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## Part I

# The Global Financial Environment

Part I of this text (chapters 1 through 4) presents an overview of the global financial environment. Chapter 1 develops the goals of the financial decision-making process of multinational companies and examines the role of global finance in achieving these goals. Chapter 2 examines motives for world trade and foreign investment. Before considering foreign trade and foreign investment separately in the coming chapters, we discuss key trade and investment theories. Chapter 3 describes the balance of payments and its relationship to currency regimes. Chapter 4 looks at an overview of the international monetary system and how the choice of system affects exchange rates.



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# Chapter 1

## Introduction

### ***Opening Case 1: Shareholder Value and Corporate Governance***

Do you know why the US economy has performed better than those of Japan, Europe, and other countries in the 1990s? The answer is simple. US companies have treated shareholder value maximization as their primary goal for years. How? Through effective corporate governance.

Today, many companies in Germany, Japan, and other countries are doing something that used to be unheard of in their countries: they are restructuring their business operations to enhance shareholder value. For example, Veba of Germany, Nissan of Japan, and Unilever of England have recently laid off thousands of workers, fired long-time managers, closed factories, and spun off noncore businesses – all for the sake of making their investors richer. US companies have engaged in this sort of corporate strategy, known as “restructuring”, since the early 1980s, largely due to influential oversight and control and effective management exerted by institutional investors. This shareholder activism is an example of active corporate governance.

To maximize shareholder value, US companies have increased asset dispositions, avoided overinvestment, increased dividends and share repurchases, increased the utilization rate of assets, increased mergers and acquisitions, linked executive pay to share price performance, and increased the use of stock splits. To see how such actions increase shareholder value, take the linkage between executive pay and stock price as an example. Most large US companies link a significant portion of executive and board pay to the company's stock price performance through stock options and grants. Thus, management gets richer when shareholders get richer. A recent study by the Watson Wyatt Worldwide consulting firm found that shareholders earned about three times the returns over a 5-year period when their executives owned a large number of shares, compared with firms where executive stock ownership was low.

Many non-US companies have just begun to adopt American-style corporate governance practices in an effort to increase shareholder value. That is why this edition of *Global Corporate Finance* treats shareholder value and effective corporate governance as its foundations. In other words, this book will teach you how to enhance shareholder value through strong corporate governance so that you will make an immediate and important contribution to your future company upon graduation.

*Sources:* “Changing Values: Satisfying Shareholders is a Hot New Concept at Some German Firms,” *The Wall Street Journal*, March 6, 1996, pp. A1, A10; “Japan Restructures,” *The Wall Street Journal*, Nov. 1, 1999, p. A54; “Serving the Shareholders,” *The Detroit News*, Nov. 26, 1999, pp. 1B–6B; and “Unilever to Cut 25,000 Jobs, Close Factories,” *The Wall Street Journal*, Feb. 23, 2000, p. A17.

Globalization – the increasing economic integration of goods, services, and financial markets – presents opportunities and challenges for governments, business firms, and individuals. Although business operations in countries across the globe have existed for centuries, the world has recently entered an era of unprecedented worldwide production and distribution. Worldwide production and distribution are critical for the survival of the multinational corporation (MNC) – its ability to produce products and sell them at a profit. International finance is an integral part of total management and cuts across functional boundaries because it expresses inputs, outputs, plants, and results in monetary terms.

This book deals with the financial decisions of an MNC, decisions which both large and small MNCs must make. Thus the underlying financial principles are basically the same for both types of companies. In this introductory chapter, we lay the foundation for the entire text with 7 separate sections. The first section explains reasons to study international finance. The second section identifies the primary goal of the MNC and the functions of the financial manager necessary to achieve this primary goal. The third section analyzes MNCs and their performance. The fourth section discusses the major principles of global finance which favor MNCs over domestic companies. The fifth section describes two major constraints that impede an MNC’s effort to achieve its goal: large agency costs and environmental differences. The sixth section discusses environmental factors affecting MNCs. The last section gives an overview of the book.

## 1.1 Reasons to Study International Finance

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A college student, such as yourself, should study international finance. “I’m not an international finance major,” you say. “Why should I have to take a course in international finance?” That’s a reasonable question. It is true that most readers of this book will not necessarily work in the international finance department of a large

company such as IBM or the foreign exchange department of a large bank such as Chase Manhattan. All textbooks on business and economics teach that resources are scarce. We know that your time is one of those scarce resources. Hence, we will give you just a few reasons why you should study international finance.

### *To understand a global economy*

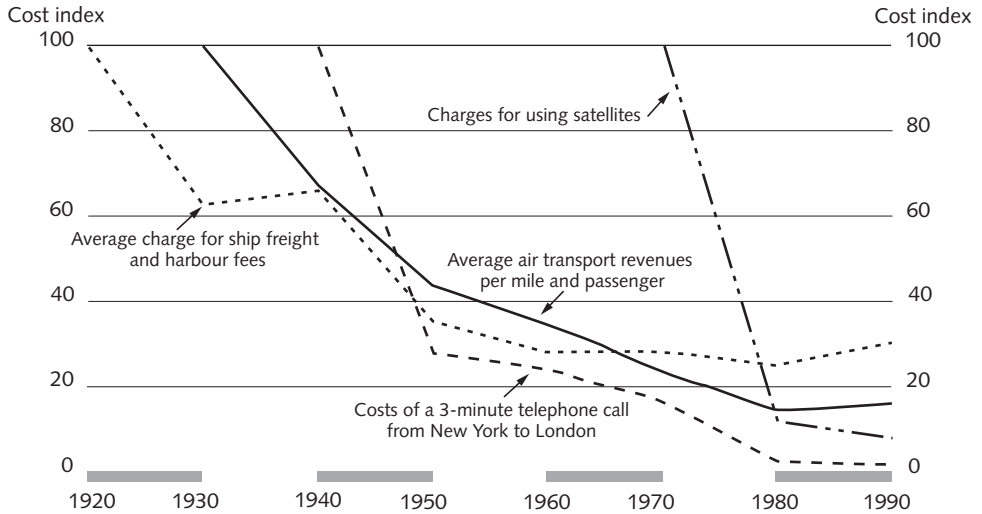
In the 1990s, the world reached the climax in a drama of economic change. No one can deny the effects of these changes on our hopes for peace and prosperity: the disintegration of the Soviet Union; political and economic freedom in eastern Europe; the emergence of market-oriented economies in Asia; the creation of a single European market; trade liberalization through regional trading blocs, such as the European Union, and the world's joint mechanism, such as the World Trade Organization. As global integration advances amid intensified international competition, the United States, Japan, and Europe are expected to lead the world toward a system of free trade and open markets.

Three recent changes have had a profound effect on the international financial environment: the end of the Cold War, the emergence of growing markets among the developing countries of east Asia and Latin America, and the increasing globalization of the international economy. Understanding these changes should help you see where the international economy is headed in the future so that you can more effectively respond to these challenges, fulfill your responsibilities, and take advantage of these opportunities.

**THE END OF THE COLD WAR** In 1989 the Soviet Union relaxed its control over the eastern European countries that had suffered its domination for over 40 years. These countries immediately seized the opportunity to throw off authoritarian Communist rule. Two years later the Soviet Union itself underwent a political and ideological upheaval, which quickly led to its breakup into 15 independent states. Most of these and other formerly centrally planned economies are now engaged in a process of transition from central planning and state ownership to market forces and private ownership.

