



International Finance



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About the Tutorial

International Finance deals with the management of finances in a global business. It explains how to trade in international markets and how to exchange foreign currency, and earn profit through such activities.

This tutorial provides a brief overview of the current trends in finance, along with detailed inputs on the current global markets, foreign exchange markets, international capital markets, hedging and risk management, and strategic decision-making.

Audience

This tutorial is an easy and informative read for management students and finance professionals. The objective of this tutorial is to equip the readers with an understanding of the international financial system and its growing importance.

Prerequisites

To understand this tutorial, it is advisable to have a foundation level knowledge of business and macroeconomics. However, general students who wish to get a brief overview International Finance may find it quite useful.

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Part 1 – International Finance and Global Markets

1. INTERNATIONAL FINANCE – INTRODUCTION

International Finance is an important part of financial economics. It mainly discusses the issues related with monetary interactions of at least two or more countries. International finance is concerned with subjects such as exchange rates of currencies, monetary systems of the world, foreign direct investment (FDI), and other important issues associated with international financial management.

Like international trade and business, **international finance** exists due to the fact that economic activities of businesses, governments, and organizations get affected by the existence of nations. It is a known fact that countries often borrow and lend from each other. In such trades, many countries use their own currencies. Therefore, we must understand how the currencies compare with each other. Moreover, we should also have a good understanding of how these goods are paid for and what is the determining factor of the prices that the currencies trade at.

Note: The World Bank, the International Finance Corporation (IFC), the International Monetary Fund (IMF), and the National Bureau of Economic Research (NBER) are some of the notable international finance organizations.

International trade is one of the most important factors of growth and prosperity of participating economies. Its importance has got magnified many times due to globalization. Moreover, the resurgence of the US from being the biggest international creditor to become the largest international debtor is an important issue. These issues are a part of international macroeconomics, which is popularly known as international finance.



Importance of International Finance

International finance plays a critical role in international trade and inter-economy exchange of goods and services. It is important for a number of reasons, the most notable ones are listed here:

- International finance is an important tool to find the exchange rates, compare inflation rates, get an idea about investing in international debt securities, ascertain the economic status of other countries and judge the foreign markets.
- Exchange rates are very important in international finance, as they let us determine the relative values of currencies. International finance helps in calculating these rates.
- Various economic factors help in making international investment decisions. Economic factors of economies help in determining whether or not investors' money is safe with foreign debt securities.
- Utilizing **IFRS** is an important factor for many stages of international finance. Financial statements made by the countries that have adopted IFRS are similar. It helps many countries to follow similar reporting systems.
- IFRS system, which is a part of international finance, also helps in saving money by following the rules of reporting on a single accounting standard.
- International finance has grown in stature due to globalization. It helps understand the basics of all international organizations and keeps the balance intact among them.
- An international finance system maintains peace among the nations. Without a solid finance measure, all nations would work for their self-interest. International finance helps in keeping that issue at bay.
- International finance organizations, such as IMF, the World Bank, etc., provide a mediators' role in managing international finance disputes.

The very existence of an international financial system means that there are possibilities of international financial crises. This is where the study of international finance becomes very important. To know about the international financial crises, we have to understand the nature of the international financial system.

Without international finance, chances of conflicts and thereby, a resultant mess, is apparent. International finance helps keep international issues in a disciplined state.

2. FINANCIAL GLOBALIZATION

In the last two decades, the financial economies have increasingly got interconnected around the world. The impact of globalization has been felt in every aspect of economy. Financial globalization has offered substantial benefits to the national economies and to both investors and wealth creators. However, it has a wrecking effect on financial markets as well.

Driving Forces of Financial Globalization

When we talk about financial globalization, there are four major factors to be considered. They are:

- **Advancement in information and communication technologies:** Technological advancements have made market players and governments far more efficient in collecting the information needed to manage financial risks.
- **Globalization of national economies:** Economic globalization has made production, consumption, and investments dispersed over various geographic locations. As barriers to international trade have been lowered, international flows of goods and services have dramatically increased.
- **Liberalization of national financial and capital markets:** Liberalization and fast improvements in IT and the globalization of national economies have resulted in highly spread financial innovations. It has increased the growth of international capital movements.
- **Competition among intermediary services providers:** Competition has increased manifold due to technological advancements and financial liberalization. A new class of nonbank financial entities, including institutional investors, have also emerged.

Changes in Capital Markets

The driving forces of financial globalization have led to four dramatic changes in the structure of national and international capital markets.

