Module 4 Assignment

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Module 4 Assignment

# Q1 -- How do MNCs come into existence? What steps may an MNC follow in becoming global?

To deals with MNCs and how it’s come to existence here are some of over the event to be look at there has been a systematic effort to facilitate the free flow of goods and services across national boundaries over the years, a rapid economic growth in the Western countries owed much to this process.

Now this process is getting more generalized across the world. In spite of some difficulties, integration of the Environment economies across nations is progressing and moving forward.

In case of India, the period after 1991 has been' one of liberalization and integration with the world economy. Some of the steps that have been taken over a period of last years are:

1. establishment of a unified market-determined exchange rate; -introduction of current account convertibility;
2. phased introduction of capital account convertibility;
3. reduction in import duties;
4. Liberalization of portfolio and foreign direct investment.

The process of integration of the world economy has seen emergence of very large size business organization, called MNCs, and a very dynamic international financial market. Financial markets with innovative products present opportunities as well as varied risks. This required a very deep understanding of the products and market dynamics.

Capital as a resource is no longer a monopoly of a nation state bound by geographical borders. It moves around the world. A typical MNC raises capital in several countries.

An MNC moves its resources (money, technology, raw material and labor) globally to draw maximum advantage. Earlier, MNCs were largely US-based. Later on, European and Japanese MNCs also because important players. Now, some MNCs based in developing countries are also emerging.

Internationalization of a business involves steps like

* exporting,
* setting up an international operations department,
* establishing a marketing subsidiary,
* Entering into licensing agreements and eventually creating facilities, for manufacturing abroad.

This sequence represents a sequence of moving from a relatively low-risk low-return, export-oriented strategy to a higher-risk, higher return production based strategy. An MNC, while establishing production facility abroad, takes one of the two options: either to create its own affiliate or to acquire a going concern. MNCs also use licensing agreements as an alternative to establishing their own manufacturing facilities. A finance manager of an MNC aims at maximizing shareholder wealth. To be able to do so, he has to make sound financing and investment decisions.• While taking financing and investment decisions in an MNC, the finance manager faces many challenges/risks apart from those that he may face in a purely domestic firm. These include political risk, exchange rate risk, interest rate risk, different inflation rates, different tax laws and multiple money markets etc. International finance manager has to balance the risks and advantages so as to optimize the gains from internationalization of business.

## Q2- Compare licensing agreement with establishment of a subsidiary?

A licensing agreement is a legal contract between two parties, known as the licensor and the licensee. In a typical licensing agreement, the licensor grants the licensee the right to produce and sell goods, apply a brand name or trademark, or use patented technology owned by the licensor. While a company may organize subsidiaries to keep its brand identities separate. This allows each brand to maintain its established goodwill with customers and vendor relationships. Subsidiaries are often used in acquisitions where the acquiring company intends to keep the target company's name and culture

### Q3- What risks does an international finance manager face?.

### In general, the risks of conducting international business can be segmented into four main categories:

* Country,
* Political,
* Regulatory and currency risk

Financial risk is caused due to market movements and market movements can include host of factors. Based on this, financial risk can be classified into various types such as

* Market Risk,
* Credit Risk,
* Liquidity Risk,
* Operational Risk and Legal Risk.

**Q4- Describe the different kinds of international financial flows?**

International financial flows take a variety of forms, one of the most important categories being that of foreign direct investment. ... Reserve assets consist of those external assets that are readily available to, and controlled by, monetary authorities of individual countries for the financing of payments imbalances, the various types of transactions leading to international financial flows need some discussion here. Trade flows, invisibles, foreign direct and portfolio investment, external assistance and external commercial borrowings and some short-term flows

**Merchandise Trade Flows**

Environment Trade may be related to goods. Alternatively, it may be related to services. The merchandise trade has two sides. While one is export, the other is import. If India exports various goods, it will get convertible currencies and that will be an inflow of funds. On the contrary, it has to make payments in convertible currencies for the imports it makes. Thus export and import of goods lead to international financial flows.

