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Eun / Resnick / Chuluun

International Financial Management

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ninth edition

International Financial Management

Ninth Edition

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International Financial Management

Ninth Edition

Cheol S. Eun
Georgia Institute of Technology

Bruce G. Resnick
Wake Forest University

Tuugi Chuluun
Loyola University Maryland

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INTERNATIONAL FINANCIAL MANAGEMENT

Published by McGraw Hill LLC, 1325 Avenue of the Americas, New York, NY 10121.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 LWI 24 23 22 21 20

ISBN 978-1-260-57531-6
MHID 1-260-57531-4

Cover Image: *alice-photo/Shutterstock*

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To Elizabeth

C.S.E.

To Donna

B.G.R.

To Arig and Amur

T.C.

About the Authors

Cheol S. Eun,

Georgia Institute of Technology

Cheol S. Eun (Ph.D., NYU) is the Thomas R. Williams Chair and Professor of Finance at the Scheller College of Business, Georgia Institute of Technology. Before joining Georgia Tech, he taught at the University of Minnesota and the University of Maryland. He also taught at the Wharton School of the University of Pennsylvania, Korea Advanced Institute of Science and Technology (KAIST), Singapore Management University, and the Esslingen University of Technology (Germany) as a visiting professor. He has published extensively on international finance issues in such major journals as the *Journal of Finance*, *Journal of Financial Economics*, *JFQA*, *Journal of Banking and Finance*, *Journal of International Money and Finance*, *Management Science*, and *Oxford Economic Papers*. Also, he has served on the editorial boards of the *Journal of Banking and Finance*, *Journal of Financial Research*, *Journal of International Business Studies*, and *European Financial Management*. His research is widely quoted and referenced in various scholarly articles and textbooks in the United States as well as abroad.

Dr. Eun is the founding chair of the *Fortis/Georgia Tech Conference on International Finance*. The key objectives of the conference are to promote research on international finance and provide a forum for interactions among academics, practitioners, and regulators who are interested in vital current issues of international finance.

Dr. Eun has taught a variety of courses at the undergraduate, graduate, and executive levels, and was the winner of the Krowe Teaching Excellence Award at the University of Maryland. He also has served as a consultant to many national and international organizations, including the World Bank, Apex Capital, and the Korean Development Institute, advising on issues relating to capital market liberalization, global capital raising, international investment, and exchange risk management. In addition, he has been a frequent speaker at academic and professional meetings held throughout the world.

Bruce G. Resnick,

Wake Forest University

Bruce G. Resnick is Professor Emeritus of Finance at the Wake Forest University School of Business in Winston-Salem, North Carolina. Prior to retiring, he was the Joseph M. Bryan Jr. Professor of Banking and Finance. He has a D.B.A. in finance from Indiana University. Additionally, he has an M.B.A. from the University of Colorado and a B.B.A. from the University of Wisconsin-Oshkosh. Prior to coming to Wake Forest, he taught at Indiana University for ten years, the University of Minnesota for five years, and California State University, Chico for two years. He has also taught as a visiting professor at Bond University, Gold Coast, Queensland, Australia, and at the Helsinki School of Economics and Business Administration in Finland. Additionally, he served as the Indiana University resident director at the Center for European Studies at Maastricht University, the Netherlands. He also served as an external examiner to the Business Administration Department of Singapore Polytechnic and as the faculty advisor on Wake Forest University study trips to Japan, China, and Hong Kong.

Dr. Resnick taught M.B.A. courses at Wake Forest University. He specialized in the areas of investments, portfolio management, and international financial management. Dr. Resnick's research interests include market efficiency studies of options and financial futures markets and empirical tests of asset pricing models. A major interest has been the optimal design of internationally diversified portfolios constructed to control for parameter uncertainty and exchange rate risk. In recent years, he has focused on information transmission in the world money markets and yield spread comparisons of domestic and international bonds. His research articles have been published in most of the major academic journals in finance. His research is widely cited by other researchers and textbook authors. He served as an associate editor for the *Journal of Financial Research*, *Emerging Markets Review*, *Journal of Economics and Business*, and the *Journal of Multinational Financial Management*.

