Contents

I Introduction and Motivation for International Finance 1

1 Why does the Existence of Borders Matter for Finance? 3
  1.1 Key Issues in International Business Finance ....................... 4
    1.1.1 Exchange-rate Risk ..................................... 4
    1.1.2 Segmentation of the Consumer-good Markets .................. 6
    1.1.3 Credit risk ............................................. 7
    1.1.4 Political risk ........................................... 7
    1.1.5 Capital-Market Segmentation Issues, including Aspects of Corporate Governance .......................... 8
    1.1.6 International Tax Issues .................................. 10
  1.2 What is on the International CFO’s desk? ............................ 11
    1.2.1 Valuation ................................................. 11
    1.2.2 Funding .................................................. 11
    1.2.3 Hedging and, more Generally, Risk Management ............... 12
    1.2.4 Interrelations Between Risk Management, Funding and Valuation .................................................. 12
  1.3 Overview of this Book .............................................. 13
    1.3.1 Part I: Motivation and Background Matter ..................... 13
    1.3.2 Part II: International Financial Markets ...................... 13
    1.3.3 Part III: Exchange Risk, Exposure, and Risk Management ... 14
    1.3.4 Part IV: Long-term Financing and Investment Decisions .... 14

II International Finance: Institutional Background 17

2 Money and Banking: A Brief Review ................................... 17
  2.1 The Roles of Money .............................................. 18
  2.2 How Money Is Created ........................................... 18
  2.3 The International Payment Mechanism ................................ 30
    2.3.1 Some Basic Principles ..................................... 30
    2.3.2 Domestic Interbank Transfers: Real-time Gross Settlement vs. Periodic Netting ............................. 32
    2.3.3 International payments ..................................... 34
  2.4 What is the Balance of Payments? .................................. 35
    2.4.1 Definition & Principles Underlying the Balance of Payments .. 37
    2.4.2 Some Nitty-gritty ........................................ 40
    2.4.3 Statistical Discrepancy/Errors and Omissions ................ 43
    2.4.4 Where do Current Account Surpluses or Deficits Come From? 44
    2.4.5 The Net International Investment Account .................... 45
  2.5 Exchange-rate Regimes ............................................. 47
    2.5.1 Fixed Exchange Rates Relative to Gold ....................... 48
## CONTENTS

2.5.2 Fixed Exchange Rates vis-à-vis a Single Currency ........................................ 49
2.5.3 Fixed Exchange Rates Relative to a Basket ...................................................... 53
2.5.4 The 1979–1993 Exchange Rate Mechanism (ERM) of the European Monetary System .......................................................... 55
2.5.5 Other Exchange Rate Systems ........................................................................... 60
2.6 Test Your Understanding ....................................................................................... 61
   2.6.1 Quiz Questions ................................................................................................. 61
   2.6.2 Applications .................................................................................................... 63

II Currency Markets ........................................................................................................ 67

3 Spot Markets for Foreign Currency ............................................................................ 73
   3.1 Exchange Rates .................................................................................................... 73
      3.1.1 Definition of Exchange Rates ........................................................................... 74
      3.1.2 Our Convention: Home Currency per Unit of Foreign Currency ............... 75
      3.1.3 The Indirect Quoting Convention .................................................................. 76
      3.1.4 Bid and Ask Rates ......................................................................................... 78
      3.1.5 Primary rates v cross rates ............................................................................. 79
      3.1.6 Inverting Exchange Rates in the Presence of Spreads ................................... 81
   3.2 Major Markets for Foreign Exchange ................................................................... 82
      3.2.1 How Exchange Markets Work ....................................................................... 82
      3.2.2 Markets by Location and by Currency ............................................................ 89
      3.2.3 Markets by Delivery Date .............................................................................. 90
   3.3 The Law of One Price for Spot Exchange Quotes ................................................... 92
      3.3.1 Arbitrage across Competing Market Makers ................................................ 95
      3.3.2 Shopping Around across Competing Market Makers ..................................... 95
      3.3.3 Triangular Arbitrage ...................................................................................... 96
   3.4 Translating FC Figures: Nominal rates, PPP rates, and Deviations from PPP ....... 102
      3.4.1 The PPP rate .................................................................................................. 103
      3.4.2 Commodity Price Parity ................................................................................ 107
      3.4.3 The Real Exchange Rate and (Deviations from) Absolute PPP .................... 108
      3.4.4 The Change in the Real Rate and (deviations from) Relative PPP ............... 109
   3.5 CFO’s Summary ..................................................................................................... 114
   3.6 TekNotes ............................................................................................................... 116
   3.7 Test Your Understanding ....................................................................................... 117
      3.7.1 Quiz Questions ................................................................................................. 117
      3.7.2 Applications .................................................................................................... 119

