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INTERNATIONAL FINANCIAL MANAGEMENT

V. A. AVADHANI

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PREFACE

This book is intended for all students of Finance and Management, in all Management Institutes and Universities. The objectives of the book are to provide students with a conceptual framework of financial decisions taken in a multinational company and to familiarise the students with the unique economic fundamentals and financial factors which challenge the financial manager in the international context. The book covers the entire syllabus, as approved by UGC on the subject of International Financial Management.

With increasing globalisation and opening up of the economies to free market forces of competition and efficiency, the role of multinational trade and finance has grown by leaps and bounds in the last decade. This is particularly more relevant in the Indian context, where the rupee was made convertible on current account and export and import trade is growing both in absolute and relative terms. The scrips of many corporates in India are listed and traded in main foreign stock exchanges and Foreign Financial Institutions and Foreign Institutional Investors are operating in Indian financial markets both of equity and debt nature. Foreign capital flows and foreign investment are growing and gaining in importance. The international forces are throwing new challenges to the Finance Manager. It is in this context that the subject of International Financial Management has assumed vital importance to the students of Finance Management who will be the future financial managers operating in international markets, for goods, services and finance. This book is intended to cater to their requirements.

This book is presented in simple non-mathematical terms, easily understandable to the average students and lay executives of the corporates. This has the advantage of ***harmonising*** the finance function with the investment function of the Financial Manager on the one hand and integrating the domestic finance with international finance, on the other. The material is kept as brief as possible, yet with a comprehensive coverage of all the modules as approved by UGC and in accordance with their syllabus.

From time to time, it has been revised to incorporate changes in policy and empirical data. The author acknowledges all the faculty who have recommended changes and to the Himalaya Publishing House Pvt. Ltd.

— Author

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PART I

BACKDROP OF INTERNATIONAL FINANCIAL MANAGEMENT

INTRODUCTION TO INTERNATIONAL FINANCIAL MANAGEMENT

1

Introduction

International Financial Management has assumed an important role in the Indian economy, with FDI's, FFIs and FIIs playing a key role in the stock and capital markets. The recent estimate is that FIIs hold about 18% of market capitalisation of the listed companies, in the Stock Exchanges in India. Many Indian corporates are listed and traded on Foreign Stock Exchanges. Many foreign banks were permitted to operate in India and Indian banks have become more globalised in their operations. Indian exports are growing at a rate of 12%, per annum as envisaged in the Tenth Plan. Nearly more than 50% of the manufacturing output in India is exported on an average. The total of exports and imports trade crossed U.S. $ 455 billion and its foreign exchange assets are also more than U.S. $ 300 billion. With such growing importance of global sector, the operations in International Finance are also growing faster than ever before.

World trade was estimated to grow in 2008 at a rate of 4% and that of the developing countries at 8% to 10%. The scope of expansion for International Financial Management has increased. India has a major role to play in the world trade and finance. Net capital flows into Emerging Market economies on non-official basis were estimated at U.S. $ 320 billion in 2014.

India has emerged as a Creditor Country among the IMF of members. World Bank is reported to be planning to issue rupee bonds in India to raise rupee resources. Indian rupee has shown strength and resilience that it was in demand in International Finance

Markets. Many big companies in India have become international market participants and are rated as domestic MNCs in addition to many MNCs of foreign origin in India: The above picture provides a brief overview of the importance of International Financial Management. Gross capital inflows into India Through FDI are NRIs continued to grow even in a Recession year of 2009.

Objective

The object of this chapter is to develop linkages between the domestic economic and financial system and international financial system and to provide theoretical and analytical inputs necessary for a student of international financial management. The corporate executives have before them, the corporate goals for implementing the management function, finance function or marketing function. All these functions are interrelated and connected with the international financial system. The finance manager or the production manager operates at the corporate level in both domestic and foreign markets corresponding to the domestic and foreign sectors. If we start with the production function of a corporate entity and analyse the finance function of the manager, his operations in the foreign sector provide the link between the corporate sector, on the one hand, and the foreign sector, on the other. The mutual interactions between foreign sectors of various countries lead to the emergence of the international financial system. The foreign sectors are the cementing blocks of the international financial system and institutions operating in the international financial system are closely connected with the foreign sectors of the various economies. In this chapter an attempt has been made to trace back the operations in the international finance system from the international level to the national level through various financial institutions and banks and at the national level, from these institutions to the corporate units and the company managers. In view of global importance to operations of international trade and funds flow international financial management has assumed a vital role.

