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International Financial Management

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Introduction

This essay will discuss the operation of BMW --- a multinational automobile maker. As a multinational corporation, BMW is operating in different countries what the market differs one from another. In order to succeed, BMW has to adopt the financial market and make use of favorable conditions. This essay will firstly discuss the global financial environment that BMW operates in. The analysis of global financial environment will first present an overview and then examine the situation of the main markets of BMW. After that, there will be a description of international monetary system and how that will effect exchange rates (Al-Shboul, 2014). Secondly, it will introduce three types of exchange risks and how BMW suffers from these risks. Thirdly, the essay will discuss the strategies that BMW adopt to deal with the risks. Lastly, the effect of these strategies will be evaluated.

Global financial environment that BMW operates in

The global economy grew in the past few years. For MNCs, being international is beneficial from the following aspects. The global financial environment is suitable for MNCs to become international. Firstly, as we know, high expect rate of return always means high risk. The purpose of the company is to maximize the value of shareholders. Companies always have a set of opportunities, each has an expected level of return and risk. When a company becomes international, it will have an extended set of opportunities. In that case, the resources may be better allocated and risks may find its way to be dispersed. It is also possible that all of the domestic opportunities are not on the efficient frontier. So as a result, diversification across counties will lower the risk. This is called the portfolio effect. Second, there is comparative advantage. It is common that two companies from two different countries are competitors (Carrasco, 2004). However, unlike domestic companies, MNCs can benefit from theses kinds of competition. This is a classical argument that appeal for free trade in which case the comparative advantage can be better utilized (Carrasco, 2004). Assuming the US manufactures are better at producing high-tech products such as the Iphones and China manufactures are better at making clothes. If both of the two countries have to product the Iphones and clothes by themselves, they may cost more if they want to enjoy the same kind of quality or technology of the products. There is another example about

Ford and Toyota, they seem to be direct competitors and it is reasonable to think this is a zero-sum game. However, the two countries --- America and Japan are also benefit from the competition between Ford and Toyota. Ford is better at producing automobiles with great power and high acceleration because many Americans enjoy that. On the other hand, Toyota is better at producing efficient cars with low-energy consumption. Both of the two companies are experts in their areas and different customers have different needs, so the combination of them satisfies more customers while they can still concentrate on their strengths and making profits. Thirdly, the MNCs can make use of the internationalization advantage. Why do so many companies import while others extend the market overseas. Many companies want to be part of the world market and that means they have to build base in other countries. The trend of internationalization has made it possible for companies to invest directly overseas (Patro, 2002). To take advantage of internationalization, companies will better have two kinds of advantages: location and ownership. Fourthly, the global financial environment allows for economies of scale. Economies of scale is a synergistic effect, which takes place when the whole is worth more than the sum of its parts (Patro, 2002). For example, the company invest 50,000 pounds into development of a new products and the average cost is 5 dollars per unit and there is a fixed cost of 50,000 pounds. The company can only sell 10,000 units in its own countries. In that case, the average cost per unit is 15 pounds. However, if the company sells its products in different countries, let us say, the sales volume is 50,000 units. In that case, the average cost of a unit is 7 pounds which is much less than 15 pounds. Besides, the companies may be able to find a production location with cheaper labor and materials to further lower the cost of product. Investment in other markets and sell products in the global market will allow the MNSs such as BMW to gain greater synergistic effect.

BMW has its business operated in many countries, among which the USA, China are very important markets. In 2015, the US economy grows in a record rate while China decides to grow in a more stable and safe way with record low growth rate since 1990. The growth rate of China is lower than that of the past years although it is still one of the countries which have the highest growth rate in the world. China is the primary marketing for BMW, as China is holding down its growth rate and many cities in China have adopted limitation of license plate because of traffic jams and worsening

atmosphere. So the sales volume in China may be largely effected in a few years.

Besides, the US has a growth rate of 2.6 percent in 2015, as the superpower country in the world, it may influence the growth rate of many other countries in a positive way (Slowik, 2012). Japan has a growth rate of 0.6 percent in 2015, the growth potential in Japan is kind of weak, so it is hard to promote further of BMW in Japan (Slowik, 2012). As for India, it has a higher growth rate than China while other BRIC countries still perform badly (Slowik, 2012). Another big country--- Russia is still struggle to develop its economy. Although BMW has achieved a high growth in sales volume in 2015, the prospect is not optimistic and that may explain why BMW is producing cars which are cheaper and more energy-efficient. BMW is now completing with more lower-ended brands. Of course, BMW may always have the plan to expand its target customers in order to share a larger market. So although some of the main markets for BMW is not so optimistic, it may have ways to deal with that situation such as extend the products and enter new markets.

The international monetary system is the system of the rules that govern the use and the exchange of money in the world or among countries (Seldon, 1999). Every countries has its own official currency and that is why there is a issue of exchange rate. In the 19th century, the main economic center is in Europe and US. The different markets in the world are loosely related and the exchange rates are not so influential (Seldon, 1999). In the past few decades, almost all the countries including Japan, China, Russia and India have experienced dramatic changes in exchange rates which have great impact on their economies. Although the Bretton Woods Systems have been set and the systems do contribute to the stability of the world economy, exchange rate risks is still a very serious risks for the MNCs including BMW. This issue will be further discussed in the next sectors.

