## International Finance

### Why Study?
- Global integration
  - Consumption; Production; Investment

### What’s different?
- Expanded Opportunity Set
- Foreign Exchange Risk
- Political Risk
- Market Imperfections

### Expanded Opportunity Set
- **Companies**
  - Locate production in lowest cost area to increase profits
  - Raise capital where cost is lowest
  - Economies of scale

- **Investors**
  - Increased diversification
  - New choices

### Foreign Exchange Risk
- **Change in relative values of currencies**
  - Suppose $1 = ¥100 and you buy 10 shares of Toyota at ¥10,000 per share.
  - One year later the investment may be worth ten percent more in yen: ¥110,000
  - But, the yen could have gained or lost value relative to the dollar

### Currency Value Changes
- If the yen gains value relative to the dollar, your return is greater. If $1 = ¥90:
  - Value = (¥110,000)/(90) = $1,222.22
  - Which is over a 22% gain in dollars
- If the yen loses value relative to the dollar, your return is less. If $1 = ¥120:
  - Value = (¥110,000)/(120) = $916.67
  - Which is over an 8% loss in dollars
- Risk is magnified!

### Political Risk
- Governments regulate the movement of goods, capital, and people across their borders
- Laws change in unexpected ways
  - Industries “nationalized” (expropriation of wealth)
  - “Favored” status revoked
  - Tax laws changed
Market Imperfections

- Legal restrictions on movement of goods, people, and money
  - Immigration laws
  - Transaction costs
  - Shipping costs
  - Tax considerations
  - Currency movement

International Financial Management

- What goal should an effective global manager be working toward?
  - Maximization of shareholder wealth?
  - Other Goals?

Maximize Shareholder Wealth

- Long accepted as a goal in Anglo-Saxon countries, but complications arise.
- Who are and where are the shareholders?
- In what currency should we maximize their wealth?

Other Goals

- In other countries shareholders are viewed as merely one among many “stakeholders” of the firm including:
  - Employees
  - Suppliers
  - Customers
- However, other goals cannot be achieved in the long term if maximization of shareholder wealth is not given due consideration
- Goal has received increased attention as capital markets have become more integrated

Corporate Governance

- Recent corporate scandals at companies like Enron, WorldCom, and Parmalat show managers may pursue their own private interests at the expense of shareholders
- These calamities have reinforced the importance of corporate governance
  - The financial and legal framework for regulating the relationship between a firm’s management and its shareholders

Corporate Governance

- These issues can be very serious in many parts of the world
  - Emerging and transitional economies
  - Legal protection of shareholders is weak or virtually non-existent
- Board of Directors
  - Guardians of the interests of shareholders
**Globalization: Major Trends**

- Emergence of Globalized Financial Markets
- Emergence of the Euro as a Global Currency
- Trade Liberalization and Economic Integration
- Privatization

**Emergence of Globalized Financial Markets**

- Deregulation of Financial Markets and Advances in Technology have greatly reduced information and transactions costs, which has led to financial innovations
  - Currency futures and options
  - Multi-currency bonds
  - Cross-border stock listings
  - International mutual funds

**Emergence of the Euro**

- A momentous event in the history of world financial systems
  - Competition for mode of storage
  - Removal of currency “barriers” in Europe
- The “transaction domain” of the euro may become larger than the U.S. dollar’s in the near future

**Economic Integration**

- Over the past 50 years, international trade increased about twice as fast as world GDP
- There has been a change in the attitudes of many of the world’s governments who have abandoned mercantilist views and embraced free trade as the surest route to prosperity for their citizenry

**Theory of Comparative Advantage**

- Mutually beneficial for countries if they specialize in the production of those goods they produce most efficiently
- The countries then trade with others for the additional goods they need

**Liberalization of Protectionist Legislation**

- The General Agreement on Tariffs and Trade (GATT) a multilateral agreement among member countries has reduced many barriers to trade
- The World Trade Organization has the power to enforce the rules of international trade
NAFTA

- The North American Free Trade Agreement (NAFTA) calls for phasing out impediments to trade between Canada, Mexico and the United States over a 15-year period.
- For Mexico, the ratio of export to GDP has increased dramatically from 2.2% in 1973 to 28.7% in 2001.
- The increased trade will result in increased numbers of jobs and a higher standard of living for all member nations.

Privatization

- The selling of state-run enterprises to investors is also known as “Denationalization”
- Often seen in socialist economies in transition to market economies
- By most estimates this increases the efficiency of the enterprise
- Often spurs a tremendous increase in cross-border investment

Multinational Corporations

- A firm that has incorporated on one country and has production and sales operations in other countries.
- There are about 60,000 MNCs in the world.
- Many MNCs obtain raw materials from one nation, financial capital from another, produce goods with labor and capital equipment in a third country and sell their output in various other national markets.