There are various facets of the international financial system (IFS) which are analysed in depth in the chapter. To start with, an important aspect of international financial system is international trade which accounts for the largest chunk of international commercial and financial relations and payments. Thus, a part of the treatment of this book is on the subject of international trade and finance, Balance of Payments and related aspects of international economic relations. Another aspect is the institutions and organisations in it under which banks, national and international financial institutions have all found a place in this book.

The sub-markets in the financial system such as in foreign currency, corresponding to short-term flow of funds as between countries' investments in foreign money markets and in foreign claims, etc., are reflected in financial flows as between countries through the flows of money payments and receipts. Thus, both international trade and international currency and exchange markets are closely connected and are dealt with. Yet another aspect of the international financial system is the role of term lending and foreign aid in the flows of trade between countries, corresponding to long-term flows as between countries. It is in this context that foreign trade and aid are discussed as important components of the international financial system as short-term and long-term wings of the operations of the International Financial Manager.

Relevance to Management

As this book is intended for students and corporate executives, we should set out in the beginning itself the relevance of international finance to their day-to-day work. Domestic finance and international finance are next-door neighbours-both complementary and competitive- viewed either as sources or uses of funds.

Firstly, in a fast-growing world economy and world markets, it would be naïve for a corporate executive to confine himself to the domestic markets and domestic finance alone. The days of national autarky have gone by and we are in a world of interdependence. With a fast growing network of transport and communications, the world is getting closer and a finance manager can hardly ignore the forces operating on him from the international plane as much as from the domestic plane.

Secondly, as the operations and systems in domestic and international finance are different, the factors influencing them need to be studied separately.

Thirdly, in a world of competition and survival of the fittest, the managerial function involves choosing the right input mix both from home and abroad and the right output mix suitable for home and foreign markets and expose oneself to the winds of competition both at national and international levels. These aspects are clearly noticed in India, with the opening up of the economy since July 1991 through Economic and Financial Reforms.

It is to be conceded that the impact of the foreign sector on the activities of the corporate executive is more keenly felt in some lines than in others. Such lines are in exportable goods and services, finance, shipping, airways, tourism etc. If the corporate entity belongs to the sector of multinational companies, foreign-owned companies, subsidiaries or branches of foreign companies etc., international forces are relatively more important. At any rate, any management executive can ill-afford to be blind to the international economic and financial scene even if he is not directly involved in it as these forces operate on him in the modern world.

Finance Function

The objective of the finance function of a manager may be set out in different ways. He may aim at optimising the value of his assets or minimising the worth of his liabilities. Put in differently, he may maximise his gross profits or net profits and minimise risks or aim at optimising the market value of his company's shares. Looked at from any angle, the management basically aims at economy, efficiency and productivity leading to greater profitability. For this purpose, he concentrates on the efficient management of cash and credit so far as the financial aspect is concerned. But more importantly, he has to consider the production function of which cash and credit are inputs. The finance function is also closely related to marketing function also, as the latter involves the use of cash and credit. The manager has to take into account the international forces in the preparation of plans and budgets for resource inflows and outflows and in input and output markets. In the raising of funds and use of such funds, the cost of alternative uses and sources have to be considered both at home and abroad. Finance Function is all pervading being related to all activities of the firm, and particularly to the Management.

In terms of the real sector or the financial sector, the manager has to observe the criteria of efficiency and productivity etc., in the input market and output market and in allocation of physical resources or financial resources. In the input and output markets as well as in financial markets, both domestic and foreign, forces have to be reckoned with.

