

International Finance

Course Overview

Three levels to understand

1. The financial markets
2. The macroeconomy
3. The firm

The financial markets

- This is where prices are determined
- Valuation models are of two types
 - **Arbitrage-free valuation**
Interest rate parity, option valuation
 - **Equilibrium valuation**
Supply equals demand; International CAPM

The macroeconomy

- Competitive environment
- Exchange rate policy
- Monetary policy
- Fiscal policy
- Regulatory and legal environment

The firm

Based on market prices and the macro environment, the firm makes three decisions:

1. The investment decision
2. The financing decision
3. The risk management decision

The value of the firm

All three decisions matter because they affect firm value:

$$\text{Value of firm} = \frac{E[\text{Cash Flows}]}{\text{Required Return}}$$

Every topic in this course maps to the **numerator**, the **denominator**, or **both**.

Cash flow effect or discount rate effect?

When something happens in the macroeconomy or financial markets, always ask:

- Does it change **expected cash flows**?
 - Revenue, costs, margins, volumes, taxes, distress probability
- Does it change the **required return**?
 - Systematic risk, risk premia, cost of capital

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- Or **both**?

The investment decision

Does the foreign project create value?

- Estimate expected cash flows in the relevant currency
- Determine the appropriate discount rate
- Account for country risk — but where?
 - In the cash flows? (probability-weighted scenarios)
 - In the discount rate? (risk premium)
 - Through deal structuring? (insurance, contracts)
- Compute Adjusted Present Value (APV)

The financing decision

Where and in what currency should the firm borrow?

- Home currency or foreign currency?
- At what all-in cost?
- How does the cross-currency basis affect the choice?
- Which instruments transform one type of funding into another?
 - Cross-currency swaps, interest rate swaps, FRAs

The risk management decision

Should the firm hedge, and if so, how?

- In frictionless markets, hedging is irrelevant (Modigliani-Miller)
- In practice, hedging can increase firm value by:
 - Reducing costs of financial distress
 - Reducing expected taxes
 - Reducing agency costs
- What type of exposure? Transaction, translation, operating?
- What instruments? Forwards, options, swaps, operational hedges?

The course covers the three decisions in reverse order

We start with the most concrete and build toward the most complex:

Lectures	Decision
3-4	Risk management
5	Financing
6-8	Investment

But first, **Lectures 1-2** set the macro and market context:

- PPP, real exchange rates
- CIP, UIP, the basis
- FX predictability

Why reverse order?

- **Risk management** is the most accessible
Concrete instruments, clear corporate problem
- **Financing** builds on the same instruments
But asks a strategic question about currency and cost
- **Investment** is the most complex
Requires valuation architecture, cost of capital theory, and country risk decomposition

Before the firm decides: the macro context

Lectures 1 and 2 establish why these decisions are hard:

- **PPP fails** → real exchange rate risk exists
Nominal FX movements have real effects on firms
- **CIP holds (mostly)** → forwards are priced by arbitrage
But the basis reveals funding stress
- **UIP fails** → FX risk premia exist
Currency returns are compensation for bearing risk

If PPP, CIP, and UIP all held perfectly, international finance would be straightforward. They don't — and that is the course.

A diagnostic for the course

Consider these four shocks:

1. **Brexit** — GBP depreciates 15% overnight
2. **2022 inflation shock** — energy and food prices spike globally
3. **Russia sanctions** — Western firms lose access to Russian operations
4. **CHIPS Act** — US subsidizes domestic semiconductor production

For each, ask:

- Does it change **expected cash flows**?
- Does it change **required returns**?
- Does it change **financing or hedging opportunities**?
- Does it change the **competitive or regulatory** environment?

We will revisit these in Lecture 14. By then you should be able to answer precisely.

Course structure

Lecture	Topic	Decision
1	Overview, FX markets, PPP	Macro context
2	CIP, UIP, predictability, basis	Market context
3	Why hedge, measuring exposure	Risk management
4	Nonlinear exposure, FX options	Risk management
5	Swaps, FRAs, funding choice	Financing
6	Cross-border valuation, APV	Investment
7	Portfolios, ICAPM, risk premia	Investment
8	Country risk	Investment
9	Fragmentation, global risks	Application
10	Summary and integration	All