4 Understanding Forward Exchange Rates for Currency ............................................. 123
   4.1 Introduction to Forward Contracts ....................................................................... 123
   4.2 The Relation Between Exchange and Money Markets ......................................... 127
   4.3 The Law of One Price and Covered Interest Parity ............................................... 132
      4.3.1 Arbitrage and Covered Interest Parity ............................................................. 133
      4.3.2 Shopping Around (The Pointlessness of —) .................................................. 135
      4.3.3 Unfrequently Asked Questions on CIP ............................................................. 135
   4.4 The Market Value of an Outstanding Forward Contract ........................................ 140
      4.4.1 A general formula .......................................................................................... 140
      4.4.2 Corollary 1: The Value of a Forward Contract at Expiration ....................... 142
      4.4.3 Corollary 2: The Value of a Forward Contract at Inception ......................... 144
4.4.4 Corollary 3: The Forward Rate and the Risk-Adjusted Expected Future Spot Rate .................................................. 145
4.4.5 Implications for Spot Values; the Role of Interest Rates .......... 147
4.4.6 Implications for the Valuation of Foreign-Currency Assets or Liabilities ................................................................. 149
4.4.7 Implication for the Relevance of Hedging ......................... 150
4.5 CFO’s Summary ............................................................. 151
4.6 Appendix: Interest Rates, Returns, and Bond Yields ............... 153
4.6.1 Links Between Interest Rates and Effective Returns ............ 153
4.6.2 Common Pitfalls in Computing Effective Returns ................. 156
4.7 Appendix: The Forward Forward and the Forward Rate Agreement 158
4.7.1 Forward Contracts on Interest Rates ............................. 158
4.7.2 Why FRAs Exist ...................................................... 159
4.7.3 The Valuation of FFs (or FRAs) .................................. 159
4.7.4 Forward Interest Rates as the Core of the Term Structure(s) .... 163
4.8 Test Your Understanding ............................................... 168
4.8.1 Quiz Questions ....................................................... 168
4.8.2 Applications ......................................................... 169

5 Using Forwards for International Financial Management 171
5.1 Practical Aspects of Forwards in Real-world Markets ............... 171
5.1.1 Quoting Forward Rates with Bid-Ask Spreads ................... 171
5.1.2 Provisions for Default .............................................. 173
5.2 Using Forward Contracts (1): Arbitrage ............................ 176
5.2.1 Synthetic Forward Rates ........................................... 177
5.2.2 Implications of Arbitrage and Shopping-around ................. 177
5.2.3 Back to the Second Law ............................................ 178
5.3 Using Forward Contracts (2): Hedging Contractual Exposure .... 179
5.3.1 Measuring Exposure from Transactions on a Particular Date ... 180
5.3.2 Hedging Contractual Exposure from Transactions on a Particular Date ............................................................... 182
5.4 Using Forward Contracts (3): Speculation ......................... 188
5.4.1 Speculating on the Future Spot Rate ............................ 188
5.4.2 Speculating on the Forward Rate or on the Swap Rate ......... 190
5.5 Using Forward Contracts (4): Minimizing the Impact of Market Imperfections ......................................................... 192
5.5.1 Shopping Around to Minimize Transaction Costs ............... 192
5.5.2 Swapping for Tax Reasons .......................... 196
5.5.3 Swapping for Information-cost Reasons ....................... 197
5.5.4 Swapping for Legal Reasons: Replicating Back-to-Back Loans 199
5.6 Using the Forward Rate in Commercial, Financial and Accounting Decisions 207
5.6.1 The Forward Rate as the Intelligent Accountant’s Guide ....... 207
5.6.2 The Forward Rate as the Intelligent Salesperson’s Guide ...... 209
5.6.3 The Forward Rate as the Intelligent CFO’s Guide .............. 209
5.7 CFO’s Summary .......................................................... 211
5.7.1 Key Ideas for Arbitrageurs, Hedgers, and Speculators ........ 211
5.7.2 The Economic Roles of Arbitrageurs, Hedgers, and Speculators 213
5.8 Test Your Understanding ............................................... 215
5.8.1 Quiz Questions ....................................................... 215
5.8.2 Applications ......................................................... 217
## 6 The Market for Currency Futures