Input Market

In the input market, physical and financial inputs are fed into the productive system. Physical inputs relate to physical capital equipment, plant and machinery, raw materials, spare parts and intermediate (semi-finished) products, etc. They may come from domestic or foreign markets. Financial inputs relate to moneys spent on wages for labour or cash kept for current liabilities or contingencies. Such inputs can be secured both from domestic markets and foreign markets. As such, a cost calculus has to be made for the right mix of inputs and the right sources of supply of such inputs so as to minimise the costs for a given product mix. It is possible that some raw materials or spares are more cheaply available abroad than at home and due to free access to such markets the manager may plan for a mix of inputs at the least cost, subject to the technical feasibilities in the production function. The markets, both domestic and foreign, have to be assessed for these inputs in terms of costs and prices and alternative sources of supply explored. This is an area in international economics and finance. In the supply of financial inputs for production purposes one has to take into account the need for cash and credit and the relative proportions of each both from home and abroad and to assess their relative costs. Marginal costing of cash and credit is part of the wider subject of cash management. The cash component as an input in the production function is part of the subject of production management, while the overall management of all funds is in the domain of financial management.

In a subsidiary or branch of a foreign company, foreign sources play a more important role even in financial inputs. In more recent years, outsourcing in the I.T. and related areas has become important due to its cost reduction advantages. Such exercises relating to financial inputs have to be made after an assessment of cash inflows and outflows, both on current and capital accounts. On the capital account, sources and uses of funds for investment also become an important pre-requisite for planning for credit. These will be discussed below under sources and uses of funds.

Output Market

In the output market, the sale of final and intermediate products can be made both in domestic and foreign markets and mix of them. International marketing and international finance are closely interlinked and flows of finance follow the flows of trade. Marketing is an important pre-requisite for trade. International trade and international finance are close complements. The costs of production and selling costs and the available margins both on domestic sales and foreign sales have to be considered. Here again, it is assumed that there is a free market in India and abroad or trading is possible subject to satisfying all the requirements of the government policy in this regard. A cost calculus has to be made for planning for the right mix of sales at home and abroad. For an assessment of the demand prospects abroad, we need to know the alternative sources of supply in such markets, demand and supply elasticities, costs and prices of such alternative sources, transport and selling costs etc., which are the subject of international economics and finance. In India due to the premium put on export sales by government policy, the cost calculus has to take into account this aspect also.

Sources and Uses

At the micro level of a company, an analysis of the sources of funds reveals that broadly there are three categories of sources:

(i) Savings of the company which are its retained earnings,

(ii) External sources (domestic) from the capital and money markets such as banks, all-India or State-level financial institutions, government or the public and

(iii) Foreign sources, namely, markets, institutions and persons abroad. The last category can in turn be specified as follows:

- *(a)* Credit from private parties, *viz*., trade credit, buyer's credit, etc.;
- *(b)* Foreign government credit, *viz*., government to government line of credit, foreign aid or grants or loans;
- *(c)* Resources from international or inter-regional bodies such as IFC, IBRD, foreign banks or Euro-currency markets etc.; and
- *(d)* Non-resident individuals and institutions.

The same analysis holds good at the sectoral and national level. In fact, the emergence of international financial markets can be traced to this sectoral interdependence, including the foreign sector and intranational dependence. Basically, as no country is self-sufficient or autarkic but is dependent on other countries for something or the other, international economic and commercial relations emerge. These are referred to later in this chapter.

In a similar fashion, it would be appropriate to set out the pattern of use of funds of any company into various sectors of the economy, including the foreign sector. Dispensation of funds for current or capital expenditures in domestic markets and international markets can be separately set out. Such an analysis is particularly more relevant to multinational corporations and branches or subsidiaries of foreign companies in whose case foreign markets and foreign sources of supply play an important part. The head office or the holding company may spend a part of its funds in investment in the host country, make inward remittances for working capital or investment purposes and outward remittances for royalty and dividend, payments or technical fees.

