ECON360 International Finance

Topic 1: International Players, FOREX markets & International Flows

Important Players in International Financial Markets

Multinational Corporation (MNC)

Produces and sells goods or services in more than one nation. Consists of a parent company in the firm's originating country and the operating subsidiaries, branches and affiliates both at home and abroad.

Goals of an MNC:
Maximize shareholder wealth.

Agency Theory:
Studies problems that arise from the separation of ownership and control, or the conflict of goals between managers and shareholders.

How MNCS Enter Foreign Markets:

- Exporting/Importing
- Licensing – gives local firms right to manufacture their products in exchange for a fee, typically called royalties.
- Franchising – the firm provides sales or service strategies, offer support, and may even initially invest in the franchise in exchange for fees.
- Joint venture – two or more firms form a new legal entity, jointly owned and operated by all of the firms.
- Foreign direct investment (FDI): when a company from one country buys at least 10% of a company in another country.
    - M&A plays a big role in this trend
    - Greenfield: establishing new operations in a foreign country without having a local partner and without acquiring a local company.

Why MNCS Pursue International Business?

- **Theory of Comparative Advantage:** Specialization increases production efficiency.
- **Imperfect Markets Theory:** Factors of production are somewhat immobile, providing incentive to seek out foreign opportunities.
- **Product Cycle Theory:** As a firm matures, it recognizes opportunities outside its domestic market.

Other Important International Players

- International banks, e.g. Barclays and HSBC (UK), Citigroup and JP Morgan Chase (US), NAB and ANZ (AU).
- Managed funds, eg. Platinum International
- International institutions:
    - **International Monetary Fund (IMF) –** member organization whose goal is to ensure the stability of the international monetary and financial system through surveillance and technical assistance
    - **The World Bank –** member organization whose goals are development, poverty alleviation and advising
    - Multilateral Development Banks, World Trade Organization, OECD, European Union.

Foreign Exchange Markets

Exchange Rate:
The relative price of two currencies.

Spot Market:
Where exchanges of national monies are settled "immediately" (within 2 business days).

Direct Quote:
Expressed as an amount of domestic currency per unit of foreign currency.

Eg: in the US: US$0.7338 = AU$1; US$0.7583 =C AD1; US$1.1642 = €1

Indirect Quote:
Expressed an amount of foreign currency per unit of domestic currency.

Eg: in Australia: US$0.7338 = AU$1; CAD0.9668 = AU$1; €0.6307 = AU$1

Pip:
Refers to the fourth (i.e. smallest) decimal point in a currency quote. A pip represents 0.0001

- E.g. for 02 July 2018 the RBA reported that USD0.7391 = AUD1.
- For the currencies not trading around the value of 1, the convention is different.
    - E.g. for a quote of Yen110.80/$, a pip represents 0.01.

Bid Rate: Rate at which a trader is willing to buy a currency.
Ask Rate: Rate at which a trader is willing to sell a currency.
Bid-Ask Spread: Difference between sell rate & buy rate.

Appreciation:
A strengthening of the value of a floating currency.

Depreciation:
A weakening of the value of a floating currency.

Revaluation:
A discrete rise in the value of a pegged-rate currency.

E.g. in 1973 the AUD was revalued against the USD by about 12 per cent.

Devaluation:
A discrete fall in the value of a pegged-rate currency.

Balance of Payments

Summary of transactions between domestic and foreign residents for a specific country over a specified period of time.

Components of the Balance of Payments Statement

Current Account:
Summary of flow of funds due to purchases/sales of goods or services (international trade) or the provision of income on financial assets, or transfer payments.

Capital Account:
Summary of flow of funds resulting from the sale of assets between one specified country and all other countries over a specified period of time, including FDI and portfolio investment.

Examples of Balance of Payment Transactions

International Trade transactions

International *trade* transaction	Australian cash flow position	Demand or supply of Australian dollars	Entry on Australian balance of payments account
Harvey Norman purchases stereos produced in Malaysia for sale in Australian stores	Cash outflow	Supply of Australian dollars	Debit
A Chinese importer of iron ore pays an Australian mining company	Cash inflow	Demand for Australian dollars	Credit
An Australian company pays an insurance premium to Lloyds insurance in London	Cash outflow	Supply of Australian dollars	Debit
An Indian company pays an Australian consulting company for services provided by the company	Cash inflow	Demand for Australian dollars	Credit

International Income transactions

International *income* transaction	Australian cash flow position	Demand or supply of Australian dollars	Entry on Australian balance of payments account
An Australian company pays dividends to its US parent company	Cash outflow	Supply of Australian dollars	Debit
An Australian investor receives a dividend payment from a Japanese company in which she purchased stock	Cash inflow	Demand for Australian dollars	Credit
The Australian Treasury sends an interest payment to a Chinese sovereign wealth fund that purchases some Australian Commonwealth bonds	Cash outflow	Supply of Australian dollars	Debit
An Indonesian company that borrowed money from ANZ Bank sends an interest payment to the bank.	Cash inflow	Demand for Australian dollars	Credit