**INDUSTRIALIZATION AND GROWTH OF THE DEVELOPING WORLD** The second great change of recent years has been the rapid industrialization and economic growth of countries in several parts of the world. The first of these emerging markets were the four Asian “tigers”: Hong Kong, Singapore, South Korea, and Taiwan. China and other Asian countries have followed in their footsteps. Having overcome the debt crisis of the 1980s and undertaken economic and political reforms, some of the Latin American countries – Argentina, Brazil, Chile, Mexico, and Venezuela – have also begun to see faster, more sustained growth.

**INCREASED GLOBALIZATION** The third major change in the international financial environment is even more sweeping than the first two. National economies are becoming steadily more integrated. Technological barriers have fallen as



**Figure 1.1** Costs of transport and communication

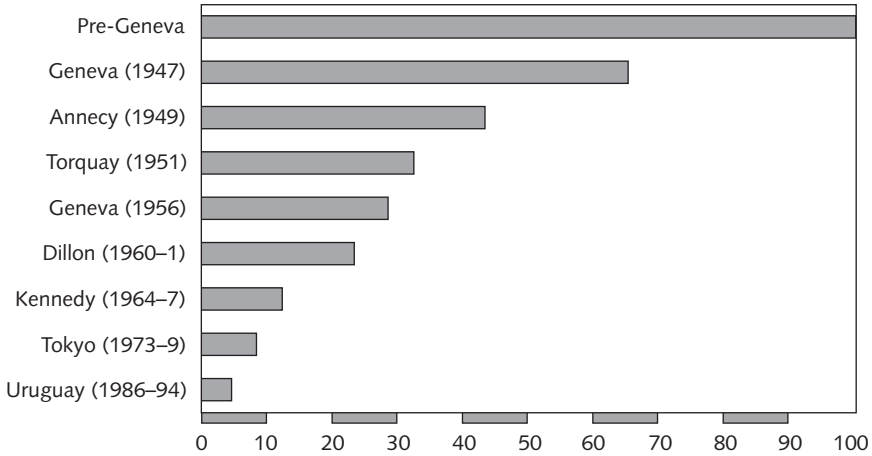
Source: OECD, ed., *The Future of the Global Economy*, Paris: OECD, 1999, p. 119.

transportation and communication costs have dropped. Government-made barriers have also fallen as tariffs and non-tariff barriers have been reduced in a series of multilateral negotiations and trading blocs since the Second World War.

Figure 1.1 shows that transport and communication costs have drastically fallen in recent years. This “death of distance” facilitates international production activities, enlarges trading areas, and enables companies to exploit international cost differentials. Figure 1.2 illustrates the significance of declining trade barriers, which describes the development of tariff rates for the United States since 1940. Other industrial countries and many developing countries have implemented similar tariff reductions. These falling technological and government-made barriers have caused trade and foreign direct investment to increase several times faster than world output since 1985 (see figure 1.3).

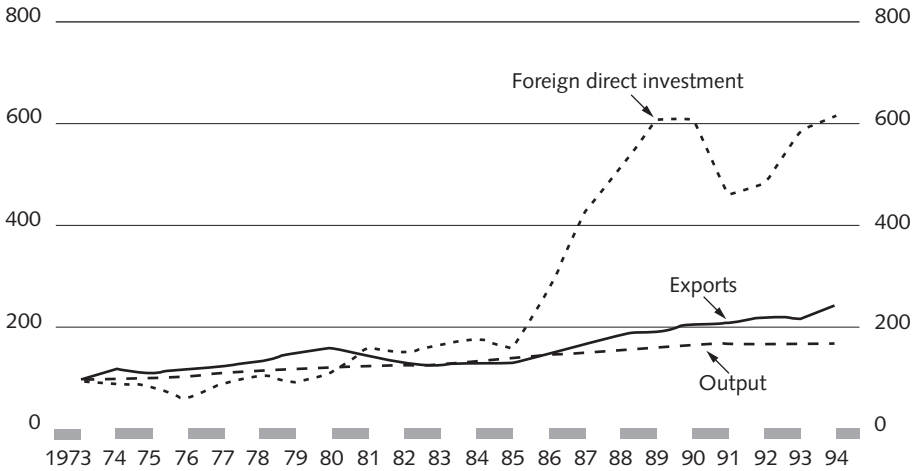
### *To understand the effect of global finance on business*

There are also many examples of the growing importance of international operations for individual companies. ExxonMobile, DaimlerChrysler, Coca Cola, and McDonald’s earn more than half of their total operating profits through international operations. MNCs, such as BP Amoco, General Motors, and Sony, do business in more than 150 countries around the world. Nestle, Philips Electronics, Ford, and IBM have more workers overseas than in their home countries. In 1996 Nestle, for example, had 203,100 workers overseas compared with only 6,700 workers in its home country, Switzerland.



**Figure 1.2** Weighted average US tariff rate after GATT rounds, pre-Geneva = 100

Source: OECD, ed., *The Future of the Global Economy*, Paris: OECD, 1999, p. 121.



**Figure 1.3** World output, exports, and foreign direct investment

Source: OECD, ed., *The Future of the Global Economy*, Paris: OECD, 1999, p. 122.

By the same token, global finance has also become increasingly important as it serves world trade and foreign investment. International earning assets for BankAmerica, for example, represent more than half of its total earning assets. Deutsche Bank maintains more than 500 overseas branches in over 100 countries. Simply stated, each nation is economically related to other nations through a complex network of international trade, foreign investment, and international loans.

Most large and many medium-size companies around the world have international business operations. In recent years it has become clear that international events significantly affect companies which do not have foreign operations. Business school graduates have an advantage in moving their companies forward if they understand the basic elements of international finance. Apart from career interests, persons who want to improve their knowledge of the world would be seriously handicapped if they do not understand the economic dynamics and policy issues of finance, trade, and investment flows among nations.

### *To make intelligent personal decisions*

When you graduate from college and decide to take a job, you may have the advantage of comparing two job offers: one from Merrill Lynch and another one from Nomura Securities. When you decide to buy a car, your choice between the latest models offered by General Motors and Volkswagen may well depend on the exchange rate between the dollar and the euro. When you begin a career and save for your retirement, you may choose between US securities and non-US securities. When you take your next vacation, you may spend it at Tokyo Disneyland or at Disneyland Paris. Although these are not international finance jobs, they all require significant knowledge of international finance to make intelligent decisions. In all of these cases, the important point is that you will participate not just in the US economy but in economies around the world.

## **1.2 Company Goals and Functions of Financial Management** \_\_\_\_\_

### *1.2.1 Multinational company goals*

Management is motivated to achieve a number of objectives, some of which conflict with each other. Such conflicts arise because the firm has a number of constituents, such as stockholders, employees, customers, creditors, suppliers, and the local community, whose desires do not necessarily coincide. It is management's responsibility to satisfy such differing desires. Hence, the conflicting objectives confronting management raise the problem of setting priorities. In addition, it is essential for management to set priorities for the most efficient use of a company's scarce resources. Setting priorities in an MNC is particularly important and difficult because it has highly diversified groups of constituents in many countries.