6.1 Handling Default Risk in Forward Markets: Old & New Tricks
   6.1.1 Default Risk and Illiquidity of Forward Contracts
   6.1.2 Standard Ways of Reducing Default Risk in the Forward Market
   6.1.3 Reducing Default Risk by Variable Collateral or Periodic Recontracting

6.2 How Futures Contracts Differ from Forward Markets
   6.2.1 Marking to Market
   6.2.2 Margin Requirements
   6.2.3 Organized Markets
   6.2.4 Standardized Contracts
   6.2.5 The Clearing Corporation
   6.2.6 How Futures Prices Are Reported

6.3 Effect of Marking to Market on Futures Prices

6.4 Hedging with Futures Contracts
   6.4.1 The Generic Problem and its Theoretical Solution
   6.4.2 Case 1: The Perfect Match
   6.4.3 Case 2: The Currency-Mismatch Hedge or Cross-Hedge
   6.4.4 Case 3: The Delta hedge
   6.4.5 Case 4: The Cross-and-Delta hedge
   6.4.6 Adjusting for the Sizes of the Spot Exposure and the Futures Contract
   6.4.7 More About Regression-based Hedges
   6.4.8 Hedging with Futures Using Contracts on More than One Currency

6.5 The CFO’s conclusion: Pros and Cons of Futures Contracts Relative to Forward Contracts

6.6 Appendix: Eurocurrency Futures Contracts
   6.6.1 The Forward Price on a CD
   6.6.2 Modern Eurodollar Futures Quotes

6.7 Test Your Understanding
   6.7.1 Quiz Questions
   6.7.2 Applications

## 7 Markets for Currency Swaps

7.1 How the Modern Swap came About
   7.1.1 The Grandfather Tailor-made Swap: IBM-WB
   7.1.2 Subsequent Evolution of the Swap Market

7.2 The Fixed-for-Fixed Currency Swaps
   7.2.1 Motivations for Undertaking a Currency Swap
   7.2.2 Characteristics of the Modern Currency Swap

7.3 Interest Rate Swaps
   7.3.1 Coupon Swaps (Fixed-for-Floating)
   7.3.2 Base Swaps

7.4 Cross-Currency Swaps

7.5 CFO’s Summary

7.6 TekNotes

7.7 Test Your Understanding
   7.7.1 Quiz Questions
   7.7.2 Applications

## 8 Currency Options (1): Concepts and Uses

8.1 An Introduction to Currency Options
CONTENTS

8.1.1 Call Options .................................................. 288
8.1.2 Put Options ................................................... 291
8.1.3 Option Premiums and Option Writing .......................... 292
8.1.4 European-style Puts and Calls as Chopped-up Forwards ...... 292
8.1.5 Jargon: Moneyness, Intrinsic Value, and Time Value ........ 293
8.2 Institutional Aspects of Options Markets .......................... 294
8.2.1 Traded Options .................................................. 294
8.2.2 Over-The-Counter Markets .................................... 297
8.3 An Aside: Futures-style Options on Futures ...................... 298
8.3.1 Options on Currency Futures ................................... 298
8.3.2 Forward-style options .......................................... 299
8.3.3 Futures-Style Options ......................................... 299
8.3.4 Futures-Style Options on Futures .............................. 300
8.4 Using Options (1): Arbitrage ....................................... 301
8.5 Using Options (2): Hedging ........................................ 308
8.5.1 Hedging the Risk of a Loss without Eliminating Possible Gains 308
8.5.2 Hedging Positions with Quantity Risk .......................... 310
8.5.3 Hedging Nonlinear Exposure .................................... 312
8.6 Using Options (3): Speculation ..................................... 315
8.6.1 Speculating on the Direction of Changes ....................... 316
8.6.2 Speculating on Changes in Volatility ......................... 316
8.7 CFO’s Summary .................................................... 318
8.8 Test Your Understanding ........................................... 322
8.8.1 Quiz Questions .................................................. 322
8.8.2 Applications ..................................................... 325

