaction.

(ii) When you have a sense of pre- and post-transaction risk, you will be able to decide on your needed level of hedging.

## Hedge your currency risk:

Hedging means that you use financial instruments, such as currency or FX forwards, to lock in the currency rate so that it remains the same over a specified period of time.

## Create an FX policy and stick to it:

(i) An effective FX policy begins with a clear corporate strategy and clarity on corporate objectives.

(ii) The policy should identify key metrics – be it cash flow, EBITDA, asset values, debt- and interest-coverage ratios.

## Accept that you have unique currency flows:

(i) Every business is unique and that is reflected in your currency flows, but also in the structure of your assets and liabilities.

(ii) It is key to understand that currency fluctuations may have an impact and the decision to hedge or not is not as simple as a roll of the dice.

**Concept and measurement of Transaction Exposure:**

**Transaction exposure:**

(i) Transaction exposure, defined as a type of foreign exchange risk faced by companies that engage in international trade, exists in any worldwide market.

**(ii)** It is also called transaction risk.

**Measurement of Transaction Exposure**

I. Call hedge

* Cost of hedging includes the price paid for the currency, along with the premium paid for the call option.
* Cost of hedging with call options is not known with certainty at the time that the options are purchased.

II. Money market hedge vs forward hedge

* Since the results of both hedges are known beforehand, the firm can implement the one that is more feasible.
* If interest rate parity exists, and transaction costs do not exist, the money market hedge will yield the same results as the forward hedge.

III. Leading and Lagging

Involve adjusting the timing of a payment request or disbursement to reflect expectations about future currency movements.

IV. Cross Hedging

* Reduces transaction exposure when the currency cannot be hedged.
* Hedged position is in a currency that serves as a proxy for the currency in which the MNC is exposed.

V. Put option hedge

* An MNC can purchase a put option on the currency denominating its receivables and lock in the minimum amount that it would receive when converting the receivables into its home currency.
* Estimate of the cash to be received from a put option hedge is the estimated cash received from selling the currency minus the premium paid for the put option.

**Techniques of transaction exposure management**:

* Risk Shifting

(i) The most obvious way is to not have any exposure. By invoicing all parts of the transactions in the home currency, the firm can avoid transaction exposure completely.

(ii) However, it is not possible in all cases.

* Currency risk sharing

The two parties can share the transaction risk. As the short-term transaction exposure is nearly a zero sum game, one party loses and the other party gains.

* Leading and Lagging

(i) It involves playing with the time of the foreign currency cash flows. When the foreign currency is appreciating, pay off the liabilities early and collect the receivables later.

(ii)The first is known as leading and the latter is called lagging.

* Reinvoicing Centers

(i) A reinvoicing center is a third-party corporate subsidiary that uses to manage one location for all transaction exposure from intra-company trade.

(ii) In a reinvoicing center, the transactions are carried out in the domestic currency, and hence, the reinvoicing center suffers from all the transaction exposure.

**Translation Exposure meaning and methods:**

**Translation exposure:**

**(i)** Translation exposure ( also known as translation risk) will changes in value as a result of exchange rate changes.

**(ii)** It is also known as “accounting exposure”**.**

**Methods of translation exposure:**

1. **Current rate method:**

* All items of income statement and balance sheet are translated at current rates.

1. **Current/ non-current method:**

* Current asset and liabilities are translated at current rate and fixed assets and long term liabilities at historical rate or at the rate at which they were acquired.

1. **Monetary / non-monetary method:**

* Assets and liabilities are classified as monetary (cash, marketable securities, accounts receivable, etc..) or non-monetary (owner’s equity, land).
* All monetary balance sheet accounts are translated at the current exchange and non-monetary items are translated at historical rate or acquired rate.

1. **Temporal method:**

* This method uses historical rate for items recorded at historical costs; fixed assets
* Items that are stated at replacement rates, market rates or expected future value are stated at current rate.

