**[305] – [International Finance]**

**Notes**

**Unit I**

**MEANING AND INTRODUCTION OF INTERNATIONAL FINANCE**

The international business activity has been in existence for hundreds of years. Adam Smith in his book "Wealth of Nations" wrote that if a foreign country can supply us with a commodity cheaper than ourselves can make it, it is better to buy it, of them with some part of the produce of our own, in which, we have some advantage.

As human societies and economies evolved, production was increasingly for exchange, not for consumption by the producer as in an earlier era; exchange with local communities and villages then within reasons and across countries and finally cross border.

So, the systematic effort to facilitates the free flow of goods and services, across national boundaries, is called international finance. Rapid economic growth in the Western countries joined, in the process, and growth of international trade continues unabated. Despite the difficulties and road blocks, integration of the world economy is moving forward. Fast means of communication have made the world a small village. No single nation can remain aloof today, without having to transact with others. Exchange of goods/services, financial resources, technology development and skilled manpower is the reality of today's international finance. The world trade has in fact grown at a pace much faster than the world output. For several countries, the growth has been described as EXPORT ORIENTED GROWTH, since the share of exports in their GDP is significantly high.

Though it is very difficult to define the term international finance, because the domain of it, are very large and infinite. Since international finance involves MNCs, national government's rules and regulations, regarding flow of capital, across the borders of the country, the international finance discipline is vivid and complex.

The term international finance is defined on the basis of various parameters:

(*a*) It is a discipline of financing the international economic and commercial relations between countries.

(b) It includes international markets (such as international banking, euro currency market, eurobond, international stock exchanges, American Depository Receipts, GDRs, international institutions viz., IMF, World Bank, Asian Development Bank, Brics Bank, China, WTO, UNCTAD, Letters of Credit, Bill of Lading, factoring and the like, international financial instruments foreign exchange markets, Balance of Payments and International risk management.

(c) It is related to management, economic, commercial and accounting activities of MNCs, governments and private individuals.

(d) It involves conversion of one currency into another.

(e) It coordinates all financial and non-financial operations with the objectives of maximisation of the shareholders' wealth.

In case of India, the period after 1991 has been one of liberalisation and integration with the world economy. Now India has got the policy of "export and prosper".

1.2 IMPORTANCE OF INTERNATIONAL FINANCE

India and other developing countries feel the need for increasing their share in international exchange of goods, services, capital and technology. Some of the important steps taken over during the last 25 years can be summarised as below —
(i) establishment of unified market determined exchange-rate.
(ii) introduction of current account convertibility and introduction of capital account convertibility in a phased or later period.
(iii) reduction in import duties.
(iv) liberalisation of portfolio and FDI.
Over a period of time, large size business houses, i.e., Multinational Corporations have production and sales activities spread in many countries.
The process of integration of world economy has witnessed the creation of very dynamic international financial market. A new field of finance viz., financial engineering has come into existence. The market of present day offers a large variety of financial products for investment, speculation and risk management. The financial market with innovative products present vast opportunities as well as unprecedented risks. Now, more and more companies are venturing into international operations in one form or another. Some companies, may be doing only exports, others may be doing both exports and imports while some may be doing exports, imports and investments.

