Contents

Preface and acknowledgements xiii

Part A	Essential background
Chapter 1	Introduction 3 What do bankers sell? 6 The creation of Eurodollars 7 Facts about the foreign exchange markets 9 Summary 10
Chapter 2	The International monetary system 14 The gold standard 14 The Great Depression 17 Exchange rates – 1914 to 1944 18 The Bretton Woods system 20 The role of gold up to 1971 21 The Second Amendment 22 International reserves 24 Exchange rate arrangements 24 The European Monetary System 26 The exchange rate mechanism of the EMS 26 Where does the EMU go from here? 31 Summary 32
Chapter 3	The Internationalization process 35 Foreign direct investment 35 The sequential process 37 Market imperfections 39 Transaction cost theory 45 Internalization and firm-specific advantages 46 Location-specific advantages 48 The product life cycle 49 The eclectic theory 54

Globalization 56 Game theory and international strategy 58 Summary 60

Part B Foreign exchange

Chapter 4 The balance of payments 63

The essence of international trade 63
The balance of payments and foreign exchange rates 64
Balance of payments accounting 68
Forecasting exchange rates and the balance of payments 71
Summary 72

Chapter 5 Exchange rates: the basic equations 74

Foreign exchange markets 74 Some basic relationships 75 Summary 87

Chapter 6 Foreign exchange markets 91

The players 91
Methods of quotation 92
Forward contracts and quotations 94
Spot settlement 96
Forward value dates 97
Main purpose of the forward market 97
Summary 98

Chapter 7 Theories and empiricism on exchange rate movements 100

Inflation and interest rate differentials 100
The balance of payments approach 101
The monetary approach 103
Overshooting – the Dornbusch model 105
The portfolio balance theory 107
The role of news 110
Chartism 110
The efficient markets hypothesis 116
Empiricism and purchasing power parity 117
Empiricism and the Fisher effect 122

Empiricism and the Fisher effect 122
Empiricism and the international Fisher effect 122
Empiricism and interest rate parity 124
Empiricism and expectations theory 125
Empiricism and foreign exchange market efficiency 126
Summary 128

Definitions of foreign exchange risk 133 Chapter 8

Transaction exposure 134 Translation exposure 134 Economic exposure 138

Summary 141

Chapter 9 Financial accounting and foreign exchange 143

FASB 8 144 FASB 52 145 SSAP 20 150 Summary 153

Test bank number 1 155

Exercises 155

Multiple-choice questions 158

Part C Hedging •••••

Chapter 10 Does foreign exchange exposure matter? 163

Transaction exposure 163 Economic exposure 165 Translation exposure 167 Forecasting exchange rates 171 Summary 172

Chapter 11 Principles of exposure management 174

Why hedge anyway? 174

What does exposure management aim to achieve? 174

The arguments against corporate hedging 175 The arguments for corporate hedging 179 Information for exposure management 184

What kind of foreign exchange exposure is significant? 185

The transaction exposure information system 186

Histogramming 190

Reinvoicing vehicles 192

Strategies for exposure management 193

Economic exposure revisited 195 Macroeconomic exposure 195

Summary 198

Chapter 12 Internal techniques of exposure management 202

Netting 202 Matching 205

Leading and lagging 206

Pricing policy 207
Asset and liability management 210
Summary 211

Chapter 13 External techniques of exposure management 213

Forward markets 213
Trading purpose of the forward market 214
Short-term borrowing 219
Discounting foreign-currency-denominated bills receivable 220
Factoring foreign-currency-denominated receivables 220
Currency overdrafts 221
Exchange risk guarantees 222
Counterparty risk 222
Summary 223

Test bank number 2 225

Exercises 225
Multiple-choice questions 229

Part D Derivatives

Chapter 14 Swaps 235

Interest rate swaps 235
Calculation of interest 241
Currency swaps 246
Assessing risk in swaps 252
Summary 255

Chapter 15 Financial futures and foreign exchange 257

Financial futures in general 257 Currency contracts 260 Hedging a borrowing 262 Basis risk 263 Use of currency futures market 264 Summary 264

Chapter 16 Currency options 266

How currency option markets work 266
Currency option strategies 270
Average rate option 273
Hedging a currency option 275
Option-pricing models 279
Option-pricing models – the empirical evidence 285

