**Chapter 1  
Multinational Financial Management: Opportunities and Challenges**   
  
◼ **Learning Objectives**

1. Examine the requirements for the creation of value
2. Consider the basic theory, *comparative advantage,* and its requirements for the explanation and justification for international trade and commerce
3. Discover what is different about international financial management
4. Detail which market imperfections give rise to the multinational enterprise
5. Consider how the globalization process moves a business from a purely domestic focus in its financial relationships and composition to one truly global in scope
6. Examine possible causes to the limitations to globalization in finance

◼ **Chapter Outline**

1. Financial Globalization and Risk
2. The Global Financial Market Place
3. Assets, Institutions, and Linkages
4. Assets
5. Institutions
6. Linkages
7. The Market for Currencies
8. Currency Symbols
9. Exchange Rate Quotations and Terminology
10. Quotation Conventions
11. Eurocurrencies and LIBOR
12. Eurocurrency Interest Rates
13. The Theory of Competitive Advantage
14. Global Outsourcing of Comparative Advantage
15. What Is Different about International Financial Management?
16. Market Imperfections: A Rationale for the Existence of the Multinational Firm
17. Why Do Firms become Multinational?
18. Market seekers
19. Raw material seekers
20. Production efficiency seekers
21. Knowledge seekers
22. Political safety seekers
23. The Globalization Process
24. Global Transition I: Trident Moves from the Domestic Phase to the International Trade Phase
25. Global Transition II: The International Trade Phase to the Multinational Phase
26. The Limits to Financial Globalization
27. ◼ Questions

1. **Globalization and the MNE.** The term globalization has become very widely used in recent years. How would you define it?

Merriam-Webster.com defines globalization as “the development of an increasingly integrated global economy marked especially by free trade, free flow of capital, and the tapping of cheaper foreign labor markets.”

Also, Narayana Murthy’s quote may be a good place to start a discussion of globalization:

I define globalization as producing where it is most cost-effective, selling where it is most profitable, and sourcing capital where it is cheapest, without worrying about national boundaries.

Narayana Murthy, President and CEO, Infosys

2. **Assets, Institutions, and Linkages**. Which assets play the most critical role in linking the major institutions that make up the global financial marketplace?

Debt securities issued by governments (e.g., U.S. Treasury Bills and Bonds) are at the heart of the global financial marketplace. The health and security of the global financial system is dependent on these assets.

3. **Eurocurrencies and LIBOR.** Why have eurocurrencies and LIBOR remained the centerpiece of the global financial marketplace for so long?

Eurocurrencies have remained a centerpiece of the global financial marketplace because the eurocurrency market is essentially a large money market relatively free from government regulation. A major reason global depositors and borrowers are attracted to the eurocurrency market is because of the narrow interest rate spread in the market. The reference rate of interest for the eurocurrency market is the London Interbank Offered Rate (LIBOR).

4. **Theory of Comparative Advantage.** Define and explain the theory of comparative advantage.

The *theory of comparative advantage* provides a basis for explaining and justifying international trade in a model world assumed to enjoy free trade, perfect competition, no uncertainty, costless information, and no government interference. The theory contains the following features:

• Exporters in Country A sell goods or services to unrelated importers in Country B, while exporters in Country B sell goods or services to importers in Country A.

• Firms in Country A specialize in making products that can be produced relatively efficiently, given Country A’s endowment of factors of production: that is, land, labor, capital, and technology. Firms in Country B do likewise, given the factors of production found in Country B. In this way, the total combined output of A and B is maximized.

• Because the factors of production cannot be moved freely from Country A to Country B, the benefits of specialization are realized through international trade.

• The way the benefits of the extra production are shared depends on the terms of trade and the ratio at which quantities of the physical goods are traded. Each country’s share is determined by supply and demand in perfectly competitive markets in the two countries. Neither Country A nor Country B is worse off than before trade, and typically both are better off, albeit perhaps unequally.

MNEs strive to take advantage of imperfections in national markets for products, factors of production, and financial assets. Large international firms are better able to exploit such competitive factors as economies of scale, managerial and technological expertise, product differentiation, and financial strength than are their local competitors.

5. **Limitations of Comparative Advantage.** Key to understanding most theories is what they say and what they don’t. What are four or five key limitations to the theory of comparative advantage?

Although international trade might have approached the comparative advantage model during the nineteenth century, it certainly does not today, for the following reasons:

• Countries do not appear to specialize only in those products that could be produced most efficiently by that country’s particular factors of production. Instead, governments interfere with comparative advantage for a variety of economic and political reasons, such as to achieve full employment, economic development, national self-sufficiency in defense-related industries, and protection of an agricultural sector’s way of life. Government interference takes the form of tariffs, quotas, and other non-tariff restrictions.

• At least two of the factors of production, capital and technology, now flow directly and easily between countries, rather than only indirectly through traded goods and services. This direct flow occurs between related subsidiaries and affiliates of multinational firms, as well as between unrelated firms via loans, and license and management contracts. Even labor flows between countries such as immigrants into the United States (legal and illegal), immigrants within the European Union, and other unions.

• Modern factors of production are more numerous than in this simple model. Factors considered in the location of production facilities worldwide include local and managerial skills, a dependable legal structure for settling contract disputes, research and development competence, educational levels of available workers, energy resources, consumer demand for brand name goods, mineral and raw material availability, access to capital, tax differentials, supporting infrastructure (roads, ports, communication facilities), and possibly others.

• Although the terms of trade are ultimately determined by supply and demand, the process by which the terms are set is different from that visualized in traditional trade theory. They are determined partly by administered pricing in oligopolistic markets.

