International Business in the Era of Disruptions

International Finance

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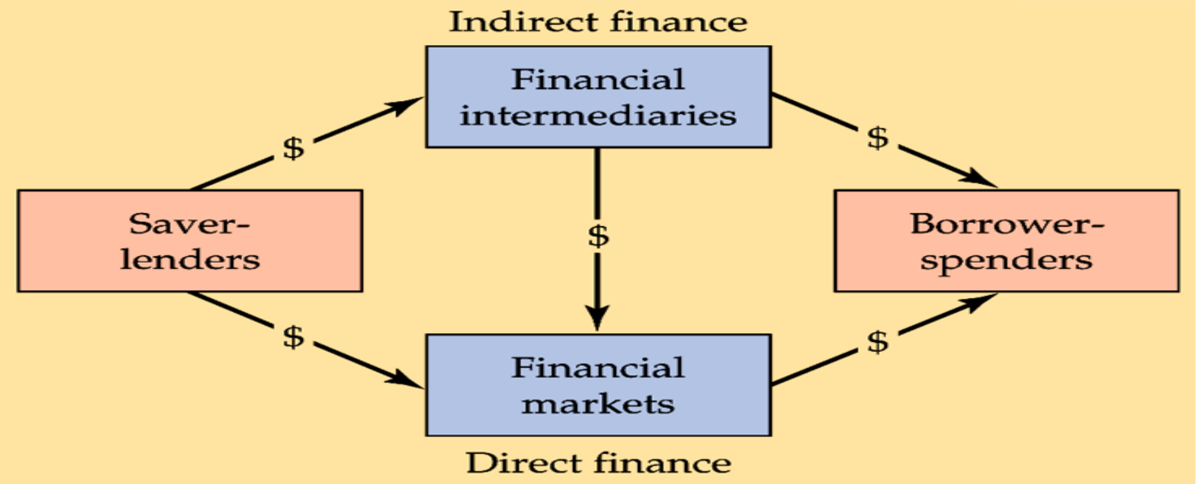
What is Finance?

- **Connecting suppliers and users of financing**
- **Planning and implementing efficient use of capital within organizations**

- **Corporate Finance**
- **Asset Pricing**
- **Financial Institutions**



"Finance is about balancing risk and return"

What is different about international finance?

- **In purely theoretical sense, not much**
- **But, in an international setting the practice and norms of connecting supplies and users of financing vary widely**
  - Market integration vs. market segmentation
    - Barriers of trade, information barriers
    - Differences in business culture, legal, accounting, and tax systems
  - Foreign Exchange (FX) markets and FX risk
  - Country risk / Political risk
  - Market orientation vs. Institutional orientation
    - Level of market development varies, which can be an opportunity for an MNE

Market integration

- **When markets are internationally fully integrated:**
  - All relevant information is available to all potential investors
  - There are neither legal/regulatory nor informational barriers to participate in foreign markets
  - Result: Efficient global markets, where "everything is priced right"
- **David Ricardo,** *classical theory of comparative advantage* **(1817)**
  - With absolute advantage, all production in countries with greatest labor productivity
  - Assumption of limited mobility of labor and capital leads to comparative advantage, each country concentrating on its relative strengths

Market integration

- **For 5 minutes, think about three questions:**
    - In the last 15 years, have we gotten globally more integrated or more segmented?
    - What is the current direction?
    - What are potential implications of the current trend?

The role of international institutions

- **IMF, World Bank, Regional and local development banks**
- **Also WTO, G20, EU, etc.**
- **Setting of common rules; reacting locally to problems that can potentially become regional/global**
    - Even acting upon regional/global political motives, when free markets face limitations
    - Note: not only focused on developing countries:

IMF urges UK to 're-evaluate' tax cuts in biting attack on fiscal plan

Multilateral lender warns 'untargeted' package risks stoking inflation

Financial Times, Sept 28, 2022

The International Monetary Fund

- **A UN agency, founded in 1945 at Bretton Woods**

WHAT IS THE IMF?

ENGLISH

The International Monetary Fund (IMF) works to achieve sustainable growth and prosperity for all of its 190 member countries. It does so by supporting economic policies that promote financial stability and monetary cooperation, which are essential to increase productivity, job creation, and economic well-being. The IMF is governed by and accountable to its member countries.

WHAT DOES THE IMF DO?

The IMF has three critical missions: furthering international monetary cooperation, encouraging the expansion of trade and economic growth, and discouraging policies that would harm prosperity. To fulfill these missions, IMF member countries work collaboratively with each other and with other international bodies.