The commonly accepted objective of an MNC is to maximize stockholder wealth on a global basis, as reflected by stock price. The stock price reflects the market's evaluation of the firm's prospective earnings stream over time, the riskiness of this stream, the dividend policy, and quality aspects of the firm's future activities. Quality aspects of future activities include stability, diversification, and growth of sales.

Stockholder wealth maximization is generally accepted as the primary goal of a company in the United States and the United Kingdom. In some other countries



such as Germany and Japan, however, the goal of a company is to maximize corporate wealth. "Corporate wealth" includes not only the company's stockholder wealth but also its marketing, technical, and human resources. Under this model, a company should treat shareholders on a par with other corporate constituents. In other words, management strives to increase the corporate wealth for the benefit of all constituents.

There are a number of compelling reasons for management to focus on stockholder wealth maximization. First, because stockholders are the owners of the company, management has a fiduciary obligation to act in their best interests. Second, stockholders provide the risk capital that protects the welfare of other constituents. Third, stockholder wealth maximization – a high stock price – provides the best defense against a hostile takeover or a forced corporate restructuring. Fourth, if a company enhances shareholder value, it is easier for the company to attract additional equity capital. For these and other reasons, many financial economists believe that stockholder wealth maximization is the only way to maximize the economic welfare of all constituents (Shapiro, 1999).

### *1.2.2 Functions of the international financial manager*

In order to achieve the firm's primary goal of maximizing stockholder wealth, the financial manager performs three major functions: (1) financial planning and control (supportive tools); (2) the efficient allocation of funds among various assets (investment decisions); and (3) the acquisition of funds on favorable terms (financing decisions).

**FINANCIAL PLANNING AND CONTROL** Financial planning and control must be considered simultaneously. For purposes of control, the financial manager establishes standards, such as budgets, for comparing actual performance with planned performance. The preparation of these budgets is a planning function, but their administration is a controlling function.

The foreign exchange market and international accounting play a key role when an MNC attempts to perform its planning and control function. For example, once a company crosses national boundaries, its return on investment depends on not only its trade gains or losses from normal business operations but also on exchange gains or losses from currency fluctuations. For example, Thailand's chemical giant Siam Cement PCL incurred a foreign exchange loss of \$517 million in the third quarter of 1997 due to currency turmoil in Asia during the second half of 1997. The company had \$4.2 billion in foreign loans, and none of it was hedged. The exchange loss wiped out all the profits the company earned between 1994 and 1996 (Glain, 1997).

International reporting and controlling have to do with techniques for controlling the operations of an MNC. Meaningful financial reports are the cornerstone of effective management. Accurate financial data are especially important in international business, where business operations are typically supervised from a distance.

**ALLOCATION OF FUNDS (INVESTMENT)** When the financial manager plans for the allocation of funds, the most urgent task is to invest funds wisely within the firm. Every dollar invested has alternative uses. Thus, funds should be allocated among assets in such a way that they will maximize the wealth of the firm's stockholders.

There are 200 countries in the world where a large MNC, such as Royal Dutch/Shell, can invest its funds. Obviously, there are more investment opportunities in the world than in a single country, but there are also more risks. International financial managers should consider these two simultaneously when they attempt to maximize their firm's value through international investment.

**ACQUISITION OF FUNDS (FINANCING)** The third role of the financial manager is to acquire funds on favorable terms. If projected cash outflow exceeds cash inflow, the financial manager will find it necessary to obtain additional funds from outside the firm. Funds are available from many sources at varying costs, with different maturities, and under various types of agreements. The critical role of the financial manager is to determine the combination of financing that most closely suits the planned needs of the firm. This requires obtaining the optimal balance between low cost and the risk of not being able to pay bills as they become due.

There are still many poor countries in the world. Thus, even Deutsche Bank, the world's largest bank in 1999, cannot acquire its funds from 200 countries. Nevertheless, MNCs can still raise their funds in many countries thanks to recent financial globalization. This globalization is driven by advances in data processing and telecommunications, liberalization of restrictions on cross-border capital flows, and deregulation of domestic capital markets. International financial managers use a puzzling array of fund acquisition strategies. Why? The financial manager of a purely domestic company has just one way to acquire funds – instruments which have varying costs, different maturities, and different types of agreements. The financial manager of an MNC, on the other hand, has three different ways to acquire funds: by picking instruments, picking countries, and picking currencies.

**THE CHANGING ROLE OF THE FINANCIAL MANAGER** The role of the financial manager has expanded in recent years. Instead of merely focusing on the efficient allocation of funds among various assets and the acquisition of funds on favorable terms, financial managers must now concern themselves with corporate strategy. The consolidation of corporate strategy and the finance function – a fundamental change in financial management – is the direct result of two recent trends: the globalization of competition and the integration of world financial markets facilitated by improved ability to collect and analyze information. For example, financial managers increasingly participate in corporate strategic matters – from basic issues such as the nature of their company's business to complex issues such as mergers and acquisitions.

The chief financial officer is emerging as a strategic planner. In an era of heightened global competition and hard-to-make-stick price increases, the financial fine points of any new strategy are more crucial than ever before. Many finance chiefs can provide that data, as well as shrewd judgment about products, marketing, and other areas. The key place where everything comes together is finance. In a recent

survey by head-hunters Korn/Ferry International, Fortune 100 chief financial officers almost unanimously described themselves as “more of a partner with the Chief Executive Officer (CEO)” than they used to be (Scism, 1993).

## 1.3 Multinational Companies and Their Performance

### 1.3.1 *What is a multinational corporation?*

In 1963, the term “multinational corporation” became a household term after a cover story about the institution in *Business Week*. Ever since, international business guided by MNCs has prospered as a result of the need for poor countries to develop, the end of the Cold War, privatization of state-owned businesses and banks, and the growing economic power of the global triad – Asia, the United States, and Europe (Baker, 1998). There are approximately 60,000 multinational companies in the world with 500,000 foreign affiliates. These account for roughly 25 percent of global output, one-third of it in host countries (Economic Report of the President to Congress, 2000). In the twenty-first century, these MNCs are expected to play an even greater role in international business because they have the know-how, money, and experience.

The *World Book Encyclopedia* defines a **multinational corporation (MNC)** as “a business organization that produces a product, sells a product, and provides a service in two or more countries.” The US Department of Commerce defines an American MNC as “the US parent and all of its foreign affiliates.” A US parent is a “person”, resident in the United States, who owns or controls a minimum of 10 percent voting equity in a foreign firm. “Person” is broadly defined to include any individual, branch, partnership, associated group, association, estate, trust, corporation, other organization, or any government entity. A **foreign affiliate** is a foreign business enterprise in which a US person owns or controls a minimum of 10 percent voting equity. A **majority-owned foreign affiliate** is a foreign affiliate in which the combined ownership of all US parents exceeds 50 percent.

Donald Lessard (1991), a professor of international finance at MIT, classifies all MNCs into three groups: (1) international opportunists – companies that focus on their domestic markets but engage in some international transactions; (2) multidomestic competitors – companies committed to a number of national markets with substantial value added in each country but with little cross-border integration of activities; and (3) global competitors – companies that focus on a series of national and supranational markets with substantial cross-border integration of activities.

