**Final Assignment**

Jake Melvin

Finance, University of Central Florida

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Dr. Geoffrey Vanderpal

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1. Describe how foreign trade would be affected if banks did not provide trade-related services and how can a banker’s acceptance be beneficial to an exporter, an importer, and a bank?

Trade-related services are instrumental to the success and efficiency of foreign trade. If banks did not provide trade-related services, foreign trade would be riddled with excess risk, and increased costs. There are several different services that play crucial roles in foreign trade. Letters of credit are written obligations issues by the importer’s bank guaranteeing that payment will be given to the exporter once documentation has been provided confirming the product has been shipped. This smooths the process over by providing reassurance to the exporter that they will receive payment, under the assumption that the bank is more trustworthy than the importer. This negates certain risks on behalf of the exporter and incurs foreign trade. Banks also provide trade-related services known as documentary collections, which are drafts processed through banking channels. These drafts can reassure the exporter with certain protections, depending on if it’s a sight draft or a time draft. Sight drafts, or documents against payment, give credibility that payment will be made once the shipment is made, giving protection to the exporter. A time draft on the other hand, or documents against acceptance, may allow the importer to receive the merchandise prior to paying for the merchandise. In this instance, the bank has no obligation, and the risk is on the exporter. Since the draft is legally binding, the exporter could at least file a lawsuit to claim their rightful earnings. A banker’s acceptance is a time draft that is given by a firm and ensured by a bank. Its beneficial to an exporter, as it provides that protection from credit risk. This may allow the exporter to do business in a new market, with a new importer. A banker’s acceptance is beneficial to an importer as it allows them to order larger quantities of merchandise that they are importing, given the assurance to the exporter that they will receive proper payment. It is also helpful to the bank itself, as it will typically earn a commission from creating the time draft in the first place.

1. Assume that interest rate parity exists. If the forward rate is an unbiased forecast of the future spot rate, explain the implications of borrowing a foreign currency (versus local financing) over time.

Borrowing a foreign currency has both short-term and long-term ramifications, and over time its results can be comparable to the usage of local financing. Interest rate parity is the state of equilibrium, where market forces cause interest and exchange rates to fluctuate in a manner that eliminates covered interest arbitrage. In principle, this should lead to parallel returns no matter what currency the investments were made with, be it local or foreign. Theoretically, a firm could be drawn to the idea of borrowing from a foreign market where the interest rate is lower than the local market, under the assumption that it may make for cheaper financing and allow the firm to save money. Unfortunately, while this is a fun idea, if the forward rate does correctly predict the spot rate, then these earnings or savings will simply be erased by the fluctuating exchange rate over time. Thus, in the short-term, a firm may temporarily be able to reduce costs by borrowing a foreign currency, but with these savings comes the uncertainty of exchange rate risks. To avoid these potential risks with exchange rate fluctuation, a company may attempt to hedge using options or forward or futures contracts. These strategies may prove effective, but due to the potential costs of these possibilities, the likelihood of the initial savings dissipating is a strong possibility. Ultimately, the firm will need to consider the amount of risk they are comfortable risk and evaluate hedging options to determine if borrowing a foreign currency will be more profitable than simply using local financing.

1. Discuss the development of a probability distribution of effective financing rates when financing in a foreign currency. How is this distribution developed?

Financing in a foreign currency has multiple possible advantages that are lucrative and attractive to MNC’s. Risk, specifically with currency fluctuation in a foreign market, impacts the exchange rate and interest rate, and overall effective financing rate. The risk associated with foreign currency is the downside to the potential advantages it offers. While there are alternatives that attempt to minimize the risk of foreign financing, foreign currencies are often still volatile and difficult to accurately forecast. The development of a probability distribution of effective financing rates greatly benefits the MNC by allowing them to view a grand scheme picture of the possible outcomes to foreign financing. By seeing all of the possible outcomes, it helps MNC’s make more informed decisions when considering foreign investment. The distribution is developed using a plethora of different economic and financial factors. Some of these key variables include historical data analysis on the exchange rate, interest rate, and domestic interest rate. While historical data analysis is not an entirely accurate tool to predict the future, patterns and trends can be drawn and interpreted to provide more information to the MNC. Using these patterns, exchange rate movements can be modeled, and these different models run through simulations. The simulations generate different outcomes, depending on the data used for each specific simulation, and after many simulations a general likelihood of events will begin to unfold. Some may fall on a high end of variance in regards to effective financing rate, while others may be at the low end. Once the range of outcomes of effective financing rate is established, the MNC can use the probability distribution to determine the likelihood of a positive result, and choose whether to pursue the foreign financing opportunity or to look for another alternative.

1. If a U.S. firm believes that the international Fisher effect holds, what are the implications regarding a strategy of continually attempting to generate high returns from investing in currencies with high interest rates?

The International Fisher Effect essentially states that the difference between the nominal interest rates of two countries will be roughly equivalent to the difference in exchange rates of those two countries. Therefore, if a firm believes that this effect holds, it seems counter-intuitive of the firm to then use a strategy of continually investing in currencies with high interest rates, in the hopes of generating high returns. This is due to the fact that while a higher interest rate may seem tempting, in all likelihood the exchange rate risk and depreciation of the foreign currency will lead to minimal gain or potential losses after being exchanged back the dollar. Even if the company hedges, odds are that the hedging costs will end up negating the potential gain on investment. The other potential costs to the firm are opportunity costs, where the firm could have chosen a local, or different foreign currency with lower interest rates, but more stable returns. Additionally, most countries that have high interest rates may exhibit characteristics of high political or economic risk. This could potentially lead to massive losses for the firm, with little upside. If the firm’s goal is to generate high returns, it is more likely they’d find greater success by diversifying across multiple different foreign markets, of different interest rates and minimizes the risk they take on.

1. Why would a U.S. firm consider investing its short-term funds in euros even when it does not have any future cash outflows in euros?

There is a couple of influencing factors that will make a U.S. firm consider investing its short-term funds in euros, even if it does not have any future cash outflows in euros. On top of this list, is interest rate differences. If the U.S firm feels the interest rate in the eurozone is more attractive than in the United States, the firm may be swayed to invest in Europe. This would be especially true if the firm felt strongly that the euro would appreciate relative to the dollar, as it could provide an opportunity to profit on the exchange rate. This also benefits the U.S. firm in terms of diversification and helps reduce the overall risk of the firms’ portfolio. Eurozone investments offer better liquidity typically than in the U.S., and this improved efficiency may be desirable for the U.S firm. The final factor that plays a part is the sheer volume of money being dealt with. If the firm was able to reduce its financing rate even 1%, then the MNC would save $5 million on an annual interest expense debt of $500 million. Therefore, a U.S. firm would consider investing short-term funds in euros, even when it doesn’t have any future outflows in euros, if they felt that the investment would be profitable for themselves.

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