1.3 SCOPE OF INTERNATIONAL FINANCE

Traditionally, international finance has been viewed as management of MNCs that engage in some form of international business. (A business firm is considered an international player according to Fortune Magazine, when its international sales exceed 20% of total). These MNCs continuously devise strategies to improve their cash flows and enhance shareholder wealth. Penetration
of foreign market creates opportunities for improving the company's cash flows. The dismantling of barriers to entry encourage companies to pursue international business. Liberal trade is the principal driver of internationalisation which encompasses unimpeded flows of capital labour and technology across national boundaries. Free trade is always beneficial because it encourages results in efficient allocation of resources and maximisation of welfare. Corporates go through different stages in this pursuit, export products or import supplies from foreign manufacturer initially to establishing subsidiaries in foreign countries.
The extent, pattern and modes of international companies' activity have been greatly influenced by the political, technological and economic events in the last three decades. The mobility aided by computer technologies and wireless is offering international companies' wider options in respect of both the creation and use of these assets and products.
The data on stock of outward foreign direct investment by large companies and inbound foreign investments by major host countries, show that foreign based activities of international companies, is the method for serving foreign markets. In all major economies, *viz.*, USA, Germany,
U.K., Japan and European countries, the role of domestic and/or foreign based companies is increasing. Inwards FDI in 2004 was, 3.4% of GDP in India and 1.4% of outward FDIs of GDP. While the world as a whole, the percentage share in 2004 was 7.5% of inward FDI as against 8.7% of outward FDIs Outward direct investment has been influenced by the opening up of erstwhile communist countries especially China.

**1.4 GLOBALISATION OF THE WORLD ECONOMY**

Global finance has assumed greater relevance in the new economic world order. The phenomenal changes that have occurred drastically after the advent of international institutions, international

markets, currency convertibility, the balance of payments position reversed to Northward journey of many economies gave a rigorous boost to international finance.
The modern way of penetrating into the new markets by hitherto restricted markets catapulted the domain of international finance. The massive growth of multinational companies from international
company to Global company, to transnational company, gave way to the renewed and necessary significance to international finance. Every country, on the growth path, transverse to financial aspects to a great extent to increase their economic growth and GDP. The main players in the international finance are multinational corporations, who are, more stronger than the national governments.
Out of 8 MNCs in India, five are in public sector and the remaining 3 are in the private sector. These MNCs wield their powers, in such a manner that the things may go topsy-turvy or rather the economies are made to bloom and blossom. International finance is the talk of the town or nation or world because finance is the lifeblood of every organisations, the economy and the running of world-trade. International finance encompasses, other than MNCs, the foreign exchange markets, international methods of payments, international financial markets, exchange rates, international risk management and so on. The financial management globally necessitates the international movement of FDI and capital inflows through foreign institutional investors.
The world has entered an era of unprecedented internationalisation and globalisation of economic activity. Each nation is economically related to the nations of the world through a complex network of international traditions and financial relationships in this context; international finance has also become increasingly important as it links world trade and foreign investments.
Inflow of foreign investments in the world during 2012 was $ 1351 bn. as against outflows of $ 1391 bn. The largest recipient of foreign invesxtments was USA with $ 168 bn. in 2012 as against largest provider of foreign investments by USA in 2012 with $ 329 bn. As capital markets of the world are becoming more integrated, a solid understanding of international finance has become essential for intelligent corporate decision making. The liberalisation of international trade has internationalise consumption patterns. The production of goods and services has also become globalised on account of the efforts of international firms to source inputs and locate production anywhere in the world, where costs are lower and profits higher. This has given rise to outsourcing which is viewed as exporting jobs from advanced countries to countries, where costs are LOWER. In US globalisation is now seen as a phenomenon that makes rich countries poorer.
Financial markets around the globe are integrated US pension and mutual funds diversify their investment portfolios internationally. The Japanese investors have been investing in US and other financial markets in efforts to re-cycle their trade surpluses. Cross Listing of shares (stock) on foreign stock exchanges has helped trading of shares and provides access to foreign capital as well. Financial globalisation which may give rise to higher capital inflows may not however lead to higher growth since it influences capital labour ratios and not total factor productivity.
International companies now force a world where consumption, production and investment decisions are globalised.
These trends especially of globalisation cannot be stopped. The hostility toward globalisation arises from the uneven distribution of benefits and costs across countries.