Tuugi Chuluun,

Loyola University Maryland

Tuugi Chuluun is an Associate Professor of Finance at Sellinger School of Business and Management at Loyola University Maryland. Her research areas include international finance, corporate finance, and behavioral finance. She has published in journals such as *Journal of Banking and Finance*, *Financial Management*, *Journal of Corporate Finance*, *Journal of Economic Behavior and Organization*, and *Small Business Economics*. Her research has also been featured in magazines such as *The Economist* and *Forbes Mongolia* and on popular websites such as HBR.org and Inc.com. She holds a Ph.D. in Finance from Georgia Institute of Technology, a master's in Financial Economics and a bachelor's degree in Economics from Ohio University. Dr. Chuluun has taught a variety of undergraduate and graduate courses, including international finance, corporate finance, investments, microeconomics, and macroeconomics at Loyola University Maryland, Georgia Institute of Technology, and West Virginia University–Parkersburg, often incorporating innovative teaching practices. At Loyola University Maryland, she was selected as the ELMBA Program Distinguished Professor of the Year and received the Sellinger School STAR Award in Research. She has also received the Financial Management Association's Superior Faculty Advisor award.

Dr. Chuluun holds the Chartered Financial Analyst (CFA) designation. She is the former president of the CFA Society Baltimore, Maryland's largest membership organization for investment professionals, and has served on the board of the society since 2013. She was also the co-chair of the "Alpha and Gender Diversity Baltimore Conference 2018" that was designed to offer collaborative discussion on how gender diversity creates a competitive advantage for investment professionals and the broader finance industry. Dr. Chuluun was a Visiting Scholar at the Brookings Institution and has international consulting experience.

Preface

Our Reason for Writing this Textbook

We (Cheol and Bruce) have been teaching international financial management to undergraduates and M.B.A. students at Georgia Institute of Technology, Wake Forest University, and at other universities we have visited for more than three decades. During this time period, we conducted many research studies, published in major finance and statistics journals, concerning the operation of international financial markets. As one might imagine, in doing this we put together an extensive set of teaching materials that we used successfully in the classroom. As the years went by, we individually relied more on our own teaching materials and notes and less on any one of the major existing textbooks in international finance (most of which we tried at some point). In this Ninth Edition, we introduce Tuugi Chuluun from Loyola University Maryland, who joins us as a co-author and will continue the tradition we have established in offering up-to-date and timely coverage of the subject of international financial management.

As you may be aware, the scope and content of international finance have been fast evolving due to cycles of deregulations and regulations of financial markets, product innovations, and technological advancements. As capital markets of the world are becoming more integrated, a solid understanding of international finance has become essential for astute corporate decision making. Reflecting the growing importance of international finance as a discipline, we have seen a sharp increase in the demand for experts in the area in both the corporate and academic worlds.

In writing *International Financial Management,* Ninth Edition, our goal was to provide well-organized, comprehensive, and up-to-date coverage of the topics that take advantage of our many years of teaching and research in this area. We hope the text is challenging to students. This does not mean that it lacks readability. The text discussion is written so that a self-contained treatment of each subject is presented in a *user-friendly* fashion. The text is intended for use at both the advanced undergraduate and M.B.A. levels.

The Underlying Philosophy

International Financial Management, Ninth Edition, like the first eight editions, is written based on two tenets: emphasis on the basics and emphasis on a managerial perspective.

Emphasis on the Basics

We believe that any subject is better learned if one first is well grounded in the basics. Consequently, we initially devote several chapters to the fundamental concepts of international finance. After these are learned, the remaining material flows easily from them. We always bring the reader back, as the more advanced topics are developed, to their relationship to the fundamentals. By doing this, we believe students will be left with a framework for analysis that will serve them well when they need to apply this material in their careers in the years ahead.

We believe this approach has produced a successfuI textbook: *International Financial Management* is used in many of the best business schools in the world. Various editions of the text have been translated into Chinese (in both traditional and simplified forms), Spanish, and Indonesian. In addition, local co-authors have assisted in preparing Canadian, Malaysian, and Indian adaptations.

Ninth Edition Organization

International Financial Management, Ninth Edition, has been completely updated. All data tables and statistics are the most current available when the text went to press. Additionally, the chapters incorporate several new International Finance in Practice boxes that contain real-world illustrations of chapter topics and concepts. In the margins below, we highlight specific changes in the Ninth Edition.

This part lays the macroeconomic foundation for all the topics to follow.

Recent economic developments such as the global financial crisis, sovereign debt crisis of Europe, and Brexit.

Updated coverage of monetary developments, including the euro zone crisis.