9 Currency Options (2): Hedging and Valuation ......................... 329
9.1 The Logic of Binomial Option Pricing: One-period Problems ........ 330
9.1.1 The Replication Approach ...................................... 332
9.1.2 The Forward Hedging Approach ................................ 332
9.1.3 The Risk-Adjusted Probability Interpretation .................... 334
9.1.4 American-style Options ......................................... 336
9.2 Notation and Assumptions for the Multiperiod Binomial Model .... 337
9.2.1 The Standard Version of the Binomial Model .................... 337
9.2.2 Does the Model make Sense? .................................... 339
9.2.3 Further Notation ................................................ 341
9.2.4 How to Choose $u$ and $d$? .................................... 342
9.3 Stepwise Multiperiod Binomial Option Pricing ..................... 344
9.3.1 Dynamic Hedging or Replication: a European-style option .... 344
9.3.2 What can go Wrong? ............................................ 348
9.3.3 American-style Options ......................................... 349
9.4 Toward Black-Merton-Scholes (European Options) .................. 350
9.4.1 A Shortcut for European Options ................................ 351
9.4.2 The General Formula ............................................ 352
9.4.3 The Delta of an Option ......................................... 355
9.5 CFO’s Summary .................................................... 355
9.6 TekNotes .......................................................... 357
9.7 Test Your Understanding ........................................... 363
9.7.1 Quiz Questions .................................................. 363
9.7.2 Applications ..................................................... 365

III  Exchange Risk, Exposure, and Risk Management  369

10 Do We Know What Makes Forex Markets Tick?  375
10.1 The behavior of spot exchange rates .......................... 378
  10.1.1 Why Levels of (log) exchange rates have bad statistical properties 378
  10.1.2 Changes in log rates: findings .......................... 381
  10.1.3 Concluding Discussion ................................. 389
10.2 The PPP Theory and the behavior of the Real Exchange Rate ...... 392
  10.2.1 Issues with PPP Tests ................................. 392
  10.2.2 Computations and Findings ............................ 395
  10.2.3 Concluding Discussion ................................. 401
10.3 Exchange Rates and Economic Policy Fundamentals ............. 407
  10.3.1 The Monetary Approach to the Exchange Rate ............... 408
  10.3.2 Computations and Findings ............................ 410
  10.3.3 Real Business Cycle Models ............................ 415
  10.3.4 Taylor Rule Models ................................. 416
  10.3.5 Concluding discussion ............................... 417
10.4 Conclusion ................................................. 419

11 Do Forex Markets Themselves See What’s Coming?  433
11.1 The Forward Rate as a Black-Box Predictor ...................... 433
  11.1.1 How to Verify the Forward Rate’s Performance as a Predictor 433
  11.1.2 Statistical Analysis of Forecast Errors: Computations and findings 436
  11.1.3 Trading rules ........................................ 443
  11.1.4 The Forward Bias: Concluding discussion .................. 447
11.2 Forecasts by Specialists ...................................... 453
  11.2.1 Forecasts Implied by Central Bank Interventions ............ 453
  11.2.2 Evaluating the Performance of Professional Traders and Forecasters 455
11.3 The CFO’s summary ........................................... 458
11.4 Test Your Understanding ...................................... 464
  11.4.1 Quiz Questions ....................................... 464

12 (When) Should a Firm Hedge its Exchange Risk?  471
12.1 The effect of corporate hedging may not just be “additive” .......... 472
  12.1.1 Corporate Hedging Reduces Costs of Bankruptcy and Financial 
    Distress .................................................. 473
  12.1.2 Hedging Reduces Agency Costs .......................... 476
  12.1.3 Hedging Reduces Expected Taxes .......................... 478
  12.1.4 Hedging May Also Provide Better Information for Internal Decision 
    Making .................................................. 479
  12.1.5 Hedged Results May Better Show Management’s Quality to Share-
    holders, and Pleases Wall Street ............................ 480
12.2 FAQs about hedging .......................................... 480
  12.2.1 FAQ1: Why can’t Firms leave Hedging to the Shareholders—Home-
    made Hedging? ........................................... 480
  12.2.2 FAQ2: Does Hedging make the Currency of Invoicing Irrelevant? 481
  12.2.3 FAQ3: “My Accountant tells me that Hedging has cost me 2.17m. 
    So how can you call this a Zero-cost Option?” ................ 484
  12.2.4 FAQ4: “Doesn’t Spot Hedging Affect the Interest Tax Shield, as 
    Interest Rates are so Different Across Currencies?” .......... 485
12.3 CFO’s Summary ................................................. 486
12.4 Test Your Understanding ........................................ 487
12.4.1 Quiz Questions ............................................. 487
12.4.2 Applications ................................................. 489