**Transaction exposure vs translation exposure:**

|  |  |  |
| --- | --- | --- |
| **Points of difference** | **Transaction exposure** | **Translation exposure** |
| **ACCOUNTING** | Transaction exposure impacts the cash flow movement and arises while conducting purchase and sale transactions in different currencies. | Translation exposure is not a cash flow change and arises as a result of consolidating results of a foreign subsidiary. |
| **GAIN / LOSS** | Transaction exposure results in realized gain or losses. | Translation exposure results in notional/ book gain or losses. |
| **TIMING IMPACT** | Transaction exposure arises the moment a company enters into a transaction involving foreign currency. | Translation exposure arises on the arises on the balance sheet consolidation date and is at the end of a given financial period(quarter or year) |
| **FIRM VALUE IMPACT** | Because a transaction exposure has an actual cash flow impact, it impacts the value of a company. | Since the translation exposure doesn’t create any cash flow impact, the value of a company doesn’t change due to this type of exposure. |
| **TAX** | Transaction exposure measures gain or loss to the cash flow on account of forex movements. | Translation exposure is a measurement concept rather than dealing with actual cash flow impact on account of forex. |

**Exchange risk management/ forex risk management:**

**Definition:**

Foreign exchange risk management strategy or FX hedging strategy are terms used to define all the measures devised by businesses or investors to protect the value of their cash flows, assets or liabilities from adverse fluctuations of the exchange rate.

**Types of Foreign Exchange Risk:**

1. Transaction Risk:

* The risk that changes in exchange rates during the time it takes to settle a cross-border contract will adversely affect the profit of a party to the transaction.
* Accounting Dictionary defines transaction risk as “The risk that future cash transactions will be affected by changing exchange rates.”

1. Open Position Risk:

* Practically, it is not possible to maintain a square position as the aggregate customer transactions will not result in marketable lots.
* Measures to mitigate open position risk.
* Limits on intra-day open positions in each currency.
* Limits on overnight open positions in each currency.

1. Mismatch Maturity Risks:

Risk that, due to differences in maturities of the long and positions in a cross hedge, the value of the risk offsetting positions will fail to move in concert.

1. Sovereign Risk:

* Arises when banks deal with other banks in other countries.
* Also arises on account of large exposures on any country which is in some trouble – then the bank that has exposure may incur a huge loss.

5. Operational Risks: Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal procedures, people and systems, or from external events.

**what is Operating exposure? Measuring and managing operating exposure?**

Operating exposure:

* Operating exposure also called economic exposure
* It measures any change in the present value of a firm resulting from changes in future operating cash flows caused by an unexpected change in exchange rates.

**Measuring and managing operating exposure:**

I. Marketing management adjustments:

* Market selection
* Pricing strategy
* Product strategy

II. Product management adjustments:

* Input mix
* Shift production among plants
* Plant location
* Raising productivity

III. Planning for exchange rate changes:

* Before the impact of an currency change makes itself felt.
* Implication

IV. Financial management of exchange rate risk:

* Provide local manager with forecasts of inflation and exchange rate changes.
* Identify and focus on competitive exposure.
* Estimate and hedge the operating exposure after adjustments made.

UNIT-V

**Foreign Direct Investment**

**Foreign direct investment:**

* A foreign direct investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country.
* It is thus distinguished from a foreign portfolio investment by a notion of direct control.

**Forms of FDI’s:**

* Tax holidays

A tax holiday is a government incentive program that offers a tax reduction or elimination to businesses.

* Other types of tax concessions

A reduction made by the government in the amount of tax that a particular group of people or type of organization has to pay or a change in the tax system that benefits those people.

* Preferential tariffs

A tariff schedule under which one or more nations are given lower rates or other advantages over others.

* Special economic zones

It is an area in which the business and trade laws are different from the rest of the country.

* EPZ – Export Processing Zones

It can be defined as a territory within a certain geographical location where the government allows the import of various factors of production.

* Bonded Warehouses

A bonded warehouse or bond is a building or other secured area in which dutiable goods may be stored, manipulated or undergo manufacturing operations without payment of duty.

