

PART I Overview and Background

Chapter 1 An Introduction to Multinational Finance

Answers to Conceptual Questions

- 1.1 List the MNC's key stakeholders. How does each have a stake in the MNC?

Stakeholders narrowly defined include shareholders, debtholders, and management. More broadly defined, stakeholders also would include employees, suppliers, customers, host governments, and residents of host countries.

- 1.2 In what ways do cultural differences impact the conduct of international business?

Because they define the rules of the game, national business and popular cultures impact each of the functional disciplines of business from research and development right through to marketing, production, and distribution.

- 1.3 What is country risk? Describe several types of country risk one might face when conducting business in another country.

Country risks refer to the political and financial risks of conducting business in a particular foreign country. Country risks include foreign exchange risk, political risk, and cultural risk.

- 1.4 What is political risk?

Political risk is the risk that a sovereign host government will unexpectedly change the rules of the game under which businesses operate.

- 1.5 What is foreign exchange risk?

Foreign exchange risk is the risk of unexpected changes in foreign currency exchange rates.

1.6 What investment opportunities might MNCs enjoy that are not available to local firms?

Operating cash flows can be increased by increasing revenues or decreasing operating expenses. The text mentions revenue-enhancing opportunities such as global branding, advantages of size and scope, and flexibility in marketing and distribution; operating cost reductions through access to low-cost labor or raw materials, flexibility in sourcing or production, and economies of scale or vertical integration; and business strategies such as follow the customer, lead the customer, follow the leader, and building capacity directly in a foreign market (going local).

1.7 How can MNCs can reduce operating expenses relative to domestic firms?

MNCs can enjoy several advantages over domestic firms including global brands, size, and flexibility in marketing and distribution. Strategies for enhancing revenues include follow the customer, lead the customer, follow the leader, and establishing local production. Operating costs can be reduced through access to low-cost raw materials and labor, flexibility in sourcing, production, or site selection, and economies of scale or vertical integration.

1.8 What are the perfect financial market assumptions? What is their implication for multinational financial management?

In a perfect market, rational investors have equal access to prices and information in a frictionless market. If financial policy is to increase firm value, it must increase expected cash flows or decrease the discount rate in a way that cannot be replicated by investors. MNCs are in a better position than domestic firms to take advantage of financial market imperfections through financial market arbitrage, hedging policy, access to international sources of capital, and multinational tax strategy.

1.9 Describe the ways in which multinational financial management is different from domestic financial management.

Multinational financial management is conducted in an environment that is influenced by more than one cultural, social, political, or economic environment.

Chapter 2 World Trade and the International Monetary System

Answers to Conceptual Questions

- 2.1 List one or more trade pacts in which your country is involved. Do these trade pacts affect all residents of your country in the same way? On balance, are these trade pacts good or bad for residents of your country?

Figure 2.1 lists the major international trade pacts. The World Trade Organization (WTO) is a supranational organization that oversees the General Agreement on Tariffs and Trade (GATT). Important regional trade pacts include the North American Free Trade Agreement (NAFTA includes the U.S., Canada, and Mexico), the European Union (EU), and the Asia-Pacific Economic Cooperation pact (APEC encompasses most countries around the Pacific Rim including Japan, China, and the United States). Trade pacts are designed to promote trade, but industries that have been protected by local governments can find that they are uncompetitive when forced to compete in global markets.

- 2.2 Do countries tend to export more or less of their gross national product today than in years past? What are the reasons for this trend?

Most countries export more of their gross national product today than in years past. Reasons include: a) the global trend toward free market economies, b) the rapid industrialization of some developing countries, c) the breakup of the former Soviet Union and the entry of China into international trade, d) the rise of regional trade pacts and the General Agreement on Tariffs and Trade, and e) advances in communication and in transportation.

- 2.3 How has globalization in the world's goods markets affected world trade? How has globalization in the world's financial markets affected world trade?