13 Measuring Exposure to Exchange Rates 491
13.1 The Concepts of Risk and Exposure: a brief survey .......... 492
13.2 Contractual-Exposure Hedging and its Limits ............ 494
13.2.1 What does Management of Contractual Exposure Achieve? . 494
13.2.2 How Certain are Certain Cashflows Anyway? ............ 496
13.2.3 Hedging “Likely” Cashflows: what’s new? .......... 497
13.3 Measuring and Hedging of Operating Exposure .......... 498
13.3.1 Operating Exposure Comes in all Shapes & Sizes .... 499
13.3.2 The Minimum-Variance Approach to Measuring and Hedging Operating Exposure .................. 502
13.3.3 Economic Exposure: CFO’s Summary .................. 509
13.4 Accounting Exposure .......................................... 511
13.4.1 Accounting Exposure of Contractual Forex Positions .. 512
13.4.2 Why Firms Need to Translate Financial Statements ... 514
13.4.3 The Choice of Different Translation Methods ........ 516
13.4.4 Accounting Exposure: CFO’s Summary ............... 522
13.5 Test Your Understanding: contractual exposure .......... 524
13.5.1 Quiz Questions ............................................. 524
13.5.2 Applications ................................................. 526
13.6 Test Your Understanding: Operating exposure ........... 528
13.6.1 Quiz Questions ............................................. 528
13.6.2 Applications ................................................. 530

14 Value-at-Risk: Quantifying Overall net Market Risks 533
14.1 Risk Budgeting—a Factor-based, Linear Approach .......... 534
14.1.1 Factors and Exposures: a Sneak Preview .............. 535
14.1.2 Domestic Interest risk .................................... 538
14.1.3 Equity Investments ....................................... 540
14.1.4 Foreign Bonds; Currency Forwards and Swaps; Options ... 541
14.1.5 Aggregates for the portfolio as a whole ............... 542
14.2 The Linear/Normal VaR Model: Potential Flaws & Corrections . 543
14.2.1 A Zero-Drift (“Martingale”) Process ................. 543
14.2.2 A Constant-Variance Process ............................ 544
14.2.3 Constant Linear Relationships Between Factors .......... 550
14.2.4 Linearizations in the Mapping from Factors to Returns 551
14.2.5 Choice of the factors ..................................... 552
14.2.6 Normality of Changes in the Portfolio Value ......... 552
14.2.7 All Assets can be Liquidated in one Day ............ 554
14.2.8 Parametric VaR: Summing up ............................ 555
14.3 Historical Backtesting, Bootstrapping, Monte Carlo, and Stress Testing 556
14.3.1 Backtesting ................................................. 556
14.3.2 Bootstrapping and Monte Carlo Simulation ......... 558
14.3.3 Stress Testing .............................................. 559
14.4 CFO’s summary ................................................. 561
14.5 Test Your Understanding ...................................... 565
14.5.1 Quiz Questions ............................................. 565
14.5.2 Applications ................................................. 566

15 Managing Credit Risk in International Trade 569
15.1 Payment Modes Without Bank Participation 570
  15.1.1 Cash Payment after Delivery 570
  15.1.2 Cash Payment before Shipping 571
  15.1.3 Trade Bills 572
  15.1.4 The Problems with Legal Redress 574
15.2 Documentary Payment Modes with Bank Participation 575
  15.2.1 Documents against Payment 576
  15.2.2 Documents against Acceptance 578
  15.2.3 Obtaining a Guarantee from the Importer's Bank: The Letter of Credit 578
  15.2.4 Advised L/Cs and Confirmed L/Cs 580
15.3 Other Standard Ways to cope with Default Risk 582
  15.3.1 Factoring 582
  15.3.2 Credit Insurance 583
  15.3.3 Export-Backed Financing 583
15.4 CEO's Summary 585
15.5 Test your Understanding 587
  15.5.1 Quiz Questions 587
  15.5.2 Applications 588

