Chapter 1

Multinational Financial Management: Opportunities and Challenges

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2. Understand how financial globalization alters the risks of multinational business
3. Explore the structures of the global financial marketplace
4. Consider how the theory of comparative advantage applies to multinational business
5. Examine how international financial management differs from domestic financial management
6. Discover the steps and stages of the globalization process
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    1. **Globalization Risks in Business**. What are some of the risks that come with the growing globalization of business?

* Exchange rates. The international monetary system, an eclectic mix of floating and managed fixed exchange rates, is constantly changing. For example the growth of the Chinese yuan is now changing the global currency landscape.
* Interest rates. Large fiscal deficits, including the current eurozone crisis, plague most of the major trading countries of the world, complicating fiscal and monetary policies, and ultimately, interest rates and exchange rates.
* Many countries experience continuing balance of payments imbalances and, in some cases, dangerously large deficits and surpluses; all will inevitably move exchange rates.
* Ownership, control, and governance vary radically across the world. The publicly traded company is not the dominant global business organization—the privately held or family-owned business is the prevalent structure and their goals and measures of performance vary dramatically.
* Global capital markets that normally provide the means to lower a firm's cost of capital, and even more critically, increase the availability of capital, have in many ways shrunk in size and have become less open and accessible to many of the world's organizations.
* Financial globalization has resulted in the ebb and flow of capital in and out of both industrial and emerging markets, greatly complicating financial management (Chapters 5 and 8).
  1. **Globalization and the Multinational Enterprise (MNE)**. The term globalization has become widely used in recent years. How would you define it?

Narayana Murthy’s quote is a good place to start any 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

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

The debt securities issued by governments are the most critical. These low risk or risk-free assets form the foundation for the creation, trading, and pricing of other financial assets like bank loans, corporate bonds, and equities (stock). In recent years a number of additional securities have been created from the existing securities – derivatives, whose value is based on market value changes in the underlying securities. The health and security of the global financial system relies on the quality of these assets.

* 1. **Currencies and Symbols**. What technological innovation is changing the symbols we use in the representation of different country currencies?

As currency trading has shifted from verbal telephone conversations to electronic and digital trading, currency symbols (many of which were not common across alphabetic platforms like the British pound, £) have been replaced with the ISO-4217 codes, three-letter currency codes like USD, EUR, and GBP.

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

Eurocurrencies and LIBOR (and there are LIBOR rates for all eurocurrencies) reflect the “purest” of market driven currencies and instrument rates. They are largely unregulated and, therefore, reflect freely traded assets whose value is set by the daily global marketplace.

* 1. **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.
* 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, 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.
  1. **Limitations of Comparative Advantage**. Key to understanding most theories is what they say and what they don’t. Name 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 most efficiently produced 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 immigration into the United States (legal and illegal), immigration 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.

* 1. **International Financial Management**. What is different about international financial management?

Multinational financial management requires an understanding of cultural, historical, and institutional differences such as those affecting corporate governance. Although both domestic firms and MNEs are exposed to foreign exchange risks, MNEs alone face certain unique risks, such as political risks, that are not normally a threat to domestic operations.

MNEs also face other risks that can be classified as extensions of domestic finance theory. For example, the normal domestic approach to the cost of capital, sourcing debt and equity, capital budgeting, working capital management, taxation, and credit analysis needs to be modified to accommodate foreign complexities. Moreover, a number of financial instruments that are used in domestic financial management have been modified for use in international financial management. Examples are foreign currency options and futures, interest rate and currency swaps, and letters of credit.

* 1. **Ganado’s Globalization**. After reading the chapter’s description of Ganado’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 what are defined as multinational and global below.

*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, i.e., in “many nations.” “Operations” in this context includes both manufacturing and selling, as well as other corporate functions, and a multinational company is often presumed to operate in a greater number of countries than simply 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 that essentially means about the same as “multinational,” i.e., operating around the globe. Global has tended to replace other terms because of its use by demonstrators at the international meetings (“global forums?”) of the International Monetary Fund and World Bank that took place in Seattle in 1999 and Rome in 2001. Terrorist attacks on the World Trade Center and the Pentagon in 2001 led politicians to refer to the need to eliminate “global terrorism.”

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

Ganado became a multinational enterprise (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 involved the import and/or export of goods and/or services.

* 1. **Role of Market Imperfections**. What is the role of market imperfections in the creation of opportunities for the multinational firm?
* MNEs strive to take advantage of imperfections in national markets for products, factors of production, and financial assets.
* Imperfections in the market for products translate into market opportunities for MNEs. Large international firms are better able than their local competitors to exploit competitive factors such as economies of scale, managerial and technological expertise, product differentiation, and financial strength.
* MNEs thrive best in markets characterized by international oligopolistic competition, where these factors are particularly critical.
* Once MNEs have established a physical presence abroad, they are in a better position than purely domestic firms to identify and implement market opportunities through their own internal information network.
  1. **Why Go?**  Why do firms become multinational?

1. Entry into new markets, not currently served by the firm, which in turn allow the firm to grow and possibly to acquire economies of scale
2. Acquisition of raw materials, not available elsewhere
3. Achievement of greater efficiency by producing in countries where one or more of the factors of production are underpriced relative to other locations
4. Acquisition of knowledge and expertise centered primarily in the foreign location
5. Location of the firms’ foreign operations in countries deemed politically safe
   1. **Multinational Versus International**. What is the difference between an international firm and a multinational firm?

A multinational firm goes beyond simply selling to or trading with firms in foreign countries (international), by expanding its intellectual capital and acquiring a physical presence in foreign countries. This allows the firm to expand and deepen its core competitiveness and global reach to more markets, customers, suppliers, and partners.

* 1. **Ganado's Phases**. What are the main phases that Ganado 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 great 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.

* 1. **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 continue to pursue the increase in 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. 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.