

- **International Financial Management** The guiding principle for international financial management, like domestic financial management, is the shareholder wealth maximisation. International financial management, however, differs from domestic financial management, as it has to deal with multiple currencies, interest rates, inflation rates and foreign exchange and political risks. There are a number of ways in which an international company can finance its foreign operations. It should strive to reduce its risk and minimise cost. It should take advantages of government subsidies and tax asymmetries.
- **Foreign Exchange Rate** is the price of one currency in terms of the other currency.
- **Spot Rate** is the current exchange rate, and is used for immediate delivery of currency (which is two business days).
- **Forward Rate** is the price determined today for delivery in the future.
- Forward premium or discount for direct quote:

$$\text{Forward premium(discount)} = \left[\frac{\text{Spot rate} - \text{Forward rate}}{\text{Spot rate}} \right] \times \frac{360}{\text{Days}}$$

- Forward premium or discount for indirect quote:

$$\text{Forward premium or discount} = \left[\frac{\text{Forward rate} - \text{Spot rate}}{\text{Spot rate}} \right] \times \frac{360}{\text{Days}}$$

- **International Parity Conditions** There exists a definite relationship between interest rates, inflation rates and exchange rates. These relationships are called international parity conditions.
- **Interest Rate Parity** The difference between the current exchange rate and the forward rate results from the differences in the interest rates of two countries. This is referred to as the interest rate parity.

Interest differential = Exchange rate (forward and spot) differential

$$\frac{(1 + r_F)}{(1 + r_D)} = \frac{f_{F/D}}{s_{F/D}}$$

where r_F is interest rate of country F (say, the foreign country), r_D is interest rate of country D (say, domestic country), $s_{F/D}$ is the spot exchange rate between the countries F and D and $f_{F/D}$ is the forward rate between the countries F and D .

- **Expectation Theory of Exchange Rates** A forward exchange rate should be what the foreign exchange market participants expect the future spot rate to be. This is the expectation theory of exchange rates.

Forward and current spot rate differential = Expected and current spot rate differential

$$\frac{f_{F/D}}{s_{F/D}} = \frac{E(s_{F/D})}{s_{F/D}}$$

- **Purchasing Power Parity** The expected future spot rate deviates from the current spot rate because of the difference in the expected inflation rates in two countries. This notion is based on the law of one price. The price of similar goods should be same in foreign currency equivalent. This is known as purchasing power parity. Nominal interest rates reflect the expected inflation rates.

Inflation rate differential = Current spot rate and expected spot rate differential

$$\frac{(1+i_F)}{(1+i_D)} = \frac{E(s_{F/D})}{s_{F/D}}$$

- **International Fisher Effect** In a perfect capital market, real rates will be same in all countries. This is the international Fisher effect.

Nominal interest rate differential = Expected inflation rate differential

$$\frac{(1+r_F)}{(1+r_D)} = \frac{E(1+i_F)}{E(1+i_D)}$$

- **Foreign Exchange Risk** An international company expecting to receive or pay cash flows in future in foreign currency is exposed to foreign exchange risk. To avoid the foreign exchange risk of borrowing, a company can borrow a mix of currencies — local as well as foreign. It can hedge against the risk of its liabilities if it creates assets in those currencies. We can distinguish between three types of foreign exchange risk: transaction exposure; economic exposure and translation exposure. There are three alternatives available to hedge the foreign exchange risk: forward contract; currency options; money market operations.
- **Transaction Exposure Risk** involves the possible exchange loss (or gain) on existing foreign currency-denominated transactions due to change in the exchange rate.
- **Economic Exposure Risk** refers to change in the value of the firm caused by the unexpected changes in the exchange rate.

- **Translation Exposure Risk** is caused when for translating the assets and liabilities of subsidiaries of a multinational company, the exchange rate at the end of the accounting period is different from the exchange rate at the beginning.
- **Forward Contract** A company can take a forward contract. It can either buy or sell a currency forward at a known forward rate.
- **Currency Option** The company can buy a currency option. A call option is the right to buy and a put option is the right to sell currency at a predetermined exchange rate. The company will exercise its option only when it is advantageous to do so. Currency options allow the company to hedge against risk and gain from favourable change in the exchange rate.
- **Money Market Operations** The company can also hedge its foreign exchange exposure through money market operations; that is, borrowing and investing in the money markets.
- **International Capital Budgeting Decisions** like domestic capital budgeting decisions, require estimates of cash flows and an appropriate discount rate. The cash flows can be estimated either in the domestic currency or in the foreign currency. The financial managers should forecast the foreign exchange rates

assuming the parity conditions. The opportunity costs should be appropriately modified, reflecting the interest rate of the country in whose currency cash flows are estimated.

- **Eurocurrency Loans or Eurobonds** A number of companies access funds in the Eurocurrency markets either through borrowing from banks or by issuing Eurobonds. Eurocurrency loans or Eurobonds are issued in countries other than the country in whose currency they are denominated. Eurocurrency markets are free from government regulations. Some companies also issue foreign bonds in foreign domestic capital markets.
- **Depository Receipts** A number of companies, particularly developing countries, also raise funds through depository receipts. Depository receipts, representing claims on the shares of a company, are issued by a depository, usually an international finance firm to investors in developed countries.
- **Depository** is an intermediary between the company and depository receipt holders. He receives dividends from the company and then converts it into receipt holders' currency and distributes to them.

- **American Depository Receipts (ADRs)** Depository receipts issued to investors in the US are called American Depository Receipts (ADRs).
- **Global Depository Receipts (GDRs)** Depository receipts issued to investors in many countries are called Global Depository Receipts (GDRs).