

CHAPTER 1

MULTINATIONAL FINANCIAL MANAGEMENT: OPPORTUNITIES AND CHALLENGES

1. **Globalization Risks for MNEs.** Was globalization responsible for the slowdown of MNE business during the financial crisis of 2008?

In today's global economy, the process that integrates world trade, links financial markets, and propels cross-border capital flows is called financial globalization. In our globalized world, €4–5 trillion in foreign exchange transactions are made daily, and around €20 trillion of goods and services are traded globally. As much as financial globalization has produced many opportunities for MNEs, it has also introduced new threats. Irresponsible bank lending and credit excesses led to failures of highly leveraged banks and large businesses. The bust credit and sharp economic downturn rapidly spread from the United States and Europe to the rest of the world. Consequently, global purchasing power and consumer confidence dropped round the world, severely impacting sales revenues. MNEs were especially hit, not only because their global sales dropped, but also because much of their excess funds were invested in risky assets.

2. **MNEs and Operation in Global Markets.** What are the factors that affect the decisions of multinational enterprises to operate in global markets?

The main determining factor for operating in a new market is the comparative advantage in terms of cost and rate of productivity of factors of production, better regulations, lower taxation, protectionist trade barriers, stable foreign exchange, and larger markets. Other factors that incentivize foreign investors are savings on transportation costs and the need to regularly adapt to changing local demand.

3. **Eurocurrencies and Eurocurrency Markets.** What are the major eurocurrencies? What is meant by a Eurocurrency market?

A eurocurrency is a freely tradable foreign currency deposited in a domestic bank of a nation that is not the native country issuing this currency. The main eurocurrencies are the US dollar, the euro, the British pound, and the Japanese yen. A eurocurrency market is a money market where financial institutions provide banking services to a variety of individual, corporate, and sovereign customers in eurocurrencies.

4. **Fragility of the Global Financial Marketplace.** How has the global financial crisis exposed the fragility of assets and institutions of the global system?

In the interlocked financial global system, the fragility of assets and institutions led to the eruption of the global financial sector. High risk assets such as derivatives were traded. While initially generated to hedge against risks and create liquidity, many of these derivatives were multi-tiered and highly opaque, making it difficult to assess the inherent risks associated with them. The institutional framework for deregulation and lapse supervision left many financial institutions and instruments unregulated. Moreover, the lack of a global regulatory framework left interbank transactions highly unsupervised. All of these factors—ranging from irresponsible issuance and trading in high risk

assets, poor domestic supervision, and the lack of global regulation of interbank transactions—exposed the fragility of the global financial framework when the global financial crisis erupted.

5. **MNEs and LIBOR.** Most MNEs either take loans in eurocurrencies or issue eurobonds with a floating coupon rate tied to the LIBOR. Explain how MNEs were affected by the LIBOR scandal.

A few large banks were fined and penalized for rigging the benchmark LIBOR rate. While large banks borrowed funds (as was the case during the global financial crisis), they made their quotes below the fair market rate. Regulators often assumed that banks were also trying to benefit their corporate customers, allowing MNEs to issue new eurobonds at lower rates, hence substantially reducing the purchasing power of those holding their bonds.

6. **Post-LIBOR Scandal.** Why do you think the UK government has resolved against the total elimination of LIBOR benchmarks after the scandal?

The London Interbank Offered Rate (LIBOR) is widely used as a benchmark interest rate for hundreds of billions of dollars in financial contracts, corporate loans, and adjustable rate home mortgages and consumer loans. In 2012, the LIBOR scandal was exposed, revealing collusion between and inaccurate interest rate quotes by a dozen large British banks, some of which fraudulently reported their short-term borrowing costs so as to profit from deals. Following the LIBOR scandal, many have called for the total elimination of LIBOR. However, as it remains the one and only pervasive interest rate benchmark, the British government decided against abandoning it and resolved to take measures to save and reform it. The number of LIBOR quotes would drop from 150 to the 20 most important ones. Among the currencies to be phased out are the Australian dollar, Canadian dollar, New Zealand dollar, Danish kroner, and Swedish kroner. Moreover, four of the longer-term maturities would be eliminated. Additionally, all reporting banks are required to submit documentation proving the sources of the rates they are quoting. However, the caveat is that many of the rates would remain unsupported by actual interbank transactions, raising doubts about the accuracy of longer-term LIBOR quotes.

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, 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.

8. Comparative Advantage in the Twenty-First Century. With reference to the theory of comparative advantage, explain how MNEs outsource some services to emerging market economies.

The theory of comparative advantage explains that specific firms or nations may, in comparison to others, have an advantage in producing a particular good or service at a lower relative opportunity cost. This advantage may arise due to differences in factor endowments, technological progress, favorable real exchange rate, protectionism, import controls, etc. Some emerging market economies have shown comparative advantage in the production of low-cost manufactured tangible commodities, hence attracting MNEs' capital inflows. But in the more developed emerging nations that allocate substantial funds to research and innovation, such as India and Malaysia, trade in services has increased five-fold over the last five decades. Accordingly, MNEs have stepped into these nations in order to manufacture high-value and high-tech manufactured goods, and provide IT-knowledge services.

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 in the following two paragraphs.

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 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.”

10. Outsourcing and MNEs. How can global outsourcing enable a firm to become a multinational enterprise?

Some firms have been able to develop comparative advantage in the production of a certain good or the provision of a service. An example is the Indian communications, information technology, and call centers. The high quality of services provided by these firms on a 24/7 basis has enabled these Indian firms to attract worldwide business, turning them into true multinational enterprises over the last decade. The services of these firms are widely used as they reduce the operating expenses of their customer firms round the world.

11. Market Conditions. The decisions of MNEs to move to new markets invariably take advantage of both market imperfections and market efficiencies. Explain.

When they decide to relocate, MNEs first consider market conditions. At one end of the spectrum, if the market conditions are favourable, MNEs would find opportunities in nations that possess cheap inputs, trained or semi-trained affordable labor, large populations with acceptable purchasing power, etc. At the other end of the spectrum, MNEs can also take advantage of market imperfections and loopholes in legislations. For example, MNEs can move into markets where the total absence or weakness of the anti-monopoly law allows MNEs to take up a large market share.

12. Why Go. What 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

13. Investment Motives of Firms. What is the difference between proactive and defensive investment motives?

Proactive investments aim at enhancing the growth, productivity, and profitability of the firm. Defensive investments aim at limiting the growth and profitability of competing firms. In this case, the firm would consider investing in a certain sector or nation in order to limit the growth of its competitors.

14. 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 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 earnings 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.

15. Financial Globalization. Explain the twin agency problems. How do the twin agency problems limit financial globalization?

Despite the reduction in barriers to global investment activity, the twin agency problems have limited the impact of financial globalization. The twin agency problems arise because corporate insiders and the rulers of some nations may pursue their own interests at the expense of outside investors. When these twin agency problems escalate, corporate insiders tend to retain substantial equity (either directly if domestic laws allow or indirectly through collusion with other owners). This could not only lead to capital flight but also to financial crises. This limits economic growth, financial development, and the ability of a country to take advantage of financial globalization.