• Comparative advantage shifts over time as less-developed countries become more developed and realize their latent opportunities. For example, during the past 150 years comparative advantage in producing cotton textiles has shifted from the United Kingdom to the United States, to Japan, to Hong Kong, to Taiwan, and to China.

• The classical model of comparative advantage did not really address certain other issues such as the effect of uncertainty and information costs, the role of differentiated products in imperfectly competitive markets, and economies of scale.

Nevertheless, although the world is a long way from the classical trade model, the general principle of comparative advantage is still valid. The closer the world gets to true international specialization, the more world production and consumption can be increased, provided the problem of equitable distribution of the benefits can be solved to the satisfaction of consumers, producers, and political leaders. Complete specialization, however, remains an unrealistic limiting case, just as perfect competition is a limiting case in microeconomic theory.

6. **Trident’s Globalization.** After reading the chapter’s description of Trident’s globalization process, how would you explain the distinctions between international, multinational, and global companies?

The difference in definitions for these three terms is subjective, with different writers using different terms at different times. No single definition can be considered definitive, although as a general matter the following probably reflect general usage.

*International* simply means that the company has some form of business interest in more than one country. That international business interest may be no more than exporting and importing, or it may include having branches or incorporated subsidiaries in other countries. International trade is usually the first step in becoming “international,” but the term also encompasses foreign subsidiaries created for the single purpose of marketing, distribution, or financing. The term *international* is also used to encompass the following definitions of *multinational* and *global*.

*Multinational* is usually taken to mean a company that has operating subsidiaries and performs a full set of its major operations in a number of countries. A *multinational* company is often presumed to operate in a greater number of countries compared to an international company. A *multinational* company is presumed to operate with each foreign unit “standing on its own”—although that term does not preclude specialization by country and/or supplying parts from one country operation to another.

*Global* is a newer term similar to “multinational” but infers an even larger international presence; i.e., operating around the globe.

7.  **Trident, the MNE.** At what point in the globalization process did Trident become a multinational enterprise (MNE)?

Trident became a MNE when it began to establish foreign sales and service subsidiaries, followed by creation of manufacturing operations abroad or by licensing foreign firms to produce and service Trident’s products. This multinational phase usually follows the international phase, which involves the import and/or export of goods and/or services.

8. **Trident’s Advantages.** What are the main advantages that Trident gains by developing a multinational presence?

* Entry into new markets, not currently served by the firm, which in turn allows the firm to grow and possibly to acquire economies of scale
* Acquisition of raw materials, not available elsewhere
* Achievement of greater efficiency, by producing in countries where one or more of the factors of production are underpriced relative to other locations
* Acquisition of knowledge and expertise centered primarily in the foreign location
* Location of the firms’ foreign operations in countries deemed politically safe

9. **Trident’s Phases.** What are the main phases that Trident passed through as it evolved into a truly global firm? What are the advantages and disadvantages of each?

a. *International trade*.Two advantages are finding out if the firms’ products are desired in the foreign country and learning about the foreign market. Two disadvantages are lack of control over the final sale and service to final customer (many exports are to distributors or other types of firms that in turn resell to the final customer) and the possibility that costs and thus final customer sales prices will be greater than those of competitors that manufacture locally.

b. *Foreign sales and service offices*. The greatest advantage is that the firm has a physical presence in the country, allowing it greater control over sales and service as well as allowing it to learn more about the local market. The disadvantage is the final local sales prices, based on home country plus transportation costs, may be greater than competitors that manufacture locally.

c. *Licensing a foreign firm to manufacture and sell*. The advantages are that product costs are based on local costs and that the local licensed firm has the knowledge and expertise to operate efficiently in the foreign country. The major disadvantages are that the firm might lose control of valuable proprietary technology and that the goals of the foreign partner might differ from those of the home country firm. Two common problems in the latter category are whether or not the foreign firm (that is manufacturing the product under license) is a shareholder wealth or corporate wealth maximizer, which in turn often leads to disagreements about reinvesting earning to achieve greater future growth versus making larger current dividends to owners and payments to other stakeholders.

d. *Part ownership of a foreign, incorporated, subsidiary; i.e., a joint venture*. The advantages and disadvantages are similar to those for licensing: Product costs are based on local costs and that the local joint owner presumably has the knowledge and expertise to operate efficiently in the foreign country. The major disadvantages are that the firm might lose control of valuable proprietary technology to its joint venture partner and that the goals of the foreign owners might differ from those of the home country firm.

e. *Direct ownership of a foreign, incorporated, subsidiary*. If fully owned, the advantage is that   
the foreign operations may be fully integrated into the global activities of the parent firm, with products resold to other units in the global corporate family without questions as to fair transfer prices or too great specialization. (Example: The Ford transmission factory in Spain is of little use as a self-standing operation; it depends on its integration into Ford’s European operations.) The disadvantage is that the firm may come to be identified as a “foreign exploiter” because politicians find it advantageous to attack foreign-owned businesses.

10. **Financial Globalization.** How do the motivations of individuals, both inside and outside the organization or business, define the limits of financial globalization?

If influential insiders in corporations and sovereign states pursue the goal of maximizing firm value, there will be a definite and continuing growth in financial globalization. But if these same influential insiders pursue their own personal agendas, which may increase their personal power, influence, or wealth, then capital will not flow into these sovereign states and corporations. This will, in turn, create limitations to globalization in finance. The result is the growth of financial inefficiency and the segmentation of globalization outcomes creating winners and losers.

The three fundamental elements—*financial theory, global business, management beliefs and actions*—combine to present either the problem or the solution to the growing debate over the benefits of globalization to countries and cultures worldwide.