### 1.3.2 *From multinational company to global company*

What Lessard called “a global competitor” has come to be known as a **global company**, a generic term used to describe an organization that attempts to standardize and integrate operations worldwide in all functional areas. Here are three possible definitions of a global company – an organization that attempts to:

- 1 have a worldwide presence in its market;
- 2 integrate its operations worldwide;
- 3 standardize operations in one or more of the company's functional areas.

For example, if a company designs a product with a global market segment in mind and/or depends on many countries for the production of a product, it qualifies as a global company. In this type of company, the development of capabilities and the decisions to diffuse them globally are essentially made in the company's home office. Some people believe that a global company must possess all these three characteristics. Critics of this definition say that there are no global companies by that definition.

### *1.3.3 Performance of US multinational companies*

Evidence indicates that US MNCs earn more money as they boost their presence in foreign markets. For example, in 1998 the operations of nonbank US MNCs grew more rapidly than the US economy. According to the 1998 annual survey of US direct investment abroad, several key economic indicators of US MNCs – worldwide gross product, employment, and capital expenditures – grew two to three times faster than those of their counterparts in the US economy for 9 years from 1989 to 1998. For majority-owned foreign affiliates, operations grew faster in 1998 than in 1989–98. In 1998, US MNCs accounted for 65 percent of US merchandise exports and for 42 percent of US merchandise imports.

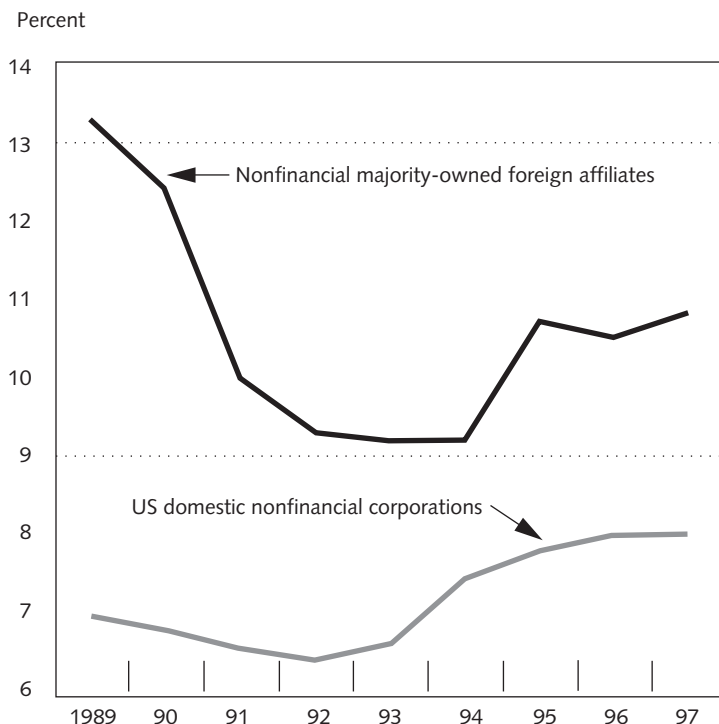
Figure 1.4 shows that the return on assets for nonfinancial US MNCs exceeded the return on assets for all US nonfinancial companies from 1989 to 1997. In fact, the return on assets for US MNCs has been nearly two times higher than the return on assets for all US companies over this 9-year period. Foreign-based companies with a higher degree of international business have also experienced superior performance in recent years. Why do multinational companies perform better than domestic companies? In the following section, we attempt to answer this important question.

## **1.4 Principles of Global Finance**

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The primary objective of this book is to help the reader understand basic principles of global finance. Before we advance too far into the material, perhaps it would be helpful to take a brief look at some of these principles so you can see where we are heading.

As discussed earlier, the financial manager has three major functions: financial planning and control, the acquisition of funds, and the allocation of funds. However, each of these three functions shares most principles of global finance and their relationships. Seven important principles of global finance are introduced in this section. In addition, these principles should help you understand why MNCs perform better than domestic companies.



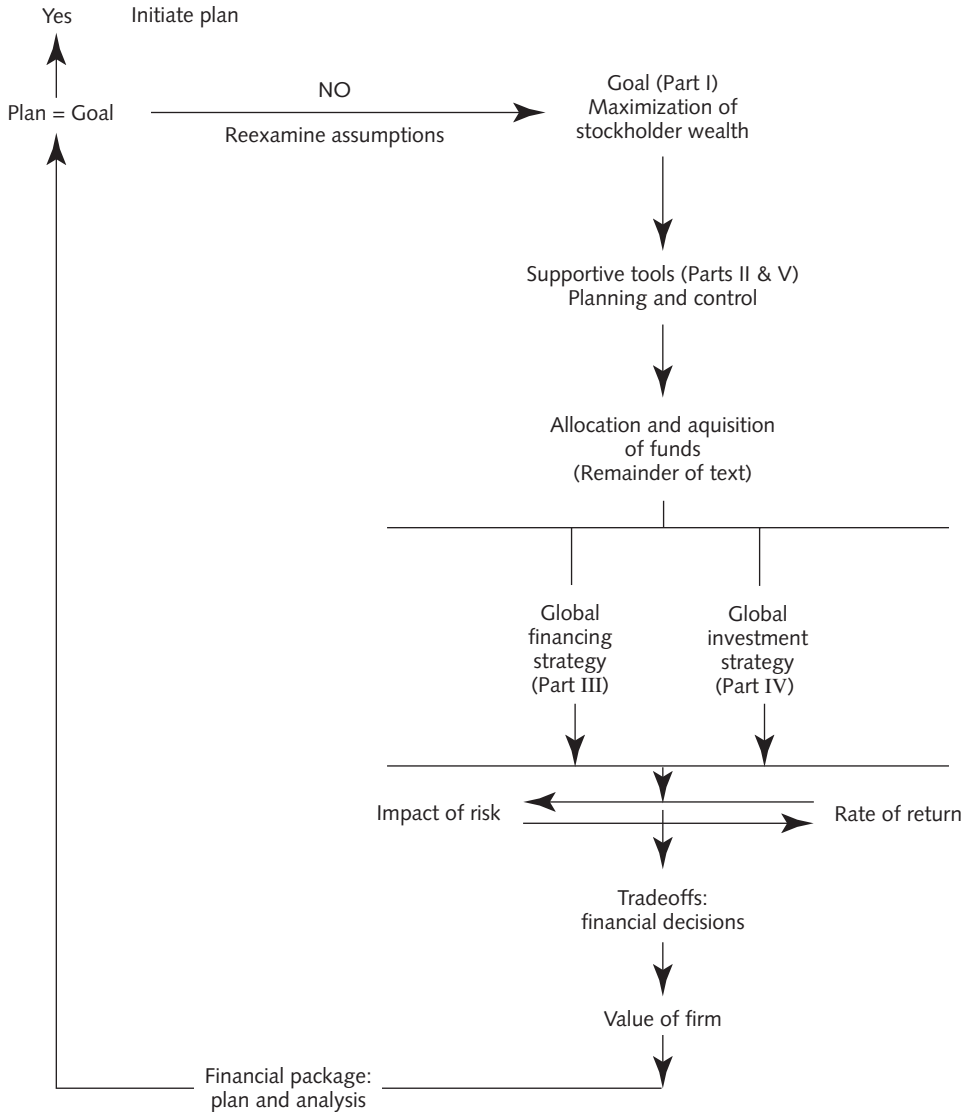
**Figure 1.4** Return on assets of US foreign affiliates and domestic firms

Source: US Dept. of Commerce, Bureau of Economic Analysis.