Macro View of Foreign Flows

RBI Company Finance Studies throw light on the macro-view of Foreign inflows and outflows in the Corporate Sector. These are published in RBI Bulletins regularly. A large number of smaller companies contribute larger foreign exchange earnings to the country. It is true that both expenditure and earnings on foreign account are concentrated in a small number of large foreign controlled Indian companies and multinational corporations, but they may not add much to the not accrual of foreign exchange. A large number of small companies do not operate on such a large scale, but add substantially to our net accrual of foreign exchange. In more recent years, the accrual of reserve is due to inflows on current account for services remittances and due to depreciation of dollar, and capital inflows for FDI, and NRE deposits.

Sectoral Interdependence

International financial markets emerged out of the felt need to facilitate operations of nations arising out of the commercial and financial transactions with the rest of the world. This emergence can be attributed logically to: *(a)* Sectoral interdependence, and *(b)* National interdependence.

It would be apt to set out here the inter-relations between the micro-level operations of a finance manager with the macro-level working of the corporate sector and foreign sector. A finance manager is a micro unit in the corporate sector. The environment he faces is competition from other similar units in the corporate sector and as suppliers of inputs or as consumers of output. Besides, the corporate sector, in turn, is interlinked with all other sectors of the economy. The micro-level manager is thus faced with a total environment of the economy which includes foreign sector, and it is thus relevant to him to be familiar with the international financial system, which is the product of developments in the foreign sectors of all the world economies.

The corporate sector is a part of the total business sector having trading and manufacturing activities. The corporate sector is also connected with all sectors of the economy, namely, government sector, household sector and foreign sector either as suppliers of inputs or as consumers of output. Besides, all these domestic and foreign sectors are interconnected through the flow of funds and savings from one sector to the other. In each sector, there are both savers and investors. Only the household sector is a net saver in India. The household sector is also a supplier of factors of production such as labour, management, enterprise etc. For some time in the past, foreign sector was a net saver, as there was a net balance on current account of our balance of payments leading to the accretion to our foreign exchange reserves. We are running huge deficits in merchandise trade account for a long time which was offset by positive balance on the net invisible trade account. For some recent years, we are having a negative savings in the foreign sector leading to a loss of our foreign exchange reserves. If there is a net inflow of funds from abroad either as foreign credits, grants, etc., or borrowings from foreign governments, international bodies etc., there may be a positive balance, in the balance of payments and foreign savings would accrue. The surplus savings in some sectors would flow into other sectors with deficit. In the corporate sector where investment is invariably more than their available savings, the units have to depend on other sectors to finance them. These savings may flow directly from the government sector or household sector or indirectly through financial institutions, banks and other agencies. It would thus, be clear that the corporate sector is intricately connected with all other sectors of the economy either as suppliers of inputs of production or suppliers of factors of production, including land, labour, capital or enterprise or consumers of their products or services.

They are also connected with other sectors of the economy through inflow or outflow of funds or savings or financial assets-moneys or near money assets or financial flows.

Another aspect of interdependence of the various sectors of the economy is foreign private investment in the domestic economy or Indian investment abroad. The investment may take the form of

(i) Equity participation in Indian enterprises,

(ii) Investment in bonds or debentures,

(iii) Granting of loans or credits either on government to government basis or party to party basis in the private sector,

(iv) Joint ventures in third countries and

(v) Technical consultancy or know-how participation etc. Transfer of technology is also one of the aspects of the international commercial and financial relations which is necessary for a sustained rate of growth at the lowest possible cost and the highest level of productivity.

All the inputs of the corporate sector come either from the household sector as labour, capital or enterprise or from Government sector as infrastructure, land, electricity, water etc., or from agriculture or industry (business sector) as raw materials, intermediate products, spares parts etc.

Particularly more relevant for our discussion is the contribution of foreign sector towards inputs of the corporate sector in the form of physical capital, plant, machinery, spares, raw materials, etc., or financial inputs in the form of short-term credits or investment in financial assets, etc. The inflows into India are through FIIs for portfolio investment and through MNCs for direct investment in equity or debt forms.