**Invisibles**

Invisibles include, broadly, trade in services, investment income and unilateral transfers. If an Indian shipping company carries goods of a foreign exporter/importer and gets the freight

Charges, it will be treated as inflow of funds on account of trade in services. Similarly, if a foreign shipping company carries goods of an Indian exporter, there will be outflow of funds in form of freight charges. There are many examples of international flow of funds on account of trade in services.

Investment income relates to the receipt and payment of dividend, technical service, fees, royalty, interest on loan, etc. A foreign company operating in India remits dividend, etc. to its home country that will represent an outflow of funds. Similarly, an Indian company operating abroad remits to India the dividend and other fees that will represent inflow of funds. Likewise, payment of interest on foreign borrowings represents outflow of funds. Any receipt of interest manifests in inflow of funds.

Unilateral transfers are unidirectional. They represent international financial flows without any services rendered. If an Indian makes a gift to his/her friend in England, it will be a case of outflow of funds on account of unilateral transfer. Similarly, a large number of Indians living abroad remit a part of their income to their family members living in India. This is a case of inflow of funds on account of unilateral transfer.

Foreign Investment.

Foreign investment may be of two kinds. While one is direct, the other is portfolio. Foreign direct investment (FDI) occurs when a firm moves abroad for the production of goods or provision of services and participates in the management of that company located abroad. On the contrary, foreign portfolio investment (FPI) is not at all concerned with the production of goods and rendering of services.

The sole purpose of a foreign portfolio investor is to earn a return through investment in foreign securities without any intention of grabbing the voting power in the company whose securities it purchases. In case of FDI too, an investor invests in the shares of a foreign company, but the sole objective is to enjoy the voting power and thereby a say in the management of the foreign company. Thus, it is primarily the voting right that differentiates between FDI and FPI. Whatever the forms may be, inflow of fiends occurs when a foreign investor makes investment in the country. On the contrary, outflow of funds occurs when the domestic investor invests in a foreign country.

**External Assistance and External Commercial Borrowings**

External assistance and external commercial borrowings are different in the sense that while the former flows normally from an official institution -bilateral or multilateral, the latter flows from international banks or other private lenders. The rate of interest in the former is usually low

Along with a longer maturity period. The latter carries market rate of interest and a shorter maturity. Last but not least, external assistance is manifest often in outright grant that does not require repayment of principal/interest payment. Whatever may be the difference between the two, any borrowing from abroad is treated as inflow of fiends Lending abroad, on the other hand, represents outflow of funds, However, repayment of loads is treated just the other way,

**Short-term Flow of funds**

Normally loans and foreign direct investment are meant for a period exceeding one year 8tit there are financial flows that occur for less than a year. Movement of funds relating to banking channels, euro notes, speculative and arbitrage activities, etc. are the examples of short term funds that move across countries.

**Q5- Comment on the structure of balance of payments. What are the basic principles governing recording of the flows?**

On this process the recording of the international financial flows in the balance of payments, a couple of norms need to be followed. One is that the structure of the balance of payments is based just on the principles of the **double-entry or book-keeping**. It means that all the inflows of funds are put on the credit side and all the outflows of funds are debited; and ultimately, the two sides are balanced.

The second norm is that since the different forms of the financial flows vary in nature, they are to be entered accordingly in the two compartments of the balance of payments. It may be mentioned that the balance of payments statement is divided into two compartments. One is known as the current account followed by the other known as the capital account. Those transactions that represent earning or spending are recorded in the current account. For example, when a country earns foreign exchange through export, the amount is entered in the current account. On the other hand, if' the financial flow does not represent earning, it is entered in the capital account. For example, foreign direct investment or foreign portfolio investment is entered in the capital account. Thus, it is on this basis that the different types of financial flows are recorded in the current and the capital accounts*.*

Prescribed Format for recording transactions

Current Account As per the prescribed format adopted by the Reserve Bank of India in the current account, first, merchandise trade is entered. Export receipts are entered on the credit side and the imports are entered on the debit side. And then, the balance is found out. The difference between the export and the import is known as the balance of trade. Excess of export over import is known as the surplus balance of trade and, on the contrary, the excess of import over export is

Known as the deficit balance of trade.