### 1.4.1 Risk–return tradeoff

The maximization of stockholder wealth depends on the tradeoff between risk and profitability. Generally, the higher the risk of a project, the higher the expected return from the project. For example, if you are offered a chance to invest in a project which offers an extremely high rate of return, you should immediately suspect that the project is very risky.

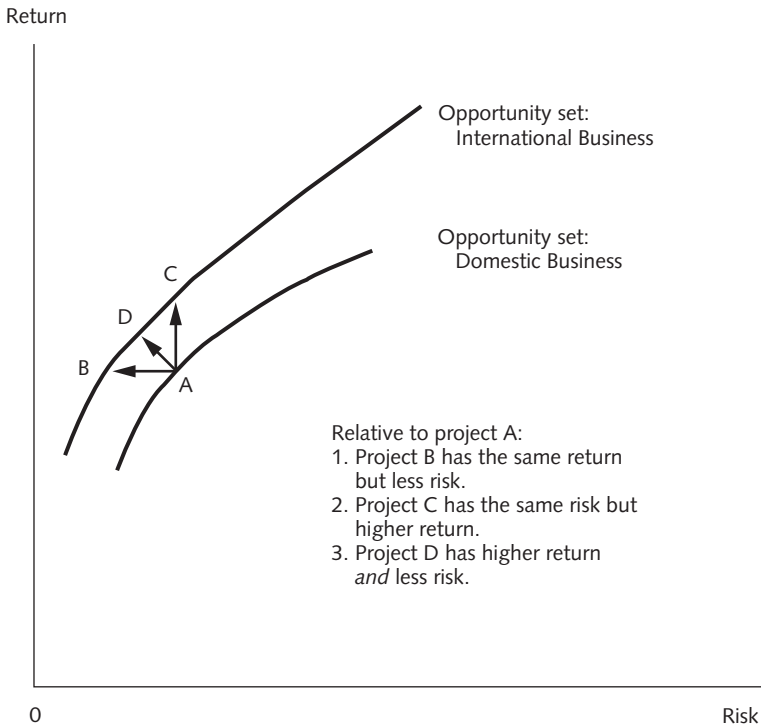
The risk–return tradeoff does not apply to 100 percent of all cases, but in a free enterprise system, it probably comes close. Thus, the financial manager must attempt to determine the optimal balance between risk and profitability that will maximize the wealth of the MNC’s stockholders. Figure 1.5 shows how the financial manager assesses the various risk–return tradeoffs available and incorporates this into the wealth maximization goal. Given the risk–return tradeoffs, various financial decisions are made to maximize stockholder wealth. Practically all financial decisions involve such tradeoffs. Such decisions include foreign exchange risk management, global reporting and controlling, global financing decisions, and global investment decisions.



**Figure 1.5** An integrated decision-making model in global finance

An investor’s risk/return tradeoff function is based on the standard economic concepts of utility theory and opportunity sets. An opportunity set shows different combinations of business opportunities, which make the investor equally happy in terms of risk–return tradeoffs.

Companies can benefit from an expanded opportunity set as they venture into global markets. It seems reasonable to assume that international business is riskier than domestic business. However, this is not necessarily true, because returns on



**Figure 1.6** Expanded opportunity set for international business

foreign investments are not highly positively correlated with returns on domestic investments. In other words, MNCs may be less risky than companies that operate strictly within the boundaries of any one country. Consequently, to minimize risk, companies should diversify not only across domestic projects but also across countries.

Possible revenue opportunities from international business are also larger than those from purely domestic business. MNCs can locate production in any country of the world to maximize their profits and raise funds in any capital market where the cost of capital is the lowest. MNCs may see another advantage from currency gains. These two factors – lower risks and larger profitability for international business – suggest the possibility that an MNC can achieve a better risk–return tradeoff than a domestic company.

Figure 1.6 shows that international business pushes out the opportunity set, thus allowing MNCs to reduce risk, increase return, or attain both. As shown in figure 1.6, we can think of three possible cases where international operations are better than domestic operations. Relative to US project A, international project B has the same return but less risk; international project C has the same risk but higher return; and international project D has higher return but less risk.

### 1.4.2 *Market imperfections*

**Perfect competition** exists when sellers of goods and services have complete freedom of entry into and exit out of any national market. Under such conditions, goods and services would be mobile and freely transferable. The unrestricted mobility of goods and services creates equality in costs and returns across countries. This cost–return uniformity everywhere in the world would remove the incentive for foreign trade and investment.

Factors of production, such as land, capital, and technology, are unequally distributed among nations. Even with such comparative advantages, however, the volume of international business would be limited if all factors of production could be easily transferred among countries. The real world has imperfect market conditions where resources available for the production of goods are somewhat immobile.

The trend toward a global economy through the World Trade Organization and the European Union will undoubtedly remove market imperfections that restrict international flows of goods and services. However, a variety of barriers still impede free movements of goods, services, and financial assets across national boundaries. These barriers include government controls, excessive transportation and transaction costs, lack of information, and discriminatory taxation. Consequently, companies can still benefit from imperfections in national markets for factors of production, products, and financial assets. In other words, imperfect national markets create a variety of incentives for companies to seek out international business. For example, Japanese automakers such as Toyota established automobile transplants in the United States to avoid US trade restrictions.

### 1.4.3 *Portfolio effect (diversification)*

The **portfolio effect** states that as more assets are added to a portfolio, the risk of the total portfolio decreases. There are some qualifying conditions that we will add to this principle later, but diversification is a very valuable quality.

This principle explains much of the rationale for large MNCs to diversify their operations not only across industries but also across countries and currencies. Some MNCs, such as Nestle of Switzerland, have operations in countries as varied as the United States, Japan, Hong Kong, France, Russia, Mexico, Brazil, Vietnam, Nigeria, and North Korea. Because it is impossible to predict which countries will outperform other countries in the future, these companies are “hedging their bets.”

Domestic investment projects tend to correlate less with foreign investment projects than with other domestic projects. As a result, international diversification is more effective than domestic diversification. The economic cycles of different countries, the United States and Japan, do not tend to be totally synchronized. On the other hand, most domestic projects tend to be highly correlated with each other because they depend on the same state of economy. The energy operations of



ExxonMobil in Saudi Arabia, for example, may be hurt if world oil prices unexpectedly take a nosedive. However, this might be offset by its operations in energy-consuming countries such as France. Overall, the MNC earns its desired rate of return even if the profitability of its investment in individual countries may not be that predictable.

#### 1.4.4 *Comparative advantage*

You have perhaps heard on the news that the Japanese are US competitors in the global economy. In some ways this is true, because American and Japanese companies produce many of the same goods. Ford and Toyota compete for the same customers in the market for automobiles. However, trade between the United States and Japan is not like a sports contest, where one team wins and the other team loses. In fact, the opposite is true. Trade between two countries can make each country better off.