* Soft loan or loan guarantees

A soft loan is a loan with no interest or a below-market rate of interest.

A loan guarantee in finance is a promise by one party to assume the debt obligation of a borrower if that borrower defaults.

* Infrastructure subsidies

Infrastructure subsidy is money given by a government for projects that are beneficial to basic public services.

**FDI in world:**

* A 2010 meta-analysis of the effects of foreign direct investment on local firms in developing and,
* Transition countries suggest that foreign investment robustly increases local productivity growth.

**List of countries received by FDI:**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  | | --- | --- | --- | --- | | Rank | country | Stock of FDI at home(millions of USD) | Date of information | | - | European union | 6,938,000 | 31  December  2016 est. | | 1 | Netherlands | 4,888,000 | 31  December  2017 est. | | 2 | United status | 4,084,000 | 31  December  2017 est. | | 3 | United kingdom | 2,027,000 | 31  December  2017 est. | |

**China**

* FDI in China, also known as RFDI (Renminbi Foreign Direct Investment), has increased considerably in the last decade, reaching $59.1 billion in the first six months of 2012,
* making China the largest recipient of foreign direct investment and topping the United States which had $57.4 billion of FDI.

**India**

* Foreign investment was introduced in 1991 under Foreign Exchange Management Act (FEMA), driven by then finance minister Man Mohan Singh.
* India imposes cap on equity holding by foreign investors in various sectors, current FDI limit in aviation sector is maximum 49%.

**United States**

* U.S. FDI totalled $194 billion in 2010. 84% of FDI in the U.S. in 2010 came fromor through eight countries:
* Switzerland, the United Kingdom, Japan, France, Germany,Luxembourg, the Netherlands, and Canada.

**Purpose of overseas investment:**

**Overseas investment**:

* Overseas direct investment means that Indian person or companies can invest directly their funds into foreign countries subject to the Indian taxation laws…

**Purpose of overseas investment:**

* Foreign direct investment is critical for developing and emerging market countries.
* Their companies need the multinationals funding and expertise to expand their international sales.
* Their countries need private investment in infrastructure, energy, and water to increase jobs and wages.
* The U.N report warned that climate change would hit them the hardest.
* Most of these countries investments are via mergers and acquisition between mature companies.
* These global corporations’ investments were for either restructuring or refocusing on core businesses.

**Benefits to the host countries:**

Host country means that country which accepts the FDI from other countries and uses this for its economic development.

**Benefits:**

* Resource transfer effects
* Supplying capital, technology and management resources
* Employment effects
* Brings jobs directly by MNE employing & indirectly by suppliers employing
* MNE tend to pay higher wages.
* Balance of payment effects
* Tracks payments to & receipts from other countries.
* FDI can substitute for imports and can exports to other countries.
* Effect on competition and economic growth.
* Green-field increases the number of players, increase competition
* Competition drive down prices and benefit consumers
* Increased productivity, innovation & economic growth.

**Effects of FDI:**

* Foreign enterprises obstruct the growth of indigenous industrial entrepreneurship.
* When foreign investments compete with home investments, profits in domestic industries fall, leading to fall in domestic savings.
* Foreign firms may influence political decisions in developing countries**.**
* The cost of foreign capital for the host country tends to be very high**.**
* Contribution of foreign firms to public revenue through corporate taxes is comparatively less.
* Financial transfer in foreign exchange
* Physical resources like machinery, tools, equipment etc..

**Political risk:**

**Meaning:**

Political risk refers to the risk that political decisions or events in a country negatively affect the profitability or sustainability of an investment.

**Types of political risk:**

* **Confiscation:**

The more severe political risk is the seizing of company’s assets without payment.

* **Expropriation:**

It is where the government, seizes an investment, but some reimbursement for the assets is made,

* **Domestication:**

Occurs when the government, mandates local ownership and greater national involvement in a foreign company’s management.

Reducing political risk:

* Cooperating with the host country in hiring local nationals
* Making the right types of investment
* Joint venture with a company in the host country.