**Q6- How can the trade deficit be reduced or eliminated? Give your arguments based on the elasticity approach?**

The adjustment in the balance of payments disequilibrium is thought of in terms of changes in the fixed exchange rate that is through devaluation or upward revaluation. But its success is dependent upon the elasticity of demand for export and import. Marshall (1924) and Lerner (1944) explained this phenomenon through the "elasticity" approach. The elasticity approach is based on partial equilibrium analysis where everything is held constant except for the effects of exchange rate changes on export or import. It is also assumed that elasticity of supply of output is infinite so that the price of export in home currency does not rise as demand increases, or the price of import falls with a squeeze in demand for imports. Again, the approach ignores the monetary effects of variation in exchange rates.

If the elasticity of demand is greater than unity, the import bill will contract and export earnings will increase as a sequel to devaluation. Trade deficit will be removed. However, the problem is that the trade partner may also devalue its own currency as a retaliatory measure. Moreover, there may be a long lapse of time before the quantities adjust sufficiently to changes in price. Till then, trade balance will be even worse than that before devaluation. Flows Stem (1973) incorporated the concept of supply elasticity in the elasticity approach. Based on the figures of British exports and imports, Stem has come to a conclusion that the balance of trade should improve if:

1- Elasticity of demand for exports and imports is high and is equal to one coupled with elasticity of supply both for imports and exports which is either high or low.

2- Elasticity of demand for imports and exports is low but the elasticity of supply for imports and exports is lower. On the contrary, if the elasticity of demand is low matched with high elasticity of supply, the balance of trade should worsen.

**Q7- Why are MNCs driving investments in South Asian Countries like Thailand, Malaysia and Indonesia?**

**MNCs** help a developing host country by increasing investment, income and employment in its economy. They contribute to the rapid process of development of the country through transfer of technology, finance and modern management. **MNCs** promoting exports of the host country Investors can avail of benefits of international diversification of investment with least obstacles to foreign investments by taking recourse to various vehicles, important of which is outlined below:

There are free benefits of international diversification may be derived by investors by investing their money in stock of MNCs who themselves engage in international business worldwide. The magnitude of the diversification benefits from such investments depends essentially on the nature and extent of their international involvement. MNCs in less diversified economies or in countries with controls on cross-border investment portfolio provide large benefits of diversification to their residents than U.S. multinationals provide to U.S. investors.

The Investors can buy foreign debentures and equity shares directly in many financial markets. The cost and benefits of deployments of funds in foreign securities through this route will be dependent on the choice of the particular assets and the vehicles used to gain access to foreign markets and on barriers to capital flow in a particular market. There are number of ways in which domestic investors can buy foreign stocks directly. Some of them are briefly discussed below:

* **Direct Purchase of Foreign Securities**: The most direct route to diversify portfolio internationally is to purchase foreign securities straight away in foreign markets. However, this route may not be so useful to small investors because of several impediments, as stated earlier.
* **Direct Purchase in the Domestic Market**: This method of portfolio diversification is becoming popular in recent years because a large number of foreign companies are issuing equity stocks in developed financial markets of Europe, North America, and South East Asia. Likewise, global bonds are being floated increasingly to satiate the borrowing needs of national governments, MNCs and transnational financial institutions such as IMF and IBRD.
* **There are two ways of listing shares by companies on foreign equity exchanges foreign shares and Depository receipts**. Foreign shares represent shares of a foreign company sold to domestic investors through a transfer agent according to domestic regulations. Depository receipts are derivative securities which represent a claim on a block of foreign stock held by a domestic trustee. These receipts denominated in local currency are sold through a domestic broker and regulated by domestic authorities.
* **American Depository Receipts (ADRs**): ADRs represent certificates of ownership issued by a U.S. Bank as a convenience to investors in lieu of the underlying shares it holds in custody. These receipts are denominated in dollars and traded on a U.S. exchange.