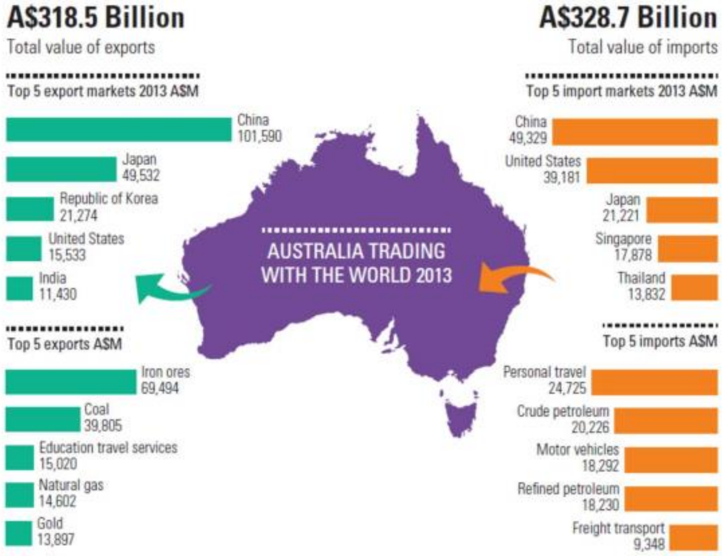
International Transfer transactions

International *transfer* transaction	Australian cash flow position	Demand or supply of Australian dollars	Entry on Australian balance of payments account
Indonesian workers in Australia send money home	Cash outflow	Supply of Australian dollars	Debit
The Australian Government provides aid to the Philippines in response to a severe cyclone	Cash outflow	Supply of Australian dollars	Debit
The Bill & Melinda Gates Foundation provides a grant to Australian scientists working on a cure for skin cancer	Cash inflow	Demand for Australian dollars	Credit

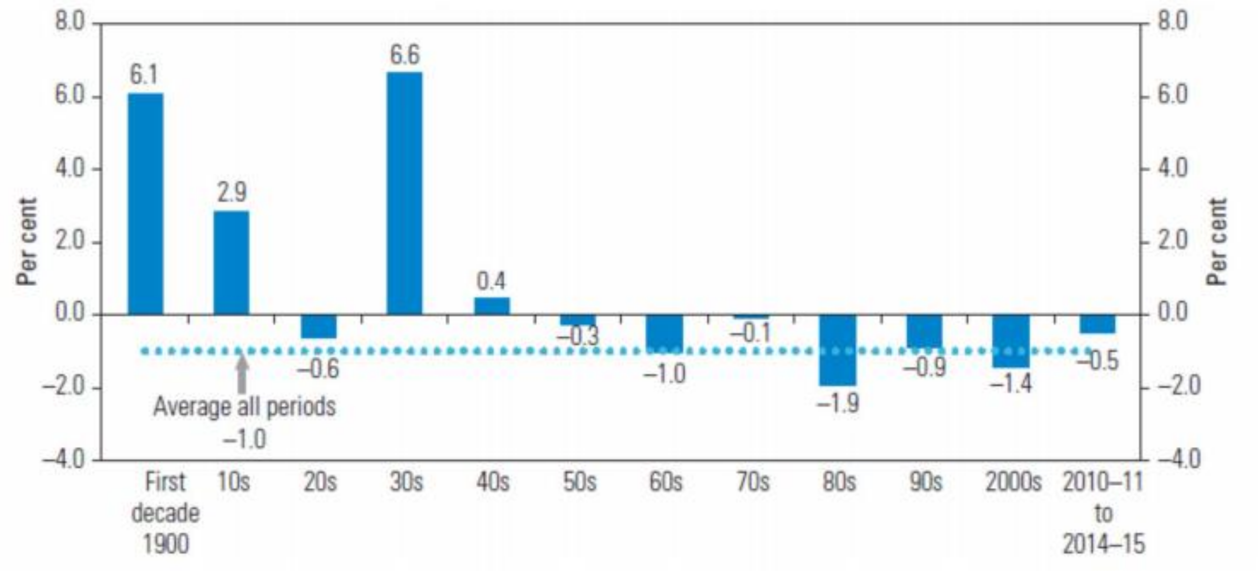
International Financial transactions

International *financial* transaction	Australian cash flow position	Demand or supply of Australian dollars	Entry on Australian balance of payments account
A Singapore pension fund buys shares on the ASX	Cash inflow	Demand for Australian dollars	Credit
A UK company loans money to its Australian subsidiary	Cash inflow	Demand for Australian dollars	Credit
An Australian company loans money to its New Zealand subsidiary	Cash outflow	Supply of Australian dollars	Debit
An Australian superannuation company buys shares on a European stock exchange	Cash outflow	Supply of Australian dollars	Debit

Australia's Global Trade



Australian Balance of Trade Over Time



Factors Affecting Trade Flows

1) Cost of labour:

Labour-abundant countries can make labour-intensive products quite cheaply, thus having an advantage when competing globally.

2) Inflation:

A relative increase in a country's inflation rate will decrease its current account, as imports increase and exports decrease.

3) National Income:

A relative increase in a country's income level will decrease its current account, as imports increase.

4) Government Restrictions:

A government may reduce its country's imports by imposing a tariff on imported goods, or by enforcing a quota.

Some trade restrictions may be imposed on certain products for health and safety reasons.

5) Exchange Rates:

If a country's currency begins to rise in value, its current account balance will decrease as imports increase and exports decrease.

Factors Affecting Foreign Direct Investment

- **Changes in Restrictions**: New opportunities have arisen from the removal of government barriers.
- **Privatization**: FDI is stimulated by new business opportunities associated with privatization. Managers of privately owned businesses are motivated to ensure profitability, further stimulating FDI.
- **Potential Economic Growth**: Countries with greater potential for economic growth are more likely to attract FDI.
- **Tax Rates:** Countries that impose relatively low tax rates on corporate earnings are more likely to attract FDI.
- **Exchange Rates:** Firms typically prefer to pursue FDI in countries where the local currency is expected to strengthen against their own.

Factors Affecting International Portfolio Investment

Tax Rates on Interest or Dividends:
Investors normally prefer to invest in a country where taxes are relatively low.

Interest Rates:
Money tends to flow to countries with high interest rates, as long as the local currencies are not expected to weaken.

Exchange Rates:
Investors are attracted to a currency that is expected to strengthen.