New presentation of balance of payments and updated balance of payments statistics.

Review of corporate governance systems in different countries, the Dodd-Frank Act, and managerial implications.

This part describes the market for foreign exchange and introduces currency derivatives that can be used to manage foreign exchange exposure.

Fully updated market data and two new International Finance in Practice boxes. Presentation of triangular arbitrage is reconstructed and enhanced with new examples.

Integrated coverage of key parity conditions and currency carry trade with fully updated market data and empirical evidence. A new International Finance in Practice box.

Fully updated market data and examples.

This part describes the various types of foreign exchange risk and discusses methods available for risk management.

Content is reorganized and new subsections comparing the hedging strategies are added for enhanced understanding of foreign currency transaction exposure management.

Conceptual and managerial analysis of economic exposure to currency risk.

A Managerial Perspective

The text presentation never loses sight of the fact that it is teaching students how to make managerial decisions. *International Financial Management*, Ninth Edition, is founded in the belief that the fundamental job of the financial manager is to maximize shareholder wealth. This belief permeates the decision-making process we present from cover to cover. To reinforce the managerial perspective, we provide numerous real-world examples whenever appropriate.

Key Features

Examples—These are integrated throughout the text, providing students with immediate application of the text concepts.

EXAMPLE | 11.1: Rollover Pricing of a Eurocredit

Teltrex International can borrow \$3,000,000 at LIBOR plus a lending margin of 0.75 percent per annum on a three-month rollover basis from Barclays in London. Suppose that three-month LIBOR is currently 5.53 percent. Further suppose that over the second three-month interval LIBOR falls to 5.12 percent. How much will Teltrex pay in interest to Barclays over the six-month period for the Eurodollar loan?

$$\begin{aligned}\text{Solution: } &\$3{,}000{,}000 \times (.0553 + .0075)/4 + \$3{,}000{,}000 \times \\ &(.0512 + .0075)/4 = \$47{,}100 + \$44{,}025 \\ &= \$91{,}125\end{aligned}$$

International Finance in Practice Boxes—Selected chapters contain International Finance in Practice boxes. These real-world illustrations offer students a practical look at the major concepts presented in the chapter.

INTERNATIONAL FINANCE IN PRACTICE

Electronification of the Foreign Exchange Market

Technological advances ranging from greater processing power to instantaneous data transfer are transforming financial markets around the world, and the foreign exchange market is no exception. Currency traders dealing currencies on behalf of their clients by holding multiple telephone conversations and yelling into their phones is no longer the norm. The Bank for International Settlements[a] suggests that more than 70 percent of spot trading since 2013 is executed electronically. According to the North American Foreign Exchange Volume Survey conducted by the Federal Reserve Bank of New York in October 2018, about 58 percent of all foreign exchange transactions and 62 percent of spot transactions in North America are executed electronically instead of relying on traditional voice trading. For trades in some currency pairs, the share of electronic trade was even higher in October 2018 such as 63 percent and 71 percent for trading in U.S. dollars–British pounds and U.S. dollars–Singaporean dollars, respectively. Similarly, some large financial institutions nowadays almost exclusively rely on electronic trading. Automation is a development that goes hand in hand with electronification, and the Bank for International Settlements reports that an estimated 70 percent of orders on Electronic Broking Services (EBS) are now submitted by algorithms, rather than manually. This trend of increasing electronification is depicted in the figure below.

FX Electronic Trading Share (% of total monthly trades executed electronically)

In More Depth—Some topics are by nature more complex than others. The chapter sections that contain such material are indicated by the section heading "In More Depth"' and are in *colored text.* These sections may be skipped without loss of continuity, enabling the instructor to easily tailor the reading assignments to the students. End-of-chapter Questions and Problems relating to the In More Depth sections of the text are also indicated by *blue type.*

In More Depth

European Option-Pricing Formula

In the last section, we examined a simple one-step version of binomial option-pricing model. Instead, we could have assumed the stock price followed a multiplicative binomial process by subdividing the option period into many subperiods. In this case, S_T and C_T could be many different values. When the number of subperiods into which the option period is subdivided goes to infinity, the European call and put pricing formulas presented in this section are obtained. Exact European call and put pricing formulas are:[5]

$$C_e = S_t e^{-i_{\pounds} T} N(d_1) - E e^{-i_{\$} T} N(d_2) \tag{7.12}$$

and

$$P_e = E e^{-i_{\$} T} N(-d_2) - S_t e^{-i_{\pounds} T} N(-d_1) \tag{7.13}$$

The interest rates $i_{\pounds}$ and $i_{\$}$ are assumed to be annualized and constant over the term-to-maturity T of the option contract, which is expressed as a fraction of a year.