**1.5 GOALS OF INTERNATIONAL FINANCE**

There are various goals of international finance. These are:
**1. To achieve higher rate of profits:** International companies search for foreign markets

that hold promise for higher rate of profits. Thus, the objective of profit affects and motivates the business to expand its operations to foreign countries. For example, Hewlett Packard in US earned 86.2% of its profits from the foreign markets, compared to that of domestic markets, in 2007. Apple earned, US $ 730 million as net profit from the foreign markets and only US $ 620 mn. as net profit, from its domestic market, in 2007.

**2. Expansion of production capacities:** Some of the domestic companies expanded their production capacities more than the demand for the product in the domestic countries. These companies in such cases, are forced to sell their excess production in foreign developed countries. Toyota of Japan is an example.

**3. Severe competition in the home country:** The weak companies which could not meet the competition of the strong companies in the domestic country started entering the markets of the developing countries.

**4. Limited home market:** When the size of the home market is limited due to the smaller size of the population or due to lower purchasing power of the people or both, the companies internalise their operations. For example, most of the Japanese automobile and electronic firms entered the U.S., Europe and even African markets due to the smaller size of the home market. I.T.C. entered the European market due to the lower purchasing power of Indians with regard to high quality cigarettes.

Similarly, the mere six million population of Switzerland, is the reason for Ciba-Geigy to internationalise its operations. In fact, this company was forced to concentrate on global market and establish manufacturing facilities in foreign countries.

**5. Political stability vs. political instability:** Political stability does not simply mean that continuation of the same party in power, but it does not mean that continuation of the same policies of the Government for a quieter longer period. It is viewed that the U.S.A. is a politically stable country. Similarly, UK, France, Germany, Italy and Japan are also politically stable countries.

International companies prefer, to enter the politically stable countries and are restrained from locating their business operations in politically instable countries. In fact, business companies shift their operations from politically instable countries to politically stable countries.

**6. Availability of technology and skilled human resources:** Availability of advanced technology and competent human resources, in some countries act as PULLING FACTORS for international companies. The developed countries due to these reasons attract companies from the developing world American and European companies, depended on Indian companies for software products and services through their BPOs. The cost of professionals in India is 10 to 15 times less compared to US and European markets. These factors helped Indian software industry to grow at a faster rate with world class standards. Added to this, satellite communications help Indian companies to serve the global business without going globally.

**7. High cost of transportation:** The major factor in lower profit margins to international companies, is the cost of transportation of the products. Under such conditions, the foreign companies are inclined to increase their profit margin by locating their manufacturing facilities in foreign countries, where there is enough demand either in one country or in a group of neighbouring countries. For example, Mobil, which was supplying the petroleum products to Ethiopia, Kenya, Eritrea, Sudan, etc. from its refineries, in Saudi Arabia, established its refinery facility in Eritrea, in order to reduce the cost of transportation.

**8. Nearness to raw materials:** The source of highly qualitative raw materials and bulk raw materials is a major factor for attracting the companies from various foreign countries. Most of the US based and European based companies located their manufacturing facilities in Saudi Arabia, Bahrain, Qatar, Iran etc. due to availability of petroleum.

**9. Availability of quality human resources:** This is a major factor for software, high technology and telecommunication companies to locate their operations in India. India is a major source for high quality and low cost human resources.

**10. Liberalisation and globalisation:** Most of the countries in the world, liberalised their economies and opened their countries to the rest of the world.

**11. Increased market share:** Some of the large scale international companies like to enhance their market share in the world market by expanding and intensifying their operations in various foreign countries. Foe example, Ball Corporation, the third largest beverage cans manufacturer in the USA, bought the European Packaging operations of continental can company. Then it expanded its operations in Europe and met the Europe demand, which is 200 per cent more than that of USA. Thus, it increased its global market share of soft drink cans.

**12. To achieve higher rate of economic development:** International companies help the governments to achieve higher growth rate of the economy, increase the total and per capita GDP, industrial growth, employment and income levels.