To issue an ADR a foreign company hires a U.S. investment banker to buy a block of shares in the foreign company. The banker then issues dollar-denominated stock certificates to the U.S. investors with foreign securities as collateral. Dividends are converted into dollars and distributed to investors directly by the Trustee. The investors in ADRs absorb the handling costs through transfer and handling charges**.**

**Q8-Why are China and India emerging as attractive centers of FDI in recent years?**

Competing in World Markets Developing countries are becoming important international markets because of their participation in global business increases and potential to reach new consumers, the various international agreements are generally becoming more and more sophisticated and complex in content, and investment-related provisions are increasingly introduced into agreements encompassing a broader range of issues. Foreign investors have been showing keen interest in India in recent years because of low risk due to political and economic stability of the country and robust economic growth as also due to favorable policy measures.

According to a corporate study, India has been found less risky than China as a business destination. India has been ranked 10th out of 100 countries in the latest country risk analysis by Economic Intelligence Unit. As a result, FDI flows to India, which has reached $ 5 billion in 2003 from $3.8 billion in 1999, is expected to go up to $ 13 billion in 2008. Extent of FDI in a particular country is dependent upon a host of factors such as the country's markets and resources as well as government regulations and fiscal and financial incentives. Countries like Singapore and Hong Kong and more recently China could attract burgeoning amount of FDI mainly because of liberal policy and a few business restrictions. Our country has, of late, attracted huge funds from FDI to the extent of $5335 million during 2003-04 because of the adoption of the policy of globalization and economic liberalization permitting foreign investors to hold 49 percent ownership share in the infrastructural sectors including banks and telecom sectors with government assurance to raise the ceiling to 74 percent.

Some countries offer various types of fiscal and financial concessions to attract foreign investments. Mexico recently reduced its restrictions on automobiles produced there. It has recently announced that it would allow foreign companies to own 100 percent of their subsidiaries established in Mexico. In a refreshing contrast, Japan could not attract much investment because of major entry barriers.

FDI as a means of accelerated economic growth should be assessed in terms of its potential gains and disadvantages for the country. Some type of FDI may be more attractive to some countries than others.

**Q9- What forces stimulate FDI in a country?**

[Foreign direct investment](https://www.economicshelp.org/blog/4987/economics/foreign-direct-investment/) (FDI) means companies purchase capital and invest in a foreign country. For example, if a US multinational, such as Nike built a factory for making trainers in Pakistan; this would count as foreign direct investment.

In summary, the main factors that affect foreign direct investment are

* Infrastructure and access to raw materials
* Communication and transport links.
* Skills and wage costs of labour

Factors affecting foreign direct investment

**1. Wage rates**

A major incentive for a multinational to invest abroad is to outsource labour intensive production to countries with lower wages. If average wages in the US are $15 an hour, but $1 an hour in the Indian sub-continent, costs can be reduced by outsourcing production. This is why many Western firms have invested in clothing factories in the Indian sub-continent.

* However, wage rates alone do not determine FDI, countries with high wage rates can still attract higher tech investment. A firm may be reluctant to invest in Sub-Saharan Africa because low wages are outweighed by other drawbacks, such as lack of infrastructure and transport links.

**2. Labour skills**

Some industries require higher skilled labour, for example pharmaceuticals and electronics. Therefore, multinationals will invest in those countries with a combination of low wages, but high labour productivity and skills. For example, India has attracted significant investment in call centres, because a high percentage of the population speak English, but wages are low. This makes it an attractive place for outsourcing and therefore attracts investment.

**3. Tax rates**

Large multinationals, such as Apple, Google and Microsoft have sought to invest in countries with lower corporation tax rates. For example, Ireland has been successful in attracting investment from Google and Microsoft. In fact it has been controversial because Google has tried to funnel all profits through Ireland, despite having operations in all European countries.

**4. Transport and infrastructure**

A key factor in the desirability of investment are the transport costs and levels of infrastructure. A country may have low labour costs, but if there is then high transport costs to get the goods onto the world market, this is a drawback. Countries with access to the sea are at an advantage to landlocked countries, who will have higher costs to ship goods.

