CHAPTER 1

MULTINATIONAL FINANCIAL MANAGEMENT: OPPORTUNITIES AND CHALLENGES

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 (Chapter 5 and 8).

2. **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

3. **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. 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.

4. **Currencies and Symbols**. What technological change is even 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.

5. **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.

6. **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.

7. **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 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, over 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.

8. **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.

9. **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 which essentially means about the same as "multinational;" i.e., operating around the globe. Global has tended to replace other terms because of its use in 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."

10. 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.

11. 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 to exploit such competitive factors as economies of scale, managerial and technological expertise, product differentiation, and financial strength than are their local competitors.
- 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.