Foreign exchange risks

This part is going to discuss three kinds of exchange risks and how BMW may suffer from these three kinds of risks. Exchange rate risk has always been important issues of concern to MNCs (Iorio, 2001). Due to the ever-changing foreign exchange market, then the business will inevitably suffer from the risks. There are three main kinds of

exchange risks --- transaction exposure, operating exposure and translation exposure.

Transaction exposure is the most common risk, as long as the business process are related to foreign currency transactions, trading risk can occur, such as the simple import and export transactions (Kim, 2015). Foreign exchange risk refers to the risks that may arise the planned, under progressed or completed transactions. Since the actual profit and loss of these services depends on the prevailing level of the nominal exchange rate, it is difficult to predict what changes may occur within a certain time so that their actual income and expected income, expected costs and actual cost may departed (Shawn, 2014). transaction risk of foreign currency transactions refers to actual profit and loss, thus the transaction will directly affect the net cash flow (Shawn, 2014).

Operating exposure refers to unexpected movements of exchange rate which will effect the cost of production, sales, prices and costs so that the future earnings or cash flow may suffer a potential loss.

Translation exchange rate risk are also known as the accounting risks, refer to balance sheet accounting of economic when converted to the functional currency to recording currency. It is possible there will be book losses due to exchange rate changes. The translation exposure is not related to flow of cash flow so there is no actual need to deal with the translation risk as far as I concerned.

By 2011, only 17% of the sales volume of the cars sold by BMW was sold in Germany (Loch, 2001). As for China, it brought more cars than people in Germany did in 2015 (Loch, 2001). Besides, Russia, the eastern Europe are also very important markets for BMW. It is obvious that the profits of BMW are always eroded by the risks caused by exchange rate risks (Loch, 2001). From the calculations of its annual reports, it can be learned that the losses raised by exchange risks totaled nearly 2.4 billion euros from 2005 to 2009 (Loch, 2001).

There are two main ways that can be used to deal with the losses caused by exchange rate risks. One is to pass the costs to consumers and that is a way Porsche had adopted to deal with the exchange rate risks. The other is to diversify the risks and lower the costs by the company itself and that is the way BMW decided to use.

BMW's strategies to manage the exchange risks and the functions of strategies

This part will discuss the strategies that BMW uses to manage the exchange risks. There are two main approaches. The first one is to use natural hedge which means it will match the currency of revenues to the currency of costs. When both the revenues and costs are in local currency, the amount of capital that is exposed to exchange risk will be much smaller (Bahmani-Oskooee, 2008).

However, it is hardly possible to avoid all the exchange risks by natural hedge. So BMW still uses other financial hedges and build up regional treasury centers in some financial centers such as US, UK and Singapore.

The natural hedge can be implemented through two methods. First, it establishes factories in the countries where it sells its cars. The second involves make more purchase of goods and materials that denominate in the local currencies (Johansson-Stenman, 2006).

Now BMW has production bases for cars and components in 13 countries (Johansson-Stenman, 2006). By time of 2011, 44 percent of the products are produced overseas. BMW had set its plant in the US in 1990s and that made the supply chain shorter. This move in US has created more than five thousand jobs in America and much more jobs are cut in Germany. As a result, the company's sales boosted in US and it has more revenues in dollars and the number continues to raise. That is to say a large part of the risks raised from the changes between US dollars and euros are avoided in this way. There is also a joint venture made between BMW and the Brilliance Automotive in China (Bartram, 2006). Half of the cars sold in China is made there. So a large portion of the exchange risk between RMB and euros are avoided (Bartram, 2006). Besides, large portion of the materials used to manufacture cars in China are purchased from local suppliers. This move does not only shorten the production line and supply chains, but also make the price of cars lower and as a result more people can afford BMW cars and the sales will increase because of that (Bartram, 2006).

What is more, the regional treasury centers are required to stare at the exchange rate exposures every week and make a report to the lead of the center. The leads will consider all the risk exposures and figure out a plan to mitigate the risks (Slowik, 2012).

It can be concluded that BMW has found a way to deal with the exchange exposures and the strategies are effective to lower the losses. Besides, the strategies BMW used to deal with exchange risks also help it lower production costs, make more sales and offer better services.

Conclusion

In conclusion, this essay firstly critically examines the issue of exchange rate risks. BMW is an international company which has been found for almost a hundred years. It is operated in a global market which is favorable for companies to become international. Although some of the main markets of BMW have suffered from decreases of growth rates or even negative growth rates, BMW is positively deal with the situations through ways such as extension of markets and lower-ended products and it keeps increasing every year. Besides, BMW is exposed to foreign exchange risks because it operates in a global market. BMW suffered a lot from foreign exchange risks. Now it uses two ways to deal with the risks and as we can see from the results of the strategies that the strategies are useful and lay a solid foundation for the further development of BMW in those markets.

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