Invoking IRP, where with continuous compounding $F_T = S_t e^{(i_{\$} - i_{\pounds})T}$, C_e and P_e in Equations 7.12 and 7.13 can be, respectively, restated as:

$$C_e = [F_T N(d_1) - EN(d_2)] e^{-i_{\$} T} \tag{7.14}$$

[5]The European option-pricing model was developed by Biger and Hull (1983), Garman and Kohlhagen (1983), and Grabbe (1983). The evolution of the model can be traced back to European option-pricing models developed by Merton (1973) and Black (1976).

Questions and Problems—Each chapter contains a set of Questions and problems. This material can be used by students on their own to test their understanding of the material, or as homework exercises assigned by the instructor. Questions and Problems relating to the in more depth sections of the text are indicated by *blue type*.

QUESTIONS

1. How would you define *transaction exposure*? How is it different from economic exposure?
2. Discuss and compare hedging transaction exposure using the forward contract versus money market instruments. When do alternative hedging approaches produce the same result?
3. Discuss and compare the costs of hedging by forward contracts and options contracts.

PROBLEMS

The spreadsheet TRNSEXP.xls may be used in solving parts of problems 2, 3, 4, and 6.

1. Cray Research sold a supercomputer to the Max Planck Institute in Germany on credit and invoiced €10 million payable in six months. Currently, the six-month forward exchange rate is \$1.10/€ and the foreign exchange adviser for Cray Research predicts that the spot rate is likely to be \$1.05/€ in six months.

   a. What is the expected gain/loss from a forward hedge?
   b. If you were the financial manager of Cray Research, would you recommend

Questions with Excel Software—An icon in the margin indicates that the end-of-chapter question is linked to an Excel program created by the authors. See the Ancillary Materials section for more information on the software.

CFA Questions—Many chapters include problems from CFA Program Curriculum study materials. These CFA problems, indicated with the CFA logo, show students the relevancy of what is expected of certified professional analysts.

CFA® PROBLEMS

Case Applications—Case Applications are incorporated within selected chapters throughout the text in order to enhance specific topics and help students apply theories and concepts to real-world situations.

CASE APPLICATION

Richard May's Options

It is Tuesday afternoon, February 14, 2012. Richard May, Assistant Treasurer at American Digital Graphics (ADG), sits in his office on the 34th floor of the building that dominates Rockefeller Plaza's west perimeter. It's Valentine's Day, and Richard and his wife have dinner reservations with another couple at Balthazar at 7:30. I must get this hedging memo done, thinks May, and get out of here. Foreign exchange options? I had better get the story straight before someone in the Finance Committee starts asking questions. Let's see, there are two ways in which I can envision us using options now. One is to hedge a dividend due on September 15th from ADG Germany. The other is to hedge our upcoming payment to Matsumerda for their spring RAM chip statement. With the yen at 78 and increasing I'm glad we haven't covered the payment so far, but now I'm getting nervous and I would like to protect my posterior. An option to buy yen on June 10 might be just the thing.

Mini Cases—Almost every chapter includes a mini case for student analysis of multiple concepts covered throughout the chapter. These Mini Case problems are real world in nature to show students how the theory and concepts in the textbook relate to the everyday world.

MINI CASE

Airbus' Dollar Exposure

Airbus sold an A400 aircraft to Delta Airlines, a U.S. company, and billed $30 million payable in six months. Airbus is concerned about the euro proceeds from international sales and would like to control exchange risk. The current spot exchange rate is $1.05/€ and the six-month forward exchange rate is $1.10/€. Airbus can buy a six-month put option on U.S. dollars with a strike price of €0.95/$ for a premium of €0.02 per U.S. dollar. Currently, six-month interest rate is 2.5 percent in the euro zone and 3.0 percent in the United States.