**5. Size of economy / potential for growth**

Foreign direct investment is often targeted to selling goods directly to the country involved in attracting the investment. Therefore, the size of the population and scope for economic growth will be important for attracting investment. For example, Eastern European countries, with a large population, e.g. Poland offers scope for new markets. This may attract foreign car firms, e.g. Volkswagen, Fiat to invest and build factories in Poland to sell to the growing consumer class. Small countries may be at a disadvantage because it is not worth investing for a small population. China will be a target for foreign investment as the new emerging Chinese middle class could have very strong demand for the goods and services of multinationals.

**6. Political stability / property rights**

Foreign direct investment has an element of risk. Countries with an uncertain political situation, will be a major disincentive. Also, economic crisis can discourage investment. For example, the recent Russian economic crisis, combined with economic sanctions, will be a major factor to discourage foreign investment. This is one reason why former Communist countries in the East are keen to join the European Union. The EU is seen as a signal of political and economic stability, which encourages foreign investment.

Related to political stability is the level of corruption and trust in institutions, especially judiciary and the extent of law and order.

**7. Commodities**

One reason for foreign investment is the existence of commodities. This has been a major reason for the growth in FDI within Africa – often by Chinese firms looking for a secure supply of commodities.

**8. Exchange rate**

A weak exchange rate in the host country can attract more FDI because it will be cheaper for the multinational to purchase assets. However, exchange rate volatility could discourage investment.

**9. Clustering effects**

Foreign firms often are attracted to invest in similar areas to existing FDI. The reason is that they can benefit from [external economies of scale](https://www.economicshelp.org/blog/glossary/external-economies-of-scale/) – growth of service industries and transport links. Also, there will be greater confidence to invest in areas with a good track record. Therefore, some countries can create a virtuous cycle of attracting investment and then these initial investments attracting more. It is also sometimes known as an [agglomeration effect](https://www.economicshelp.org/blog/glossary/agglomeration-economies/).

**10. Access to free trade areas.**

A significant factor for firms investing in Europe is access to EU Single market, which is a free trade area but also has very low non-tariff barriers because of harmonization of rules, regulations and free movement of people. For example, UK post-Brexit is likely to be less attractive to FDI, if it is outside the Single Market.

**Evaluation**

There are many different factors that determine foreign direct investment (FDI) and it is hard to isolate individual factors, given there are many different variables. It also depends on the type of industry. For example, with manufacturing FDI, low wage costs tend to be the most important, as they are a labour intensive industry. For service sector FDI, macro-economic stability and political openness tend to be more important.

Also, it depends on the source of FDI, American firms may value political openness more than Chinese firms. Or American firms may have a preference for countries where English is spoken more.

**Q10- What is internationalization theory of FDI? Discuss strengths and weaknesses of the theory?**

Internationalization. ... In economics, internationalization is the process of increasing involvement of enterprises in international markets, although there is no agreed definition of internationalization. There are several internationalization theories which try to explain why there are international activities. The theory goes like this: every strength that an individual has necessarily brings with it a weakness of which it is an inherent part. It is impossible to have strengths without weaknesses.

**Q11- Gold standard provided domestic price stability and automatic adjustment in balance of payments and in exchange rate. Discuss.**

The system performed well during 1940s and till late 1950s. The US dollar did do well as an intervention currency insofar as it was as good as gold in view of the strong position of the US economy. The central bank in many countries held the dollar denominated securities as reserves. But when the US balance of payments began experiencing growing deficits on account of widening trade deficit and outflow of dollar, the real value of dollar turned lower compared to its nominal value.

It shook confidence in dollar and the central banks began converting the US dollar denominated securities into gold. It led to the outflow of gold from the USA that in turn slashed further the real value of dollar. A vicious circle emerged between falling real value of dollar, loss of confidence in dollar, conversion of US dollar denominated securities into gold and the outflow of gold from the USA.