IV Long-Term International Funding and Direct Investment 591
16 International Fixed-Income Markets 599
  16.1 “Euro” Deposits and Loans 600
    16.1.1 Historic, Proximate Causes of Euromoney’s growth 600
    16.1.2 Comparative Advantages in the Medium Run 602
    16.1.3 Where we are now: a Truly International Market 603
    16.1.4 International Deposits 605
    16.1.5 International Credits and Loans 606
  16.2 International Bond & Commercial-paper Markets 613
    16.2.1 Why Eurobond Markets Exist 614
    16.2.2 Institutional Aspects of the International Bond Market 616
    16.2.3 Commercial Paper 620
  16.3 How to Weigh your Borrowing Alternatives 621
    16.3.1 Comparing all-in Costs of Alternatives in Open, Developed Markets 622
    16.3.2 Comparing all-in Costs of Alternatives in Regulated, Incomplete Markets 628
  16.4 CFO’s Summary 631
  16.5 Test Your Understanding 633
    16.5.1 Quiz Questions 633
    16.5.2 Applications 635

17 Segmentation and Integration in the World’s Stock Exchanges 637
  17.1 Background Information on International Stock Markets 641
    17.1.1 How Large and how International are Stock Markets? 641
    17.1.2 How do Stock Markets Work? 646
    17.1.3 Certificates, Receipts: Different Aliases for a Company’s Stocks 654
  17.2 Why don’t Exchanges Simply Merge? 660
    17.2.1 Home bias 660
17.2.2 Differences in Corporate Governance and Legal/Regulatory Environment .................................................. 661
17.3 Can Unification be Achieved by A Winner Taking All? .......................................................... 667
  17.3.1 Centripetal v Centrifugal Effects in Networks .......................................................... 668
  17.3.2 Clienteles for Regional and Niche Players? ........................................................................ 669
  17.3.3 Even New York is not perfect ......................................................................................... 671
  17.3.4 London’s Comeback ........................................................................................................ 677
17.4 The CEO’s Summary ...................................................................................................................... 680
17.5 Test Your Understanding ............................................................................................................ 682
  17.5.1 Quiz Questions ................................................................................................................ 682

18 Why—or when—Should we Cross-list our Shares? ..... 683
  18.1 Why Might Companies Want to list Shares Abroad? .......................................................... 684
    18.1.1 Possible Gains from Foreign or Cross-listings .......................................................... 685
    18.1.2 Costs of a cross-listing ................................................................................................. 687
  18.2 Shareholders Likely Reaction to Diversification Opportunities ........................................ 688
    18.2.1 Why would Investors Diversify Internationally? ......................................................... 688
    18.2.2 Why would Companies Prefer Global Investors? a Partial-equilibrium Exploration ............................................................................................................................. 690
  18.3 Sifting Through The Empirics on Cross-listing Effects ..................................................... 693
    18.3.1 The 1980-2000 Conventional Wisdom ......................................................................... 693
    18.3.2 Puzzles with the Received Wisdom .............................................................................. 694
    18.3.3 Five Lessons from the Recent Lit .................................................................................. 695
  18.4 The CFO’s Summary .................................................................................................................... 702
  18.5 Test Your Understanding ......................................................................................................... 704
    18.5.1 Quiz Questions ............................................................................................................. 704

19 Setting the Cost of International Capital .................................................................................. 705
  19.1 The Link between Capital-market Segmentation and the Sequencing of Discounting and Translation .......................................................................................................................... 708
  19.2 The Single-Country CAPM ..................................................................................................... 711
    19.2.1 How Asset Returns Determine the Portfolio Return .................................................. 712
    19.2.2 The Tangency Solution: Graphical Discussion ......................................................... 713
    19.2.3 How Portfolio Choice Affects Mean and Variance of the Portfolio Return ............... 715
    19.2.4 Efficient Portfolios: A Review ..................................................................................... 717
    19.2.5 The Market Portfolio as the Benchmark ...................................................................... 720
    19.2.6 A Replication Interpretation of the CAPM ................................................................. 721
    19.2.7 When to Use the Single-Country CAPM ................................................................... 722
  19.3 The International CAPM ............................................................................................................ 723
    19.3.1 International diversification and the traditional CAPM .............................................. 723
    19.3.2 Why Exchange Risk Pops up in the International Asset Pricing Model ..................... 724
    19.3.3 Do Assets have a Clear Nationality? .............................................................................. 727
    19.3.4 The International CAPM ............................................................................................... 729
    19.3.5 The N-Country CAPM .................................................................................................... 730
    19.3.6 Empirical Tests of the International CAPM ................................................................. 731
  19.4 The CFO’s Summary re Capital Budgeting ........................................................................... 733
    19.4.1 Determining the Relevant Model .................................................................................. 733
    19.4.2 Estimating the Risk of a Project .................................................................................... 734
    19.4.3 Estimating the Risk premia .......................................................................................... 736
## CONTENTS