The classical argument for free trade is based on the principle of comparative advantage. Assume that US workers are better at producing computer software than workers in China and that Chinese workers are better at producing shoes than workers in the United States. Comparative advantage states that trade between the two countries – the United States exporting software and China exporting shoes – can boost living standards in both. This is because the United States has comparative advantage in producing software while China has comparative advantage in producing shoes. Trade allows countries to specialize in what they do best and to enjoy a greater variety of goods and services. At the same time, companies earn profits from trade because most trade is carried out by individual companies.

#### 1.4.5 *Internationalization advantage*

Why do some companies prefer to export while others build overseas manufacturing facilities? When a company expands its operations beyond national borders for the first time, it tends to exploit a foreign market through exports. An export-oriented strategy serves a company well for some time. However, to become part of a global market, a company should have a world presence. Because the world presence cannot be sustained by exports alone, the company should eventually invest.

The advantages of internationalization influence companies to invest directly in foreign countries. These advantages depend on three factors: location, ownership, and internationalization. ExxonMobil has ownership advantages, such as technology, marketing expertise, capital, and brand names. Venezuela has location advantages, such as crude oil, abundant labor, and low taxes. Thus, ExxonMobil has built oil refineries in Venezuela. These factories magnify both wages of workers in Venezuela and profits of ExxonMobil from the use of its technology and capital.

These magnified portions of location advantages and ownership advantages are called **internationalization advantages**. These internationalization advantages allow MNCs to enjoy superior earnings performance over domestic companies.

#### 1.4.6 *Economies of scale*

There are economies of scale in the use of many assets. **Economies of scale** take place due to a synergistic effect, which is said to exist when the whole is worth more than the mere sum of its parts. When companies produce or sell their primary product in new markets, they may increase their earnings and shareholder wealth due to economies of scale. Economies of scale explain why so many Asian companies invested in North America in preparation for the North American Free Trade Agreement of 1994. As the European Union removed trade barriers in 1993, it allowed US MNCs to achieve greater economies of scale through their investment in western Europe.

Companies can gain from greater economies of scale when their real capital and monetary assets are deployed on a global basis. The expansion of a company's operations beyond national borders allow it to acquire necessary management skills and spread existing management skills over a larger operation. There are also opportunities to eliminate duplicate facilities and consolidate the functions of production and marketing. In addition, MNCs can raise funds at the lower cost of capital and reduce the pool of money without loss in the level of production. These types of operating and financial economies, along with better management, can cause an MNC to increase its profit margin and reduce its risks as well.

#### 1.4.7 *Valuation*

The valuation principle states that the value of an asset is equal to the present value of its expected earnings. Because the values of all assets stem from streams of expected earnings, all such assets are valued in essentially the same way. First, the earning is estimated. Second, the required rate of return for each earning is established. Third, each earning is discounted by its required rate of return, and these present values are then summed to find the value of the asset. Alternatively, the value of an entire firm is determined by dividing the firm's earnings after taxes or net cash flows by its required rate of return.

The value of an MNC is usually higher than the value of a domestic company for two reasons. First, studies show that MNCs earn more profits than domestic companies. Second, the earnings of larger companies are capitalized at lower rates. The securities of MNCs have better marketability than those of domestic companies. MNCs are also better known among investors. These factors lead to lower required rates of return and higher price-earnings ratios. When MNCs attempt to maximize their overall company value, they also face various constraints. Those constraints that hamper an MNC's efforts to maximize its stockholder wealth include large agency costs and environmental differences.

## 1.5 Agency Theory and Corporate Governance

### 1.5.1 Agency theory: management vs. stockholders

**Agency theory** deals with the conflict of interest between managers and shareholders. We may think of managers as agents of the owners. Stockholders delegate decision-making authority to managers on the condition that the agents will act in the stockholders' best interest. However, it has often been argued that the objectives of managers may differ from those of the firm's stockholders. Because the stockholders of most MNCs today are well diversified, the control of these companies is separated from ownership. This situation allows managers to act in their own best interest rather than in the best interest of the stockholders. Thus, some managers may be concerned with their own welfare, such as their own income, power, self-esteem, and prestige. The welfare of managers, therefore, could be increased by management decisions that tend to lower stockholder wealth.

To ensure that managers act in the best interest of the stockholders, the managers must be monitored and rewarded with appropriate incentives. Incentives could include stock options, bonuses, and perquisites. Monitoring can be done by reviewing management perquisites, auditing financial statements, and limiting management decisions. **Agency costs** include incentives and monitoring costs. It is reasonable to assume that managers will undertake actions that are relatively consistent with stockholder wealth maximization. This is because, over the long run, their own goals, including survival, will largely depend on the value of the firm.

In this text, we explain the issues and concepts of international finance as though managers act on behalf of the firm's stockholders. Nevertheless, the size of some MNCs can make it difficult to determine whether all managers make decisions on the basis of this single corporate objective – stockholder wealth maximization on a global basis. For example, financial managers of MNCs with many subsidiaries may be tempted to make decisions that would maximize the value of their respective subsidiaries at the expense of their parent company. Consequently, the agency costs of assuring that managers try to maximize stockholder wealth can be larger for MNCs than for purely domestic companies.

### 1.5.2 Corporate governance

**Corporate governance** refers to the way in which major stakeholders exert control over operations of a company. The rights of the company's stakeholders in corporate governance are determined by each nation's laws, legal institutions and conventions, and regulations. However, corporate governance is often narrowly defined as the prudent exercise of ownership rights toward the goal of increased shareholder value (Gillan and Starks, 1998). In the United States, corporate governance has evolved from a system with a few influential individual investors, around the turn of the last century, to the present environment in which large institutional investors flex their shareholder muscle. Institutional investors include pension

funds, mutual funds, university and other nonprofit endowments, and insurance companies.

Today, large institutional investors actively encourage effective corporate governance practices to maximize their investment returns. Major corporate governance issues include board independence, executive compensation, and antitakeover devices. Unlike other stakeholders that have dealings with the corporation—customers, suppliers, lenders, and labor—common shareholders do not have contractual protection of their interests. Thus, shareholder activism is an important part of corporate governance to ensure that managers take actions to mitigate agency problems (conflicts) and thus increase shareholder value.

**SHAREHOLDER ACTIVISM** is any activity of an investor who tries to change the status quo through voice without the control of the company. The voice reflected in the most common form of shareholder activism covers a broad spectrum of activities, such as a shareholder proposal for a proxy fight, direct negotiation with management, and public targeting of a corporation.

**Proxy** represents the assignment of the voting right to management or a group of outsiders. If earnings are poor and stockholders are dissatisfied, an outside group may solicit the proxies in an effort to overthrow management and take control of the business. This is known as a proxy fight. When performance analysis reveals problems with a company's governance practices, shareholders will directly negotiate with management for needed changes in the company's practices and policies. Public targeting is the use of media to send information to other investors about the problems and needed changes at a company. The issues addressed by these voice activities span a wide range of topics, but most often pertain to issues of social policy or corporate governance reform.

**CHANGES IN CORPORATE GOVERNANCE** Since 1980, a number of changes have made US managers more responsive to the interests of shareholders. These changes include a more active takeover market, an increased usage of executive incentive plans that increase the link between management performance and corporate performance, and more active institutional shareholders who have demonstrated a growing tendency to vote against management (Grinblatt and Titman, 1998).

