**INTERNATIONAL FINANCE**

***Why does the Existence of Borders Matter for Finance?***

Almost tautologically, international finance selects from the broad field of finance those issues that have to do with the existence of many distinct countries. The fact that the world is organized into more or less independent entities instead of a single global state complicates a CFO's life in many ways that matter far more than does the existence of provinces or counties or departments within a country. Below, we discuss

* the existence of national currencies and, hence, the issue of exchange rates and exchange risk;
* the segmentation of goods markets along predominantly national lines; in combination with price stickiness, this makes most exchange-rate changes “real";
* the existence of separate judicial systems, which further complicates the already big issue of credit risk, and has given rise to private-justice solutions;
* the sovereign autonomy of countries, which adds political risks to standard commercial credit risks
* The existence of separate and occasionally incompatible tax systems, giving rise to issues of double and triple taxation.

***Key Issues in International Business Finance***

***Exchange-rate Risk***

Why do most countries have their own money? One disarmingly simple reason is that printing bank notes is profitable, obviously, and even the minting of coins is usually a positive-NPV business. In the West, at least since the days of the Greeks and Romans, governments have been involved as monopoly producers of coins. More recently, the ascent of paper money, where profit margins are almost too good to be true, has led to monopolies virtually everywhere. One reason why money production is not handed over to the UN or the IMF or WB is that governments dislike giving up their monopoly rents. For instance, the shareholders of the European Central Bank are the individual Euro-countries, not the EU itself. In addition, having one's own money is a matter of national pride too: Lastly, a country with its own money can adopt a monetary policy of its own, tailored to the local situation. Giving up a local policy is a big issue at the time the introduction of a common Currency.

Exchange risk means that there is uncertainty about the value of an asset or liability that expires at some future point in time and is denominated in a foreign currency (“contractual exposure"). But exchange risk affects a company's financial health also via another channels and interaction with another inter-national issue: segmentation of the consumption goods markets.

***Segmentation of the Consumer-good Markets***

While there are true world markets and, therefore, world prices for commodities, many consumer goods are really priced locally, and for traditional services the international influence is virtually absent. Unlike corporate buyers of say oil or corn or aluminum, private consumers do not bother to shop around internationally for the best prices: the amounts at stake are too small, and the transportation cost and hassle and delay from international trade would be prohibitive anyway. Distributors, who are better placed for international shopping-around, prefer to pocket the resulting quasi-rents themselves rather than passing them on to consumers. For traditional services, international trade is not even an option. So prices are not homogenized internationally even after conversion into a common currency. One strong empirical regularity is that, internationally, prices rise with GDP/capita. Richer countries in terms of per capita GDP tend to have higher prices.

Within a country, by contrast, there is less of this price heterogeneity. For example, price differences between twin" towns that face each other across the Kenya- Uganda or Kenya- Tanzania border are many times larger than differences between towns within Kenya. One likely reason that contributes to more homogenous pricing within a country is that distributors are typically organized nationally. Of course, the absence of hassle with customs and international shippers and foreign indirect tax administrations also helps.

A second observation is that prices tend to be sticky. Companies prefer to avoid price increases, because the harm done to sales is not easily reversed: consumers are resentful, or they just write off the company as “too expensive" so that they do not even notice when prices come down again. Price decreases, on the other hand, risk setting off price wars, and so on.

***Credit risk***

If a domestic customer does not pay, you resort to legal redress, and the courts enforce the ruling. Internationally, one problem is that at least two legal systems are involved, and they may contradict each other. Usually, therefore, the contract will stipulate what court will rule and on the basis of what law, say Kenyan law in a Ugandan court. Even then, the new issue is that this court cannot enforce its ruling outside its own jurisdiction. This has given rise to private-contract solutions: we seek guarantees from specialized financial institutions (banks, factors, insurance companies) that (i) are better placed to deal with the credit risks we shifted towards them, and (ii) have an incentive to honor their own undertakings because they need to preserve a reputation and safeguard relations with fellow banks etc.

***Political risk***

Governments that decide or rule as sovereigns, having in mind the interest of their country (or claiming to have this in mind), cannot be sued in court as long as what they do is constitutional. Still, these decisions can hurt a company. One example is imposing currency controls, that is, block some or all exchange contracts, so that the money you have in a foreign bank account gets stuck there (transfer risk ). You need to know how you can react pro- and retroactively. You also need to know how this risk has to be taken into account in international capital budgeting. If and when your foreign-earned cash gets stuck abroad, it is obviously worth less than its nominal converted value because you cannot spend the money freely where and how you want, but how does one estimate the probabilities of this happening at various dates, and how does one predict the size of the value loss?

Another political risk is expropriation or nationalization, overtly or on the stealth. While governments can also expropriate locally-owned companies, foreign companies in the “strategic" sectors (energy, transportation, mining & extraction) are especially vulnerable: most of them were expropriated or had to sell to locals in the 1970s. The 2006 Bolivian example, where President Evo Morales announced that “The state recovers title, possession and total and absolute control over [our oil and gas] resources" (The Economist, May 4, 2006.) also has to do with such a sector. Again, one issue is how to factor this in into NPV calculations.

***Capital-Market Segmentation Issues, including Aspects of Corporate Governance***

A truly international stock and bond market does not exist. First, while stocks and bonds of big corporations do get traded in many places and are held by investors all over the world, mid-size or small-cap companies are largely one-country instruments. Second, portfolios of individual and institutional investors exhibit strong home bias, that is, heavy overweighting of local stocks relative to foreign stocks. .Even regarding their holdings of shares in large corporations, a third aspect of fragmentation in stock markets is that we see no genuine international stock exchanges (in the sense of institutions where organized trading of shares takes place); instead, we have a lot of local bourses. A company that wants its shares to be held in many places gets a listing on two or three or more exchanges (dual or multiple listings; cross-listing): being traded in relatively international places like London or New York is not enough, apparently, to generate worldwide shareholder ship. How come?

***Issues on an international CFO’s Desk?***

*Issues that concern an international CFO, and which we shall cover in this course are:*

* *Valuation of international projects.*
* *Funding of international projects.*
* *Hedging, or more generally risk management.*