The option parity theorem 286 Corporate use of currency options 287 Summary 291

Chapter 17 Interest rate risk 293

The term structure of interest rates 293
Interest rate exposure 297
Forward rate agreements 300
Interest rate futures 301
Interest rate swaps 301
Interest rate options 302
Summary 303

Chapter 18 Financial engineering 305

Forward contracts 305
Option contracts 307
Some new financial instruments 312
Summary 314

Test bank number 3 316

Exercises 316
Multiple-choice questions 319

Part E International capital budgeting

Exchange controls 325

Chapter 19 Exchange controls and corporate tax in international investment 325

Profits repatriation 327
Circumventing profit repatriation restrictions 328
Other techniques of unblocking funds 332
International corporate taxation 332
Taxation of UK multinationals 336
Multicurrency management centres 337
Co-ordination centres 338
Foreign exchange rate strategy 339
Summary 340

Chapter 20 The international capital budgeting framework 342

The international complications 343
NPV or APV 348
Foreign investment and the cost of capital 350
The basic model 350
Empirical studies of international investment appraisal 352
Summary 356

Chapter 21 The international capital budgeting model 358

Real operating options 359

International project appraisal 363

Taxation 364

Project evaluation with no exchange controls 366

Project evaluation with exchange controls 378

Debt-equity swaps 383

Sensitivity analysis 384

Summary 384

Chapter 22 International investment: what discount rate? 388

US evidence 388

British evidence 394

The excess return in other parts of the world 397

Country risk 397

The international capital asset pricing model 399

Summary 405

Chapter 23 Political risk 406

The measurement of political risk 406

Managing political risk 410

Post-expropriation policies 412

Political risk analysis in international capital budgeting 413

Summary 418

Test bank number 4 420

Exercises 420

Multiple-choice questions 425

Part F International financing

Chapter 24 International debt instruments 431

Short-term borrowing 433

Medium-term borrowing 435

Euromarkets 436

Definitions of key Eurocurrency terms 437

Eurodollar deposits and loans 438

Historical underpinnings of the Eurocurrency market 440

The players in the market 441

Euromarket deposits and borrowings 442

The Eurocredit market 442

Loan syndication 443

Securitization 446

Eurocurrency interest rates and their linkage with domestic rates 447 The international bond market 449 The advantages of the Eurobond market to borrowers 454 The advantages of Eurobonds to investors 454 Summary 455

Chapter 25 Financing the multinational and its overseas subsidiaries 457

The international financing choice 457

Minimization of global taxes 458

Managing risk 459

Financial market distortions 460

The multinational's capital structure 461

Political risk 462

Exchange control risk 463

Currency risk 463

Losses earned by subsidiaries 464

Inter-company credit 464

Taxation effects 465

Dividend policy 465

Other methods of profit transfer 466

Parent company guarantees 466

Partly owned subsidiaries 467

Euroequity 468

Some more empirical evidence 470

Measuring the cost of international borrowing 472

The advantages of borrowing internationally 473

The risks of borrowing internationally 474

Foreign currency financing decisions 476

Summary 479

Chapter 26 Project finance 480

Limited recourse finance 480

Equity finance 481

The lender's viewpoint 481

What does project finance achieve? 484

Overview 485

Summary 486

Chapter 27 Financing international trade and minimizing credit risk 487

Cash with order 487

Open account 488

Bills of exchange 489

Documentary letters of credit 492

Government assistance schemes 495

Sources of export finance 497
Forfaiting 499
Countertrade 501
Summary 501

Part G Miscellaneous

Chapter 28 Miscellaneous issues in multinational finance 505

Overseas subsidiary performance measurement 505
Problems in overseas performance evaluation 506
Treasury management performance 510
Centralization of exposure management 511
The treasury as a profit centre 513
Authority and limits 513
Foreign exchange dealing with banks 515
Dealing room security 516
Commercial paper 517
Credit rating 518
Transfer pricing 523
Capital flight 523
Corporate hedging policies 524
Summary 534

Test bank number 5 536

Exercises 536 Multiple-choice questions 538

Suggested answers to selected exercises 543
Solutions to multiple-choice questions 559
Appendix 1: Present value of \$1 561
Appendix 2: Present value of \$1 received annually for n years 562
Appendix 3: Table of areas under the normal curve 563
Glossary 564
References 587
Index 603