First, the threat of a hostile takeover for inefficiently managed companies tends to encourage managers to make decisions that enhance stockholder wealth. Other companies are more likely to acquire undervalued companies at a low price and might lay off existing managers. Chapter 14 discusses this issue in detail.

Second, these days many companies partially compensate their executives with stock options which encourage managers to make decisions that maximize their company's stock price. Stock options and other types of incentive plans such as bonuses are designed to increase the link between management performance and corporate performance.

Third, institutions have become more active as shareholders and have compelled managers to act in the stockholders' best interest. Increased shareholder activism by institutions has occurred at the same time as the rapid increase in institutional investor holdings during the last two decades. These holdings grew from approxi-

mately one-quarter of US equity markets in 1980 to over one-half today. Two rule changes in the early 1990s by the US Security and Exchange Commission have also sparked the active role of institutional investors. The first change, which required complete disclosure of executive compensation packages, put managers under greater pressure to perform up to their level of compensation. The second change made it easier for shareholders to get information about other shareholders and reduced the cost of staging a proxy fight.

**NATIONAL DIFFERENCES IN CORPORATE GOVERNANCE** Although national legal systems in industrial countries share many common elements, laws for corporate governance have notable differences. The United Kingdom and the United States are often viewed as prototypes of a market-oriented financial system (AS model), whereas continental Europe (France and Germany) and Japan are generally regarded as typical representatives of a bank- or relationship-based system (CEJ model).

In AS countries, institutional investors make up an important part of the financial system. In CEJ countries, banks represent the most important part of the financial system. Equity finance is important in AS countries, and institutional shareholders exert a great deal of corporate control. The accepted objective of the AS model is to maximize shareholder value. In 1998, an international advisory panel to the Organization for Economic Cooperation and Development (OECD) endorsed shareholder value maximization as the primary goal of companies. On May 27, 1999, the OECD officially adopted “OECD Principles of Corporate Governance” recommended by its advisory panel.

OECD Principles of Corporate Governance are intended to achieve two goals. The first goal is to assist member and nonmember governments in their effort to improve the legal, institutional, and regulatory framework for corporate governance in their countries. The second goal is to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The document for the OECD Principles of Corporate Governance covers five areas: (1) the rights of shareholders, (2) the equitable treatment of shareholders, (3) the role of stakeholders, (4) disclosure and transparency, and (5) the responsibilities of the board.

Although securities markets are more important in market-based systems, banks are prominent in both systems. A crucial distinction concerns the roles that banks play. In AS countries, banks are one of many sources of external finance for companies. They compete with bond and commercial paper markets, along with markets for equity, to provide funds to companies. And bank loans are typically provided through arm’s-length market transactions. In CEJ countries, particularly in Japan, banks are the main source of funds for many companies and thus take an active role in monitoring the decisions of the borrowing firm’s management. The influence of Japanese banks is further enhanced by their stock ownership. In contrast with the United States, Japanese banks can hold common stock up to 5 percent of a company’s shares. In addition, the large cross-holdings of Japanese firms mean that corporate decision-making can be heavily influenced by personal relationships

between top executives who sit on each other's board of directors. Individual shareholders have little voice, and the result is relatively low return on capital.

Most Asian countries used to have Japanese-style corporate governance structures. Some analysts argue that the Japanese economic problems of the 1990s and the Asian financial crisis of 1997 can be traced back to weak corporate governance. The head of the panel at the OECD was quoted as saying that nobody was watching Asian management; "they were growing for the sake of growth with no concern for shareholder value" (Simison, 1998). The crisis could most likely have been avoided, he said, had American-style corporate governance been in place.

American-style corporate governance is frequently cited as one of the major reasons for the unusually strong performance of both the US stock market and the US economy during the 1990s. Consequently, corporate policies throughout the world are now undertaken with more awareness about their impact on the stock price. Other countries have just begun to adopt American-style corporate governance practices in an effort to force local companies to make decisions that satisfy their respective stockholders.

## 1.6 Environmental Differences

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What are the differences between MNCs and domestic companies from a financial manager's point of view? An efficient allocation of funds among assets (investment) and an acquisition of funds on favorable terms (financing) are conceptually the same for both types of companies. These two types of companies, however, differ because they do business in different environments. International financial managers must understand these differences if they are to succeed in the international environment.

For successful international operations, a manager must have information about environmental factors that affect business operations in foreign countries. Domestic methods should be adjusted to accommodate customs, attitudes, economic factors, and political factors which prevail in the country of operation.

How do management practices in one country differ from those in other countries? In principle, concepts in accounting, economics, finance, management, and marketing are as relevant to business management in one country as they are in another country. However, when a business crosses national boundaries, the environment differs for these functions. In other words, multinational financial managers are confronted with various environmental constraints when they attempt to maximize their firm's value on a global basis. The three types of environmental constraints described in this section are (1) various risks, (2) conflicts of interest, and (3) multiple environments. These constraints are not mutually exclusive, nor do they exhaust the differences we might find in international business.

### 1.6.1 *Types of risk*

Three major risks in international business are political, financial, and regulatory. **Political risks** range from moderate actions, such as exchange controls, to extreme

actions, such as confiscation of assets. **Financial risks** involve varying exchange rates, divergent tax laws, different interest and inflation rates, and balance-of-payments considerations. **Regulatory risks** are differences in legal systems, overlapping jurisdictions, and restrictive business practices against foreign companies.

If a company plans to invest heavily in foreign countries, it must consider all of these risks. Business operations which cross national boundaries add dimensions of risk rarely confronted in domestic business operations. Ideally, a company should analyze these risks to understand their underlying causal forces so that the company can develop specific measures to handle them.

### 1.6.2 *Conflicts of interest*

Conflicts of interest may occur for a variety of reasons. Owners, employees, suppliers, and customers may have different national identities. The interests of sovereign national states may be divergent. The goals of MNCs and host countries may conflict. Some conflicts of interest may exist within an MNC. Furthermore, the MNC and the external environment may clash.

Companies tend to have home-country nationals in key positions for foreign operations, but they tend to hire local persons for nonmanagerial positions. Thus, disparities in salaries and wages are inevitable. Most developing countries require MNCs to hire and train local people for management positions in exchange for local business operations. External conflicts relate to profit-motivated decisions which involve the transfer of funds, production, exports, imports, and employment from one country to another. For instance, an MNC's wish for foreign exchange remittances frequently conflicts with a local government's restrictions on these remittances.

### 1.6.3 *Multiple environments*

In addition to risk and conflict, MNCs can have operational problems because they are present in several international environments. These environmental diversities require different concepts, analytical methods, and information. So, MNCs should identify, evaluate, and predict all environmental variables. Some important environmental variables are the form of business organization, different institutional settings, and cultural differences.

## 1.7 The Structure of this Book

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This book has five major parts. Part I (chapters 1 through 4) provides an overview of the global financial environment, such as motives for foreign trade and investment, the balance of payments, and the international monetary system. In other words, this part develops the primary goals of an MNC and the basics of international finance.

Part II (chapters 5 through 9) deals with the forces that affect the relative prices of currencies in international markets. This part is devoted to financial derivatives—currency forwards, futures, options, and swaps – with an emphasis on their relationships to foreign exchange risk management.

Part III (chapters 10 through 13) describes sources of global corporate finance. One major facet of corporate finance is to raise funds on favorable terms. In the case of global corporate finance, financing involves the sources of funds for international trade and foreign investment.