19.5 Technical Notes 737
19.6 Test Your Understanding: basics of the CAPM 742
19.6.1 Quiz Questions 742
19.6.2 Applications 742
19.7 Test Your Understanding: iCAPM 744
19.7.1 Quiz Questions 744
19.7.2 Applications 747

### 20 International Taxation of Foreign Investments 749

20.1 Forms of Foreign Activity 749
20.1.1 Modes of Operation (1): A Managerial Perspective 750
20.1.2 Modes of Operation (2): A Legal Perspective 751
20.1.3 Modes of Operation (3): A Fiscal Perspective 752
20.2 Multiple Taxation versus Tax Neutrality 755
20.2.1 Tax Neutrality 756
20.3 International Taxation of a Branch (1): the Credit System 759
20.3.1 Disagreement on the Tax Basis 759
20.3.2 The Problem of Excess Tax Credits 760
20.3.3 Tax Planning for a Branch under the Credit System 763
20.4 International Taxation of a Branch (2): the Exclusion System 765
20.4.1 Partial Exclusion and Progressive Taxes 765
20.4.2 Disagreement on the Tax Basis 766
20.4.3 Tax Planning for a Branch under the Exclusion System 766
20.5 Remittances from a Subsidiary: An Overview 768
20.5.1 Capital Transactions 768
20.5.2 Dividends 769
20.5.3 Other Forms of Remittances (Unbundling) 770
20.5.4 Transfer Pricing 771
20.6 International Taxation of a Subsidiary (1): the Credit System 771
20.6.1 Direct and Indirect Tax Credits on Foreign Dividends 771
20.6.2 Tax Planning through Unbundling of the Intragroup Transfers 775
20.7 International Taxation of a Subsidiary (2): the Exclusion System 777
20.8 CFO's Summary 779
20.9 Test Your Understanding 781
20.9.1 Quiz Questions 781
20.9.2 Applications 783

### 21 Putting it all Together: International Capital Budgeting 787

21.1 Domestic Capital Budgeting: A Quick Review 787
21.1.1 Net Present Value (NPV) 788
21.1.2 Adjusted Net Present Value (ANPV) 793
21.1.3 The Interest Tax Shield Controversy 794
21.1.4 Why We Use ANPV Rather than the Weighted Average Cost of Capital 797
21.2 i-NPV issue #1: How to Deal with the Implications of Non-equity Financing 799
21.2.1 Step 1: The Branch Scenario or Bundled Approach 801
21.2.2 Step 2: The Unbundling Stage 803
21.2.3 Step 3: The Implications of External Financing 805
21.3 i-NPV issue #2: How to Deal with Exchange Rates 807
21.4 i-NPV issue #3: How to Deal with Political Risks 809
21.4.1 Proactive Management of Transfer Risk 809
## CONTENTS

21.4.2 Management of Transfer Risk after the Imposition of Capital Controls 811  
21.4.3 How to Account for Transfer Risk in NPV Calculations 812  
21.4.4 Other Political Risks 813  
21.5 Issue #4: Make sure to Include All Incremental Cash Flows 814  
21.6 Other Things to do in Spreadsheets While you’re There 815  
21.7 CFO’s summary 817  
21.8 TekNotes 820  
21.9 Test Your Understanding 823  
21.9.1 Quiz Questions 823  
21.9.2 Applications 825

22 Negotiating a Joint-Venture Contract: the NPV Perspective 827  
22.1 The Three-Step Approach to Joint-Venture Capital Budgeting 829  
22.2 A Framework for Profit Sharing 831  
22.3 Case I: A Simple Pro-Rata Joint Branch with Neutral Taxes and Integrated Capital Markets 832  
22.4 Case II: Valuing A Pro-Rata Joint Branch When Taxes Differ 834  
22.5 Case III: An Unbundled Joint Venture with a License Contract or a Management Contract 837  
22.5.1 Possible Motivations for a License Contract 838  
22.5.2 The Equal-Gains Principle with a License Contract 840  
22.5.3 Finding Fair Equity Share when Terms of License Contract Are Given 842  
22.5.4 Finding the Fair Royalty for a Given Equity Share 843  
22.6 CFO’s Summary & Extensions 844  
22.7 Test Your Understanding 849  
22.7.1 Quiz Questions 849  
22.7.2 Applications 850