Market integration: Case of Africa

- **Many African countries have poorly developed local financial markets**
  - Companies' access to funding is limited, which impedes growth
- **Colak, Habimana, Korkeamäki: "THE EFFECTS OF GOVERNMENT DEBT ON CORPORATE BORROWING IN DEVELOPING ECONOMIES: EVIDENCE FROM AFRICA"**
  - Existing studies in other markets document a crowding out effect, where government borrowing has a negative effect on access to debt for local firms
  - We find the opposite in Africa
    - Very active role of international institutions, and China in particular, causes concerns, but has also positive effects

Country risk

- **Risk defined: *Actual outcomes can differ from expectations***
- **Country risk = possibility of an unexpected change in business environment in a country**
- **The issue: National government has the judicial power on its territory**
    - From the local perspective the incentives on foreign direct investments can change rapidly once the investments have been made
    - Management tools include ensuring that the firm generates value to the host country (and that local losses will occur upon undesirable events)

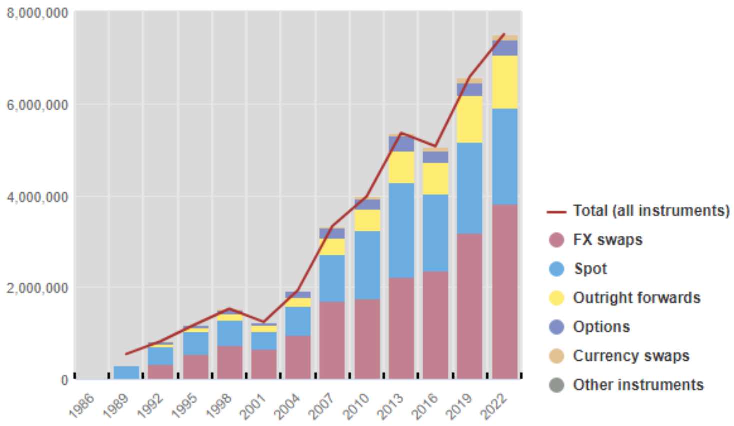
Country risk

Can be classified into

- Political risk
  - Unexpected change caused by political events
- Financial risk
  - Unexpected change in economic environment
  - Includes FX risk

FX rates and FX market

- **Fixed vs. floating rate systems**
  - Is any system truly fixed (forever)?
  - “Automatic” adjustments by markets or “Forced” adjustments under political pressure?
- **Spot and derivative markets**
  - Over $7.5 trillion per day!
  - “End users” a minority
  - Enable risk management
  - Often very short holding periods
  - Large volume limits ability to manage FX rates (see next slide)



www.bis.org

FX rates and FX market

Foreign exchange + Add to myFT

Investors stand by big yen short despite BoJ intervention

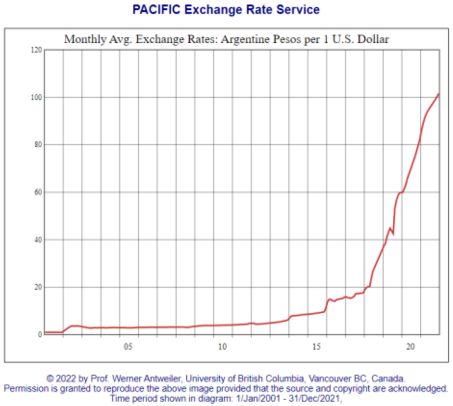
Analysts say Japan's central bank does not have enough firepower to prop up currency in long term

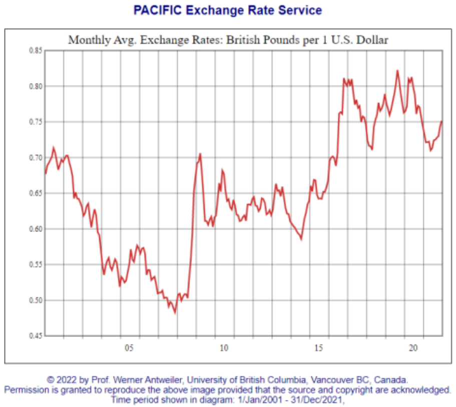
The yen reached its weakest level against the US currency in 24 years on Thursday before the Bank of Japan stepped in © REUTERS

Kate Duguid in New York SEPTEMBER 23 2022 38

FX prediction

- **Very challenging, especially in the short run**
  - Drivers include economic growth and monetary policy (both current and expected), expected fiscal policy choices, uncertainty (also global)
    - At times of increased uncertainty, “escape to quality” tends to strengthen USD
  - Huge effects on both trade and foreign direct investment





FX exposure

- **Exposure = how much we have at risk (due to potential currency fluctuation)**
- **Can be further classified into**
  - Transaction exposure
    - Change in value of outstanding financial obligations
  - Economic (or operating) exposure
    - Change in value of expected future operating cash flows
    - Depends on how FX rate changes affect sales volume, prices, and costs
  - Translation (or accounting) exposure
    - Changes in the accounting value of foreign subsidiaries
    - Arises when foreign affiliates' financial statements are consolidated to parent firm's financial reports

FX exposure

- **Case Carlsberg:**
    - Balance between transaction-, economic-, and translation exposures and their management
    - Illustrates how FX exposure reflects part of country risk, and how political- and financial risks are intertangled
- **A firm has FX exposure when its profits, net cash flows, or market value can change because of FX rate changes**
- **Can you imagine a firm that does not have FX exposure?**

Summary

- **Finance connects users and suppliers of capital**
- **In international setting, institutions and cultures present both challenges and opportunities**
- **International institutions seek to predict and address international imbalances**
- **International financial markets have enormous daily volumes, and they enable transactions, risk management, and also speculation**
- **Relevant issues re: Carlsberg Breweries**
  - Cultural & legal differences, mgmt of political risk (both home and abroad), economic exposure, functioning of international markets