Part IV (chapters 14 through 19) discusses the management of assets. The second major facet of corporate finance is the efficient allocation of funds among assets. A decision to invest abroad must take into account various environmental differences, such as disparities in exchange rates, differences in taxes, and differences in risk factors.

Part V (chapters 20 through 22) describes techniques for reporting and controlling the operations of an MNC. Accurate financial data are especially important in international businesses because foreign operations are supervised from a distance. Taxation is an important part of international finance because it affects all aspects of multinational operations. Once a company establishes foreign operations, international transfer pricing becomes an important dimension of pricing strategies.

## **SUMMARY**

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The international financial manager has the same objective as every other manager in the multinational firm: to maximize the wealth of the stockholders. If the firm's stock price goes up as a result of the manager's decisions, the decisions were good ones. The stockholders would recognize that the value of the company has been enhanced by the managers' efforts. In order to achieve the firm's primary goal of maximizing stockholder wealth, the financial manager performs three major functions: financial planning and control, the efficient allocation of funds, and the acquisition of funds on favorable terms.

MNCs have superior performance over domestic companies because they enjoy a better risk–return tradeoff, market imperfections, portfolio effects, comparative advantage, internationalization advantage, economies of scale, and a higher valuation. However, when MNCs attempt to maximize their overall company value, they face various constraints, such as large agency costs, a variety of risks, potential conflicts of interest, and multiple environments.



# Questions

- 1 What is the primary goal of multinational companies? Why is stockholder wealth maximization more important than profit maximization?
- 2 Discuss the agency problem of multinational companies.
- 3 In order to achieve a firm's primary goal of maximizing stockholder wealth, the financial manager performs a number of important functions. What are the three major functions of financial management?
- 4 Why do multinational companies perform better than domestic companies?
- 5 Explain environmental constraints that conflict with the primary goal of multinational companies.
- 6 The concept of a perfect market depends on a number of conditions. What are these conditions? Would inflation rates, interest rates, and wages among countries be more similar or less similar under perfect market conditions than under imperfect market conditions?
- 7 A growing movement to "buy American" debates the term: what is an "American" car? One of the following cars is made only in the United States. Can you name it? For extra points, match all the cars to their countries of origin.

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1 Pontiac LeMans	A. Canada
2 Chevrolet Lumina	B. Korea
3 Mercury Capri	C. Mexico
4 Honda Accord Coupe	D. US
5 Dodge Stealth	E. Japan
6 Mercury Tracer	F. Canada
7 Plymouth Voyager	G. Australia

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- 8 What are the two major sets of external forces which are causing fundamental change in financial management?
- 9 Explain why management should focus on stockholder wealth maximization.
- 10 What is corporate governance? What changes made US managers more responsive to the interests of shareholders since 1980?
- 11 What is meant by Japanese-style corporate governance structures?

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## Case Problem 1: What is a National Company?

Evidence indicates that it has become increasingly difficult to define a national company in recent years. "There is no longer any such thing as a purely national economy. The rest of the world is just too big to ignore, either as a market or as a competitor. If business schools do nothing other than to train their students to think internationally, they would have accomplished an important task" (John Young, CEO of Hewlett-Packard). "There is no German, French, or American capital market any more. It is a global capital market, and all we have to play by the same rules" (Ulrich Hartmann, CEO of Veba AG). On the one hand, many non-US companies such as Toyota Motor and BP Amoco are also listed on the New York Stock exchange. On the other hand, US companies such as IBM and GM are listed on most European stock exchanges. A management team from Ford took

over Mazda Motor of Japan in 1996. In 1999, capital raised in several countries by Deutsche Bank financed its acquisition of Bankers Trust New York, which had taken over management of overseas clients from Nippon Credit Bank of Japan in 1996.

Companies have pursued international business for many years – in order to expand sales, acquire resources, diversify sources of sales and supplies, and minimize competitive risk. However, they have recently entered an era of unprecedented worldwide production, distribution, and financing due to several factors: expansion of technology, liberalization of cross-border movements, increased global competition, and development of supporting institutional arrangements.

In today's global economy it is not easy to define "a national company," especially a US company. In his recent interview with *The Wall Street Journal*, Edmund Fitzgerald, Chairman of Northern Telecom, said: "My company has its headquarters in Canada, but most of its sales are in the United States. It employs about as many Americans as Canadians. A big chunk of its shares are owned by Americans. Whose company is it anyway?"

In 1993, US government economic officials attempted to prepare papers on the issue and debated it at the National Economic Council. The outcome of these discussions would deeply influence trade and technology policies, ranging from who builds next-generation television sets to US negotiations with Japan. The US government needs a set of guidelines to follow so that government economic officials can handle such questions as: What is an American Company? Whose interests do we advocate?"

The former Labor Secretary, Robert Reich, posed a simple-sounding but fundamental question to US capitalism: "Who is us?" In an age of global business, he asked, do US-owned companies still represent the US?

Mr. Reich argued that American workers should come first because America's standard of living depends primarily on improving worker skills. "American" companies are those that provide high-skill jobs for American workers in America – regardless of whether those companies are owned by American, German, or Japanese shareholders. The flag that flies over a factory or corporate headquarters is less and less relevant, he said.

Not at all, responded chief White House economist Laura Tyson, who said the nationality of a company still largely determines where it will locate the bulk of its sales, production, and research and development. In her paper entitled "They Are Not Us," written before either she or Mr. Reich joined the government, Tyson argued that "the economic fate of nations is still tied closely to the success of their domestically-based corporations."

With the globalization of trade, dumping cases can be difficult. Under American law, only US companies are eligible to bring charges. In case law, though not by statute, the firm is considered to be a US company when half or more of a product is made in the United States. A US subsidiary of a Japanese firm, Brother Industries USA, makes portable electric typewriters in the United States. In 1993, it won a dumping case against Smith-Corona, a US company that makes its typewriters in Singapore.

## Case Questions

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- 1 What are the reasons for recent international business growth?
- 2 What are possible definitions of a US company described in the case?
- 3 Why is it so important to be a US company?
- 4 Explain how Japanese negotiators have cited Mr. Reich's theories in talks with the US over opening the Japanese government procurement market to foreign computer makers (see Reich, 1990, below)?
- 5 Can you guess how Mr. Reich reacted to the fact that the Bush administration helped Toys "R" Us Inc. set up stores in Japan? Do you think that Clinton's Japan team had the same reaction as Mr. Reich's?
- 6 How would Mr. Reich rank companies owned by Americans and/or with US operations?
- 7 The website of the White House, [www.whitehouse.gov](http://www.whitehouse.gov), gives direct access to US Federal services, a virtual library of White House press releases, executive orders, and many other pieces of information. Access the above website to answer the following questions: How and when was the National Economic Council (NEC) created? Who is the current chairman of the NEC? What are the principal functions of the NEC?

*Sources:* D. B., "Clinton Aids Grapple With Definition of a US Company in Global Economy," *The Wall Street Journal*, July 2, 1993. R. B. Reich, "Who Is Us?" *Harvard Business Review*, Jan./Feb., 1990, pp. 53–64. M. Starr, "Who is the Boss? The Globalization of US Employment Law," *Business Lawyer*, May 1996, pp. 635–52.