

9.1: Chapter Introduction

Foreign Exchange and the Global Capital Markets

WHAT'S IN IT FOR ME?

1. What do we mean by currency and foreign exchange?
2. How do you determine exchange rates?
3. What are the global capital markets?
4. What is the impact of the global capital markets (particularly the venture capital and global capital markets) on international business?

This chapter explores currencies, foreign exchange rates, and how they are determined. It also discusses the global capital markets—the key components and how they impact global business. Foreign exchange is one aspect of the global capital markets. Companies access the global capital markets to utilize both the debt and equity markets; these are important for growth. Being able to access transparent and efficient capital markets around the world is another important component in the flattening world for global firms. Finally, this chapter discusses how the expansion of the global capital markets has benefited entrepreneurship and venture capitalists.

Opening Case: Why a Main Street Firm, Walmart, Is Impacted by Foreign Exchange Fluctuations

Most people in North America are familiar with the name Walmart. It conjures up an image of a gigantic, box-like store filled with a wide range of essential and nonessential products. What's less known is that Walmart is the world's largest company, in terms of revenues, as ranked by the Fortune 500 in 2010. With \$408 billion in sales, it operates in fifteen global markets and has 4,343 stores *outside* of the United States, which amounts to about 50 percent of its total stores. More than 700,000 people work for Walmart *internationally*. With numbers like this, it's easy to see how important the global markets have become for this company. "Walmart Stores Inc. Data Sheet—Worldwide Unit Details November 2010," Walmart Corporation, accessed May 25, 2011, <http://walmartstores.com/pressroom/news/10497.aspx>.

Walmart's strength comes from the upper hand it has in its negotiations with suppliers around the world. Suppliers are motivated to negotiate with Walmart because of the huge sales volume the stores offer manufacturers. The business rationale for many suppliers is that while they may lose a certain percentage of profitability per product, the overall sales volume of an order from Walmart can make them far more money overall than orders from most other stores. Walmart's purchasing professionals are known for being aggressive negotiators on purchases and for extracting the best terms for the company.

In order to buy goods from around the world, Walmart has to deal extensively in different currencies. Small changes in the daily foreign currency market can significantly impact the costs for Walmart and in turn both its profitability and that of its global suppliers.

A company like Walmart needs foreign exchange and capital for different reasons, including the following common operational uses:

1. To build new stores, expand stores, or refurbish stores in a specific country
2. To purchase products locally by paying in local currencies or the US dollar, whichever is cheaper and works to Walmart's advantage
3. To pay salaries and benefits for its local employees in each country as well as its expatriate and global workforce
4. To take profits out of a country and either reinvest the money in another country or market or save it and make profits from returns on investment

To illustrate this impact of foreign currency, let's look at the currency of China, the renminbi (RMB), and its impact on a global business like Walmart. Many global analysts argue that the Chinese government tries to keep the value of its currency low or cheap to help promote exports. When the local RMB is valued cheaply or low, Chinese importers that buy foreign goods find that the prices are more expensive and higher.

However, Chinese exporters, those businesses that sell goods and services to foreign buyers, find that sales increase because their prices are cheaper or lower for the foreign buyers. Economists say that the Chinese government has intervened to keep the renminbi cheap in order to keep Chinese exports cheap; this has led to a huge trade surplus with the United States and most of the world. Each country tries to promote its exports to generate a trade advantage or surplus in its favor. When China has a trade surplus, it means the other country or countries are running trade deficits, which has "become an irritant to a lot of China's trading

partners and those who are competing with China to sell goods around the world.”David Barboza, “Currency Fight with China Divides U.S. Business,” *New York Times*, November 16, 2010, accessed May 25, 2011, www.nytimes.com/2010/11/17/business/global/17yuan.html?_r=1&pagewanted=2.

For Walmart, an American company, a cheap renminbi means that it takes fewer US dollars to buy Chinese products. Walmart can then buy cheap Chinese products, add a small profit margin, and then sell the goods in the United States at a price lower than what its competitors can offer. If the Chinese RMB increased in value, then Walmart would have to spend more US dollars to buy the same products, whether the products are clothing, electronics, or furniture. Any increase in cost for Walmart will mean an increase in cost for their customers in the United States, which could lead to a decrease in sales. So we can see why Walmart would be opposed to an increase in the value of the RMB.

To manage this currency concern, Walmart often requires that the currency exchange rate be fixed in its purchasing contracts with Chinese suppliers. By fixing the currency exchange rate, Walmart locks in its product costs and therefore its profitability. Fixing the exchange rate means setting the price that one currency will convert into another. This is how a company like Walmart can avoid unexpected drops or increases in the value of the RMB and the US dollar.

While global companies have to buy and sell in different currencies around the world, their primary goal is to avoid losses and to fix the price of the currency exchange so that they can manage their profitability with surety. This chapter takes a look at some of the currency tools that companies use to manage this risk.

Global firms like Walmart often set up local operations that help them balance or manage their risk by doing business in local currencies. Walmart now has 304 stores in China. Each store generates sales in renminbi, earning the company local currency that it can use to manage its local operations and to purchase local goods for sale in its other global markets. David Barboza, “Currency Fight with China Divides U.S. Business,” *New York Times*, November 16, 2010, accessed May 25, 2011, www.nytimes.com/2010/11/17/business/global/17yuan.html?_r=1&pagewanted=2.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. List two reasons a global company needs foreign exchange.
2. Why is Walmart concerned about foreign exchange rates?

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