Some of the economic consequences of globalization in the world's goods markets include: a) an increase in cross-border investment in real assets (land, natural resource projects, and manufacturing facilities), b) an increasing interdependence between national economies leading to global business cycles that are shared by all nations, and c) changing political risk for multinational corporations as nations redefine their borders as well as their national identities. The demise of capital flow barriers in international financial markets has had several consequences including: a) an increase in cross-border financing as multinational corporations raise capital in whichever market and in whatever

currency offers the most attractive rates, b) an increasing number of cross-border partnerships including many international mergers, acquisitions, and joint ventures, and c) increasingly interdependent national financial markets.

2.4 What distinguishes developed, less developed, and newly industrializing economies?

Developed economies have a well-developed manufacturing base. Less developed countries (LDCs) lack this industrial base. Countries that have seen recent growth in their industrial base are called newly industrializing countries (NICs).

2.5 Describe the International Monetary Fund's balance-of-payments accounting system.

The IMF publishes a monthly summary of cross-border transactions that tracks each country's cross-border flow of goods, services, and capital.

2.6 How would an economist categorize exchange rate systems? How would the IMF make this classification? In what ways are these the same? How are they different?

Economists have traditionally classified exchange rate systems as either fixed rate or floating rate systems. The IMF has adapted this system to the plethora of systems in practice today. The IMF's classification scheme includes "more flexible," "limited flexibility," and "pegged" exchange rate systems.

2.7 Describe the Bretton Woods agreement. How long did the agreement last? What forced its collapse?

After World War II, representatives of the Allied nations convened at Bretton Woods, New Hampshire to stabilize financial markets and promote world trade. Under Bretton Woods' "gold exchange standard," currencies were pegged to the price of gold (or to the U.S. dollar). Bretton Woods also created the International Monetary Fund and the International Bank for Reconstruction and Development (the World Bank). The Bretton Woods fixed-exchange rate system lasted until 1970, when high U.S. inflation relative to gold prices and to other currencies forced the dollar off the gold exchange standard.

2.8 What factors contributed to the Mexican peso crisis of 1995 and to the Asian crises of 1997?

In each instance, the government tried to maintain the value of the local currency at artificially high levels. This depleted foreign currency reserves. Local businesses and governments were also borrowing in non-local currencies (primarily the dollar), which heavily exposed them to a drop in the value of the local currency.

2.9 What is moral hazard and how does it relate to IMF rescue packages?

Moral hazard occurs when the existence of a contract changes the behaviors of parties to the contract. When the IMF assists countries in defending their currencies, it changes the expectations and hence the behaviors of lenders, borrowers, and governments. For example, lenders might underestimate the risks of lending to struggling economies if there is an expectation that the IMF will intervene during difficult times.

2.10 What were the causes and consequences of the global financial crisis of 2008?

Securitization of U.S. home loans combined with lax U.S. credit standards to create a subprime crisis in the market for collateralized debt obligations (CDOs). This subprime crisis impaired liquidity in the CDO market and eventually spilled over to other markets including real estate, stocks, bonds, other credit markets. Many governments had budget deficits from the drop in tax revenues and the increase in expenses from fiscal stimulus programs. Some governments (e.g., Greece and Iceland) saw their bond prices fall because of the increased perception of default risk.

Problem Solution

2.1 This open-ended question is intended to engage the student and bring their knowledge up-to-date. Useful websites are listed on the inside-front cover of the text, and include:

Bank for International Settlements	www.bis.org
International Monetary Fund (IMF)	www.imf.org
World Trade Organization (WTO)	www.wto.org
International Labor Organization	www.ilo.org

International Chamber of Commerce

www.iccwbo.org

Michigan State University Global Edge

globaledge.msu.edu

United Nations

www.un.org

United Nations' Commission on International Trade Law

www.uncitral.org

World Bank

www.worldbank.org

World Bank's Multilateral Investment Guarantee Agency

www.miga.org

World Economic Forum