The outflow of gold was so huge in August 1971 that the then President Nixon suspended the convertibility of US dollar into gold. This decision threatened the very fundamentals of the fixed parity system. In order to bring back confidence in US dollar, the Smithsonian Committee resolutions of December 197I devalued dollar and re-valued upwardly some major currencies. At the same time, the normal fluctuation band was widened to +/- 2.25 per cent. But the Smithsonian measures failed to generate confidence. A few currencies came on to float, and finally, the fixed parity system collapsed in February 1973.

A committee was formed to suggest a feasible system. The new system, as suggested by the Committee, provided various options to the member countries. The member countries adopted them depending upon their convenience, although the system was given a legal shape through amending the Articles of Agreement of the IMF that came into force from April 1978. The system is still in vogue.

The Present System of Exchange Rate

The new/present system provides different options ranging from fixed to floating or even a hybrid of the two. The options are:

1. Fixed exchange rate

a) Pegging to a single currency

b) Pegging to a basket of currency

c) Pegging to SDRs

d) Currency board arrangement

2 Floating exchange rate

a) Independent floating

b) Managed floating

3 Crawling peg

4 Target-zone arrangements

If one looks at the options over a period of time, there is a definite shift in preference among the member countries in favor of floating exchange rate. At present, 35 out of 187 countries have an independent floating system. The other 51 countries have managed floating system. While 53 countries have some or the other kind of fixed exchange rate. 7 countries have gone for a crawling peg. The European Monetary Union (EMU) and other 20 countries of Africa and the Caribbean region have target zone arrangement. Lastly 9 countries do not have their own currency as legal tender (IMF, 2005).

Let us explain in brief the different kinds of options.

Fixed Exchange Rate

In a fixed exchange rate system, the government of a country can peg its currency to the currency of another country. It is normally done in a case where the other currency accounts for a sizeable trade with that country. The currency of Bhutan is, for example, pegged to Indian rupee.

A currency can be pegged to a basket of currencies. Indian rupee was, for example, pegged to a basket of five currencies prior to 1993. The reason is that the appreciation and depreciation of currencies in the basket make the weighted average comparatively stable. A few currencies were pegged to SDRs when the latter was more stable. But now no currency is pegged to SDRs.

Sometimes pegging is a legislative commitment that 'is often known as the currency board arrangement. The currency board pegs the domestic currency to another nation's currency and

buys and sells foreign currency reserves in order to maintain the parity value. Again, it is a fact that the exchange rate is fixed in case of pegging, yet it fluctuates within a narrow margin of +/- 1.0 per cent around the central rate.

On the contrary, in some countries, the fluctuation band is wider and the arrangement is known as pegged exchange rates within horizontal bands.

Floating Exchange Rate

Floating exchange rate is determined by the market forces of supply and demand. A particular currency is subject to fluctuations depending upon the changes in the demand and supply positions. Suppose the exchange rate between Indian rupee and the US dollar is determined by the demand for, and supply of, US dollar in the foreign exchange market. If dollar experiences greater demand, the value of dollar vis-a-vis Indian rupee will appreciate; or in other words, Indian rupee will depreciate vis-a-vis US dollar.

On the other hand, if supply of US dollar increases, the reverse will be the case. Floating rate system may be either independent or it may be managed. Theoretically speaking, there is no intervention by the central bank of a country in case of the independent floating. On the contrary, it does occur in a managed floating rate system.

But the experiences show that intervention is a common phenomenon irrespective of the system being independent or managed. It is because of this fact that the IMF gives a clarification. If the purpose of intervention is to moderate the exchange rate and to check undue fluctuation, it will

be an independent floating. But if the central bank intervenes to establish a level for the exchange rate, this will be a case of managed floating.

Now the readers must be anxious to know what intervention is. It is nothing but the sale and purchase of foreign currency by the central bank in the foreign exchange market in order to influence the demand and supply positions of the foreign currency and thereby to influence its value vis-a-vis the domestic currency.

So if the Reserve Bank of India sells US dollar in the foreign exchange market, the supply of dollar will increase and rupee will appreciate vis-a-vis dollar. If it buys dollar in the market, demand for dollar will increase and rupee will depreciate vis-a-vis dollar.

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