Such interdependence between the corporate sector and other sectors is also noticed in the field of outputs. The main consumers of some products may in fact be the foreigners. Either in respect of consumer goods or capital goods, there is a good element of foreign demand, particularly from the less developed countries. In view of the vastness of our domestic markets, the executives of the corporate sector rarely explore the foreign markets, unless the products are export-oriented. With the projected expansion of the industry and limitations in the domestic markets, the present executives may have to think more in terms of foreign markets than of domestic markets. More recently, export-oriented industries and 100 per cent export units are being encouraged by the government in the light of the prevailing balance of payments difficulties of the country and increasing export shortfalls. Besides, the philosophy of the government is also veering round to the view of making our economy more competitive with a greater role allocated to the private sector. The recent trend to globalisation and opening up of the economy to free market forces make the foreign sector more relevant than before. The cost consciousness and competitiveness has increased in the Indian enterprise. In such an environment, the role of foreign sector can be hardly overemphasised when the chilly winds of competition and cost consciousness make the present executives of the corporate enterprise more alert and informed on both the domestic and external sectors. The foreign environment would be equally important and more challenging than the domestic market due to the ever changing scene of demand and supply forces, competition and cost price factors operating from all sides of the world. These may hopefully improve the efficiency of factors and lower the costs of production.

There is another reason why the foreign sector is more important to India, namely, the limits are already reached in the domestic markets and the scope for further expansion of markets lies abroad. Besides, there is the debt service burden which we carry due to our reliance on foreign credits during the last few decades of our planning. This burden can be discharged by a continuous flow of goods and services outside the country leading to an export surplus for the nation.

In the output market, the domestic household sector has been the main consumer in India, followed by the government sector which needs the output of the corporate sector both for capital formation and current consumption. Besides, the government with its contracting role in the economy has got less say in the affairs of the corporate sector today and is likely to become lesser in future due to their avowed policy of a greater role for the private sector in the years to come. The business sector comprising industry and agriculture continue to consume the products of the corporate sector as intermediates or raw materials for manufacture or further processing. These facts are brought out in any analysis of input-output matrix tables for the economy, brought out by the ISI and CSO.

International Flow of Funds

We have seen that national economy of a country is composed of a number of sectors, including the foreign sector and the interdependence of these sectors either as suppliers of savings or of factors of production, or of other inputs in the productive process or as consumers of their output leads to economic, commercial and financial transactions as between these sectors. It is such transactions between the domestic sectors and foreign sector that gives rise to the international financial system.

An extension of this principle of mutual interdependence to the case of national economy of one country depending upon that of others lends further support to our thesis that emergence of international financial markets is the result of such interdependence and intra flow of funds. Thus, no modern nation/state is self-sufficient nor is it closed to external forces from other nations and states. This dependence is the result of the expanding civilisation and modern socio-economic systems. It is now well recognised that countries are interdependent in various degrees resulting in economic commercial and financial transactions among them. Such interdependence is a necessary but not a sufficient condition for the emergence of international financial markets. But the conquering of the distance and time by revolution in telecommunications, electronic media and information technology has brought the world together and led to a sufficient condition for emergence of International Financial Management, as an area of vital importance. More importance is given recently to globalisation and privatisation leading to greater international interdependence.

The interdependence of nations can be ascribed to the following factors:

(1) Differential factor endowments and natural endowments in different countries, leading to different production functions.

(2) Different stages of growth of industry, agriculture and other sectors in the economies of these countries, and different levels of savings and investment.

(3) Differentials in technological advancement, R&D, and economies of scale.

(4) Differences in habits, tastes and consumer preferences, leading to different demand functions.

(5) Differences in standards of living and incomes, leading to flow of funds through grants, loans etc.

Conclusion

It would thus, be seen that the importance of international financial management can be traced to the sectoral and national interdependence which leads to international economic, commercial and financial relations as between countries. International trade, aid and financial flows account for the bulk of such transactions as between nations. The basic economic principles of efficiency, productivity and least cost optimisation process necessitate the use of inputs both domestic and foreign and flow of goods and services across national borders, provided there are no barriers to such flows. The result is the exchange of goods and services involving payments and receipts as between countries and exchange of one currency for another and borrowing and lending of money or near money assets across borders. These transactions and trading in foreign currencies, foreign assets or liabilities and foreign claims constitute the international financial system, and are the subject matter of International Financial Management.

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