- First, banking systems have been under a process of **disintermediation**. Financial intermediation is happening more through tradable securities and not through bank loans and deposits.
- Second, cross-border financing has increased. Investors are now trying to enhance their returns by diversifying their portfolios internationally. They are now seeking the best investment opportunities from around the world.
- Third, the non-banking financial institutions are competing with banks in national and international markets, decreasing the prices of financial instruments. They are taking advantage of economies of scale.

- Fourth, banks have accessed a market beyond their traditional businesses. It has enabled the banks to diversify their sources of income and the risks.

Benefits and Risks of Financial Globalization

One of the major benefits of Financial Globalization is that the risk of a "credit crunch" has been reduced to extremely low levels. When banks are under strain, they can now raise funds from international capital markets.

Another benefit is that, with more choices, borrowers and investors get a better pricing on their financing. Corporations can finance the investments more cheaply.

The disadvantage is that the markets are now extremely volatile, and this can be a threat to financial stability. Financial globalization has altered the balance of risks in international capital markets.

With financial globalization, creditworthy banks and businesses in emerging markets can now reduce their borrowing costs. However, emerging markets with weak or poorly managed banks are at risk.

Safeguarding Financial Stability

The crises of the 1990s have shown the importance for a prudent sovereign debt management, effective capital account liberalization, and management of domestic financial systems.

Private financial institutions and market players can now contribute to financial stability by managing their businesses well and avoiding unnecessary risk-taking.

As financial stability is a global public good, governments and regulators also play a key role in it. The scope of this role is increasingly getting international.

The IMF is a key role-player as well. Its global surveillance initiatives to enhance its ability to manage international financial stability must also stay in track.

Part 2 – Foreign Exchange Markets

3. BALANCE OF PAYMENTS

It is important to measure the performance of an economy. **Balance of Payment** (BOP) is one way to do so. It shows the big picture of the total transactions of an economy with other economies. It takes the net inflows and outflows of money into account and then differentiates them into sections. It is important to balance all accounts of BOP in case of an imbalance so that the economic transactions can be measured and taken into account in a systematic and prudent manner.

Balance of Payment is a statement that shows an economy's transactions with the remaining world in a given duration. Sometimes also called the balance of international payments, BOP includes each and every transaction between a nation's residents and its nonresidents.

Current Account and Capital Account

All the transactions in BOP are classified into two accounts: the **current account** and the **capital account**.

- **Current account:** It denotes the final net payment a nation is earning when it is in surplus, or spending when it is in deficit. It is obtained by adding the **balance of trade** (exports earnings minus imports expenses), **factor income** (foreign investment earning minus expenses for investment in a foreign country) and other **cash transfers**. The *current* word denotes that it covers transactions that are happening "here and now".
- **Capital account:** It shows net change in foreign-asset-ownership of a nation. The capital account consists the **reserve** account (the net change of foreign exchange of a nation's central bank in market operations), **loans and investments** made by the nation (excluding the future interest payments and dividends yielded by loans and investments). If net foreign exchange is negative, the capital account is said to be in deficit.

BOP data does not include the real payments. Rather, it is involved with the transactions. This means that the figure of BOP may differ significantly from net payments made to an entity over a period of time.

BOP data is crucial in deciding the national and international economic policy. Part of the BOP, such as current account imbalances and foreign direct investment (FDI), are very important issues which are addressed in the economic policies of a nation. Economic policies with specific objectives impact the BOP.

The Tweak in Case of IMF

The IMF's BOP terminology uses the term "financial account" to include the transactions that would under alternative definitions be included in the general capital account. The IMF uses the term **capital account** for a subset of transactions that form a small part of the overall capital account. The IMF calculates the transactions in an additional top level division of the BOP accounts.

The BOP identity, according to IMF terminology, can be written as:

$$\text{Current account} + \text{Financial account} + \text{Capital account} + \text{Balancing item} = 0$$

According to IMF, the term **current account** has its own three leading sub-divisions, which are: the goods and services account (the overall trade balance), the primary income account (factor income), and the secondary income account (transfer payments).

Points to Note

- BOP is an account to show the expenses made by consumers and firms on imported goods and services.
- BOP is also a pointer to how much the successful firms of a country are exporting to foreign countries.
- The money or the foreign currency entering a nation is taken as a positive entry (e.g. exports sold to foreign countries)
- The money going out or expenses of foreign currency is adjusted as a negative entry (e.g. imports such as goods and services)

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