**13. Tariffs and import quotas:** It was quite common before globalisation that governments imposed tariffs or duty on imports to protect the domestic companies. Sometimes government also fixes import quotas to reduce the competition to the domestic companies from competent foreign companies. To avoid high tariffs and quotas companies prefer direct investments to go globally. For example, companies like Sony, Honda and Toyota preferred direct foreign investment in various countries by establishing subsidiaries or through joint ventures.

**1.6 EMERGING CHALLENGES IN INTERNATIONAL FINANCE**

The players in international business, who are multinational companies are beset with many number of difficulties and road blocks. These challenges have hampered international companies business considerably. The following are the important challenges in international finance:

**1. Varied Economic Systems:** Economic system refers to the kind of governance of a country. It may be on the basis of the principles of communism, capitalism, socialism and mixed economy, rules and ideologies. The international companies have to navigate with country specific economic systems. American companies are looked with scepticism by Japan, European and gulf countries and vice versa. The economic system issue is not possible to address but MNCs may harness for their economic gains.

**2. Tariff and non-tariff trade barriers:** The progress of the world trade is dependent on FREE TRADE POLICY. Many countries distorted the free trade among themselves and this trade restriction is called trade barrier. The opposite of free trade is trade barrier. These barriers are of two kinds:

— Tariff and
— Non-tariff

By imposing a high tariff (a kind of duty or customs imposed on imports or exports) rates, foreign trade is scuttled. The other reason to restrain the imports is rejecting the goods for the reasons of environmental safety, health hazards, labour standards, subsidy and so on. This is called protectionism or non-tariff barriers World Trade Organisation provides a more powerful organisation, with 159 member countries, its members at the end of 31st March 2014, to solve disputes over trade among the member countries.

**3. Political Risks:** The instability in the governance by political system in different countries is a major setback for international companies. The draconian rules and policies of some countries

restrict market access.
**4. Environmental safeguards:** One of the major challenges today in the world is global warming. The carbon dioxide emissions by different countries and the green house effect therein resulted in depletion of ozone layer. The relentless use of natural resources is the route cause for environmental delay. The international trade and environmental protection should go hand in hand in the interest of the future generation.
**5. Dumping:** It refers to selling a product at a high price in the home currency and relatively at a LOW PRICE in the host country by an international company. This practice ruins industries and employment opportunities in the host country especially micro and small scale industries. For example, the Chinese goods like goods sold in Dipawali, Holi and other festivals are sold, at very low prices in India.
**6. Cultural differences:** Every country has unique cultural heritage that shape values and influence the conduct of business. Even within geographic regions that are considered relatively homogeneous, different sub-cultures are prevailing. International companies have to cope with these differences and adopt to the culture and sub-culture of the countries, where they operate. MNCs find that matters such as defining the appropriate goals of the company, attitudes toward risk, dealing with employees and the ability to curtail and profitable operations vary dramatically from one country to the next.
**7. Language differences:** The ability to communicate is critical in all business, including international transactions. The Indian and US. citizens are often at a disadvantage because they are generally fluent in English, while European and German people are usually fluent in several languages including English.
**8. Intellectual property rights:** The trinity of intellectual properties are patents (for inventions) trade marks (for brand name, image etc.) and copyright (for author, musicians, lyrics, filmmakers). The invention of the new things require world class Research and Development set up by foreign firms. The problem of privacy is haunting several leading companies and brands. India, after a great fight with USA has registered the patent protection for Basmati rice, turmeric and tomato. In case of pharma products, a large number of patent infringements is happening around the world especially the life savings drugs. This is a vital issue in international business and finance.
**9. Cyber crimes:** Cyber crime is a crime committed with the use of computer and internet. Today, all around the world e-commerce and e-business, e-governance, are flourishing. The flip side of the e-commerce, is cyber crime. The privacy is interrupted,
money in some others accounts are withdrawn, manipulated and transferred. The cyber crimes if unabated will pose a great danger to the world business. The WTO has asked all the member