KASNEB

PART 3

SECTION 6

INTERNATIONAL FINANCE

REVISED KASNEB STUDY TEXT

REVISED ON: APRIL 2020

INTRODUCTION

Following our continued effort to provide quality study and revision materials at an affordable price for the private students who study on their own, full time and part time students, we partnered with other team of professionals to make this possible.

This Study Text covers KASNEB syllabus and contains past examination past papers and our suggested answers as examples which are provided by a team of lecturers who are experts in their area of training. The book is intended to help the learner do enough study and practice on how to handle exam questions and this makes it easy to pass kasneb exams.

Special appreciation and recognition goes to FA Kegicha William Momanyi (MBA Accounting, CPA, CISA and CCP), Johnmark Mwangi (MSc Finance, CPAK, BCom Finance), and FA Bramwel Omogo (B.sc Acturial Science, CIFA, CIIA final level and ICIFA member)

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to analyse and manage investments in the international financial market environment.

17.0 LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Evaluate the operations of international financial markets
- Analyse fixed versus flexible exchange rate regimes
- Apply risk management strategies in international markets
- Justify government intervention in international finance management and international debt crisis
- Assess the role of the multinational corporation in international financial and capital flows
- Analyse the various finance issues related to multinational corporations
- Advise on various ethical dilemmas faced by multinational corporations' managers
- Identify types of country risks and their measurement.

CONTENT

17.1 The environment of international finance

- International finance: Theory of comparative advantage, the theory of factors endowment, product life cycle, globalisation of the world economy, the multinational corporation
- Goals of international finance
- International flow of funds
- The balance of payments: current account, financial account; factors affecting the financial account
- Sources of international finance: rising funds in foreign markets and investments in foreign projects (short term, medium term and long term

sources)
- Terms of payments in international trading

17.2 The foreign exchange market

- Function and structure of the foreign exchange market
- Mechanics of foreign exchange: The market for foreign exchange; exchange rates(direct and indirect quotations, cross-rate calculations, bid-ask quotes and spreads, cross-rate calculations with bid-ask spreads), exchange rate determination
- Parity relationship: interest rate parity, purchasing power parity; international fisher effects
- Forecasting exchange rates
- Indices of currency movements and exchange rate speculation; efficient fundamental and technical approaches to forecasting; forecasting performance and market efficiency; currency betas and consistent forecasts; international arbitrage

17.3 The foreign exchange rates regimes

- Fixed or pegged exchange rate system
- Floating or flexible exchange rate system
- Managed floating exchange rate systems
- Government Intervention in the foreign exchange market
- Deficit finance and exchange rates

17.4 Managing foreign exchange exposure

- Transaction exposure: identification of transaction exposure; hedging (forward, money and options market hedges), limitations of hedging short term exposure, hedging long term exposure, techniques of reducing transaction exposure
- Economic exposure: Measuring economic exposure, managing operating exposures (selecting low cost production sites, flexible sourcing policy, research and development and product differentiation, financial hedging,

and diversification of the market)
- Translation exposure: Translation methods, financial accounting standards, hedging translation exposure

17.5 International financial markets

- Motives for world trade and foreign investment
- International financial institutions, the international monetary system, multilateral financial institutions, bilateral financial institution, trade-related investment measures (TRIMS),trading blocks
- International banking and money market: International banking services; capital adequacy standards; banking regulations among countries; international money markets
- International bond and equity markets: Long term financing decisions, foreign bonds, types of instruments, dual currency bonds, bond market credit ratings, market capitalisation (developed and developing countries), market structures, trading practices and costs, equity market benchmarks, trading in international equities

17.6 International financial crisis

- The debt crisis
- Causes and remedies of the international debt crises
- Bank management of loan exposure
- Bank assessment of country risk
- Basel I,II and III requirements

17.7 Foreign direct investments (FDIs)

- Definition of FDI
- Classification of FDI
- Motives for FDI
- Foreign market entry strategies, factors favouring FDI, complexities of FDI, Imperfect markets and foreign direct investments FDI's, benefits of international diversification, the direct foreign investment decision, political

risks and foreign direct investments FDI's

17.8 International capital structures and the cost of capital

- Cost of Capital
- Cost of Capital in segmented versus integrated markets
- Comparisons of capital structure across countries
- Cross-border listings of stocks
- Capital asset pricing model (CAPM) under cross-listings
- The effect of foreign equity ownership restrictions
- The financial structure of subsidiaries

17.9 International capital budgeting

- Subsidiary versus parent perspective: translation
- Foreign investment decision process
- Factors to consider in multinational capital budgeting
- The adjusted present value model
- Risk adjustment in capital budgeting analysis
- Divesture analysis; international acquisitions, reducing exposure to host government takeovers

