International finance and financial derivatives

MBA-915-18

lecture notes

What Is International Finance?

International finance, sometimes known as international macroeconomics, is the study of monetary interactions between two or more countries, focusing on areas such as foreign direct investment and currency exchange rates.

Understanding International Finance

International finance deals with the economic interactions between multiple countries, rather than narrowly focusing on individual markets. International finance research is conducted by large institutions such as the International Finance Corp. (IFC), and the National Bureau of Economic Research (NBER). Furthermore, the U.S. Federal Reserve has a division dedicated to analyzing policies germane to U.S. capital flow, external trade, and the development of global markets.

International finance analyzes the following specific areas of study:

- **The Mundell-Fleming Model**, which studies the interaction between the goods market and the money market, is based on the assumption that price levels of said goods are fixed.
- **International Fisher Effect** is an international finance theory that assumes nominal interest rates mirror fluctuations in the spot exchange rate between nations.

- **The optimum currency area theory** states that certain geographical regions would maximize economic efficiency if the entire area adopted a single currency.
- **Purchasing power parity** is the measurement of prices in different areas using a specific good or a specific set of goods to compare the absolute purchasing power between different currencies.
- **Interest rate parity** describes an equilibrium state in which investors are indifferent to interest rates attached to bank deposits in two separate countries.

Scope of International Finance

As many prospects come into the picture, there is the scope it books profits and benefits from each of these prospects accordingly.

1 It is important while determine the exchange rates of the country. One can do this against the commodity or the common currency.

2. It plays a crucial role in investing in foreign debt securities to have a clear idea about the market.

3. The transaction between countries can be significant in assessing the economic conditions of the other country.

4. One can use arbitrage in tax, risk, and price to market imperfections to book good profits while transacting in international trade.

Significance and Importance

In a growing world moving towards globalization, its importance is growing in magnitude. Every day, the transaction between two countries for trade is scaling up with the supporting factors.

It considers the world a single market instead of individual markets and carries out the other procedures. For the same reason, the firms and corporations doing such research include institutions like the International Monetary fund (IMF), International Finance Corp (IFC), and the World Bank. Trade between two foreign countries is one factor in developing the local economy and improving economies of scale.

Currency fluctuations, arbitrage, interest rate, trade deficit, and other international macroeconomic factors are crucial in prevailing scenarios.

International Finance vs Domestic Finance

When all the business and economic transactions occur within a domestic boundary of the country, it is said to be domestic finance. However, if the transactions occur across international borders, it refers to international finance.

There is more than taxation; international finance's cultural and economic environment will be similar to domestic finance.

Currency rates and currency derivatives are usually involved in international finance. Whereas in domestic finance, not many financial instruments as such are used.

The stakeholders in domestic finance are usually uniform with a similar culture, language, and beliefs. Still, we can see diversity among stakeholders' cultures, languages, and values in international finance.

There are numerous options to raise capital from international finance, so the challenge will be high. Whereas in domestic finance, not many

opportunities to raise money will be there. Thus, resulting in fewer challenges.

The accounting standards need to be as per GAAP in terms of international finance, whereas there is no need to maintain separate ones in domestic finance.

Benefits

There is a range of options in international trade and finance to raise and manage the capital for the business.

The scope of growth for companies concentrating on international trade is significantly higher than for companies that do not.

Different currencies and more opportunities to manage the capital involved will improve its financial performance.

The competitiveness improves when international trade is enabled in such markets. That is because the quality of goods and services will improve without much difference in price due to competition.

Revenue from international trade can protect the company and not worry about domestic demand as they still need overseas.

The company has operations in more than one country and can act swiftly in emergencies and conduct BCP (Business Continuity Protocol).

Disadvantages

In political turmoil in one country, a stakeholder of international trade affect the other stakeholders of the same business.

Depending on other countries' exchange rates is always risky, given that all currencies have significant volatility.

One should carefully manage the credit risk because of international trade. Otherwise, it can hamper profitability to a greater extent.

It requires the disclosure of sensitive data more than domestic finance; the chance of stolen confidential information is more in global markets.

Local players cannot compete with big global players who are resource and research-backed to develop quality products and services.

As more than one culture is involved, cultural differences can damage the brand's reputation if not tackled properly.

Conclusion

It is a concept growing significantly in the era of technology and globalization. The idea brings various opportunities for the company to manage capital more effectively and increases the competition to produce and deliver quality goods and services. The local players will have to compete with huge global players, so there is the least scope of mistake in the quality of products.

With many factors like exchange rate, inflation rate, and diversity in culture and language, international finance can be a boon if managed perfectly by the company or become a bane if any aspects are out of understanding and mismanaged. Thus, companies involved in such finance have no

choice but to engage. First, however, they have to make sure they do it efficiently.