1. Compute the guaranteed euro proceeds from the American sale if Airbus decides to hedge using a forward contract.
2. If Airbus decides to hedge using money market instruments, what action does Airbus need to take? What would be the guaranteed euro proceeds from the American sale in this case?
3. If Airbus decides to hedge using put options on U.S. dollars, what would be the "expected" euro proceeds from the American sale? Assume that Airbus regards the current forward exchange rate as an unbiased predictor of the future spot exchange rate.
4. At what future spot exchange do you think Airbus will be indifferent between the option and money market hedge?

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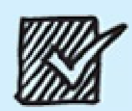

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“I really liked this app—it made it easy to study when you don't have your textbook in front of you.”

- Jordan Cunningham,
Eastern Washington University

No surprises.

The Connect Calendar and Reports tools keep you on track with the work you need to get done and your assignment scores. Life gets busy; Connect tools help you keep learning through it all.

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Ancillary Materials

To assist in course preparation, the following instructor ancillaries are within the Instructor Library in Connect:

- **Solutions Manual**—Includes detailed suggested answers and solutions to the end-of-chapter questions and problems, written by the authors.
- **Test Bank**—True/false and multiple-choice test questions for each chapter prepared by Leslie Rush, University of Hawaii–West Oahu. Available as Word documents and assignable within Connect.
- **PowerPoint Presentations**—PowerPoint slides for each chapter to use in classroom lecture settings, created by Courtney Baggett, Troy University.

The resources also include the International Finance Software that can be used with this book. This Excel software has four main programs:

- A currency options pricing program allows students to price put and call options on foreign exchange.
- A hedging program allows students to compare forward, money market instruments, futures, and options for hedging exchange risk.
- A currency swap program allows students to calculate the cash flows and notional values associated with swapping fixed-rate debt from one currency into another.
- A portfolio optimization program based on the Markowitz model allows for examining the benefits of international portfolio diversification.

The four programs can be used to solve certain end-of-chapter problems (marked with an Excel icon) or assignments the instructor devises. A User's Manual and sample projects are included in the Instructor Resources.

Acknowledgments

We are indebted to the many colleagues who provided insight and guidance throughout the development process. Their careful work enabled us to create a text that is current, accurate, and modern in its approach. Among all who helped in this endeavor for the Ninth Edition:

Richard Ajayi
University of Central Florida

Lawrence A. Beer
Arizona State University

Nishant Dass
Georgia Institute of Technology

John Hund
Rice Univèrsity

Irina Khindanova
University of Denver

Gew-rae Kim
University of Bridgeport

Jaemin Kim
San Diego State University

Yong-Cheol Kim
University of Wisconsin, Milwaukee

Yen-Sheng Lee
Bellevue University

Charmen Loh
Rider University

Atsuyuki Naka
University of New Orleans

Richard L. Patterson
Indiana University, Bloomington

Adrian Shopp
Metropolitan State University of Denver

John Wald
University of Texas at San Antonio

H. Douglas Witte
Missouri State University

Many people assisted in the production of this textbook. At the risk of overlooking some individuals, we would like to acknowledge Brian Conzachi for the outstanding job he did proofreading the entire manuscript. Additionally, we thank Yusri Zaro for his hard work - checking the accuracy of the solutions manual. Marta Gaia Bras, Ernest Jang, Rohan-Rao Ganduri, Kristen Seaver, Milind Shrikhande, Jin-Gil Jeong, Sanjiv Sabherwal, Sandy Lai, Jinsoo Lee, Hyung Suk Choi, Teng Zhang, Minho Wang, and Victor Huang provided useful inputs into the text. Professor Martin Glaum of the Giessen University (Germany) also provided valuable comments.

We also wish to thank the many professionals at McGraw-Hill Education for their time and patience with us. Charles Synovec, executive brand manager; Allison McCabe-Carroll, senior product developer; and Jill Eccher, content project manager have done a marvelous job guiding us through this edition.

Last, but not least, we would like to thank our families, Christine, James, and Elizabeth Eun; Donna Resnick; and Puje Olkhanud, Maya Chuluun, and Dolgormaa Tsegmed, for their tireless love and support, without which this book would not have become a reality.

We hope that you enjoy using *International Financial Management*, Ninth Edition. In addition, we welcome your comments for improvement. Please let us know either through McGraw-Hill Education, c/o Editorial, or at our e-mail addresses provided below.

Cheol S. Eun
cheol.eun@scheller.gatech.edu

Bruce G. Resnick
resnicbg@wfu.edu

Tuugi Chuluun
tchuluun@loyola.edu

Contents in Brief