17.10 Multinational cash management

- The size of cash balances, choice of currency
- Cash management systems in practice: bilateral and multilateral netting of internal and external net cash flow
- Transfer pricing and related issues
- Blocked funds, methods used in moving blocked funds
- Factors influencing financing in foreign currencies
- Cash flow analysis for parent/subsidiary, optimisation of cash flows and distortion of subsidiary performance, reduction in precautionary cash balances, financing with a portfolio of currencies

17.11 The international tax environment

- The objectives of taxation: tax neutrality, tax equity
- Types of taxation: income tax, withholding tax, value-added tax
- National tax environment: worldwide taxation, territorial taxation, foreign tax credit
- Organisational structures for reducing tax liabilities: branch and subsidiary income, tax havens, controlled foreign corporation
- Use of transfer pricing to reduce taxes
- Corporate behaviour and international tax laws
- Multinational corporate policy

17.12 Ethics in the international financial environment

- Ethical dilemmas for multinational corporations (MNC) and its manager
- The Green movement

17.13 Country risk analysis

17.13.1 Country risk characteristics

- Political risk characteristics
- Economic risk characteristics
- Financial risk characteristics

17.13.2 Measuring country risk/ country risk profiling

- Methods or techniques of measuring country risk
- Derivation of country risk rating
- Comparison of country risk rating among different countries
- Decision making process from country risk rating

17.14 Emerging issues and trends

TOPIC **PAGE NUMBER**

CHAPTER ONE

THE ENVIRONMENT OF INTERNATIONAL FINANCE

International finance is the branch of economics that studies the dynamics of foreign exchange, foreign direct investment and how these affect international trade. Also studies the international projects, international investment and the international capital flow.
International Finance can be broadly defined, as the study of the financial decisions taken by a multinational corporation in the area of international business i.e. global corporate finance.

International finance draws much of its background from the preliminary studies in the topics of corporate finance such as capital budgeting, portfolio theory and cost of capital but now viewed in the international dimension.

Reasons to study international finance

(i) To understand the global economy and its relation to:

- The end of the cold war
- The emergency of growing markets among the developing countries and
- The increasing globalization of the international economy

The great change of recent years has been the rapid industrialization and economic growth of countries in several parts of the world, such as Asia, Latin America and Africa. Another change in the international financial environment is increased globalization- national economies are becoming steadily more integrated.

(ii) To understand the effect of Global Finance on business
  - Global finance has become increasingly important as it serves world trade and foreign investment.
  - Most large and many medium –sized companies in the developed world

have international business operations
- In recent years, it has become clear that international events significantly affect companies, which do not have foreign operations.

(iii) To make intelligent decisions

Although most personal decisions have nothing to do with international finance jobs, they all require significant knowledge of international finance to make intelligent decisions.

Classification of international business operations

The international business firms are broadly divided into three categories:

(a) International Firm

The traditional activity of an international firm involves importing and exporting. Goods are produced in the domestic market and then exported to foreign buyers. Financial management problems of this basic international trade activity focus on the payment process between the foreign buyer (seller) and domestic seller (buyer).

(b) Multinational firm

As international business expands, the firm needs to be closer to the consumer, closer to cheaper sources of inputs, or closer to other producers of the same product gain from their activities. It needs to produce abroad as well as sell abroad. As the domestic firm expands its operations across borders, incorporating activities in other countries, it is classified as a multinational.
Hence Multinational Corporation is a company engaged in producing and selling goods or services in more than one country. It ordinarily consists of a parent company located in the home country and at least five or six foreign subsidiaries, typically with a high degree of strategic interaction among the units.

(c) Transnational Firm

As the multinational firm expands its branches, affiliates, subsidiaries, and network of suppliers, consumers, distributors and all others, which fall under the firm umbrella of activities, the once traditional home country becomes less and less well defined.

Firms like Unilever, Phillips, Ford, and Sonny have become intricate network with home offices defined differently for products, processes, capitalization and even taxation.

PROBLEMS FACING MULTINATIONAL CORPORATIONS

Companies operating in several countries have greater control problems that those operating in only one because of the significantly increased complexity.

One problem that is immediately evident is language, but there are difficulties especially related to organization, planning and control systems and performance measurements.

Therefore, we examine the problems in the three given classifications above.

(a) Organization

- Most large organizations adopt a form of divisionalization or decentralization. Multinational operation adds in a further dimension that needs to be addressed. Operating units can be organized either within countries or across them.
- The balance of local control and central direction must be made. The management culture and quality in each country must be taken into account in determining the level of the autonomy allowed.
- The determination of the structure of operating unit needs to reflect the requirement for efficiency and also be tailored to the particular national environment. Factors such as legislation and taxation will impose differing demands from country to country.
- One common bugbear of international operation is the determinations of transfer prices for inter-company trade. Several problems arise; tax

planning, performance evaluation, goal congruence and currency fluctuations must all be factored into the method adopted.

- International operation will require adoption of an accounting system that satisfies the local and head office financial reporting standards. This can sometimes require maintaining two sets of books in each country, one for local reporting and other for consolidation into the group accounts.

(b) Planning

- Planning the operations of the company will be complicated by the need to consider the needs of the whole group as well as the particular circumstances country by country. The exercise may produce conflicting demands that could cause tensions within the group.
- Central management will need to have a full understanding of the situation in several countries. The planning process will require gathering and assimilating information from all the company's locations, which may be a complicated exercise.
- Any plans set by local management must be reviewed by for congruence with the company's overall aims. As with any decentralized operation with a degree of divisional autonomy there is potential for conflict between the aims of local and central management.

THEORY OF COMPARATIVE ADVANTAGE

The theory of comparative advantage holds that a country has a comparative advantage over another in producing particular goods if it can produce that good at a lower relative opportunity costs.

The theory has the following assumptions:

1. There are no transport costs
2. There are only two economies
3. The two economies are producing only two goods
4. The market is perfect
5. There are no tariffs or trade barriers
6. The factors of production are assumed to be perfectly mobile

FACTOR ENDOWMENT THEORY

The theory holds that countries are likely to be abundant in different types of resources. Countries should strive economically to produce goods and services that require resources they are heavily endowed with e.g. a country with a high ratio of capital to labor will be more efficient at producing computers than it would produce corn.

ASSUMPTIONS

1. There are two countries
2. There are two factors of production: Labor and capital
3. There are no transport costs
4. The demand conditions in both countries are identical
5. There are two goods which are either labor intensive or capital intensive.
6. There is completion in both commodity and factor market

THEORY OF PRODUCT LIFE CYCLE

It consists of the following stages:

1. **Introduction stage** - New product is made at the local market and sold at local market. When there is saturation, it is exported.
2. **Growth stage** - Other people are also producing your product; there are competitors and the product is known all over the world.
3. **Maturity stage** - Industry contracts and concentrates. The lowest cost producer wins
4. **Saturation stage** - A period when the sales of a product both at home and away reach a peak and there is no further possibility of increase .Marketers try to develop new and alternative uses of the product.
5. **Decline stage** - Poor countries constitute the only markets for the products. They act as dumping sites.

ASSUMPTIONS

1. The product completes the 5 stages of its life
2. The duration of each stage is fixed or equal
3. There is no reintroduction of the product

4. The product passes through the stages in a chronological order.

INTERNATIONAL FLOW OF FUNDS

It includes:

- Portfolio investments
- Direct foreign investments
- Official investments-government to government
- Intermediated Investments

BALANCE OF PAYMENT EQUATION

$\{(X\text{-}M) + (D^i\text{-}D^o) + UT\} + \{(DFI^i\text{-}DFI^o) + (PI^i\text{-}PI^o) + (II^i\text{-}II^o) + OI\} + OSB = 0$

Where:

X-Exports

M-Imports

D^i – Dividends/Interest received

D^o-Dividends/Interest paid

UT-Net inflow of unilateral transfers

DFI^i-Direct foreign investment inflows

DFI^o-Direct foreign investment outflows

PI^i-Portfolio investment inflows

PI^o-Portfolio investment outflows

II^i-Intermediated investment inflows

II^o-Intermediated investment outflows

OSB-Official settlement balance

CURRENT ACCOUNT

Records $\{(X\text{-}M) + (D^i\text{-}D^o) + UT\}$ in BOP which are the components of current account.

IMPORTANCE OF CURRENT ACCOUNT

1. Nations with chronic current a/c deficits often come under increased scrutiny during periods of highlighted uncertainty. Currencies of such nations come under speculative attack during such times. This creates a

vicious cycle where previous foreign exchange reserves are used to support the domestic currency.

2. A country with current a/c surplus normally will have surplus foreign exchange it can use to invest in other countries.
3. Surplus in current a/c implies possibility of increased employment in export sector

DEC 2012 Q1c

The following information relates to the republic of Zengaland for the year ended 31st December 2011:

	Sh. 'billions'
Export of goods	5,000
Import of goods	3,000
Receipts from interest and dividends	1,500
Payments of interest and dividends	1,000
Gifts received from abroad	800
Gifts to foreign countries	1,200

Required;

A current account for the year ended 31 December 2011

Solution

REPUBLIC OF ZENGALAND

CURRENT A/C AS AT 31ST DEC 2011

	Billions		Billions
Exports	5000	Imports	3000
Receipts from interest and dividend	1500	Payments of interest and dividend	1000
Gifts received	800	Gift to foreign currency	1200
		Bal c/d surplus	2100
	7300		7300

FINANCIAL/CAPITAL ACCOUNT

The account records $\{(DFI^i\text{-}DFI^o) + (PI^i\text{-}PI^o) + (II^i\text{-}II^o) + OI\} + OSB$ in BOP