Ch. 1 Multinational Financial Mgmt: Opportunities and Challenges

Topics

- Global Capital Markets
- Theories of International Business
- Globalization process
  - International trade phase – on the risks and rewards of a business
  - Multinational operations

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Global Capital Markets

- Global capital markets totaled $231 trillion in 2022.
  - Global fixed income markets outstanding decreased 3.2 % Y/Y to $129.8 trillion in 2022, while global long-term fixed income issuance decreased 17.5% to $22.5 trillion.
  - Global equity market capitalization decreased 16.2% Y/Y to $101.2 trillion in 2022, as global equity issuance drops to $0.4 trillion, a decrease of 61.2% Y/Y.
- Links among three items
  - Assets – Government-issued debt securities
  - Institutions – Central banks, Commercial banks, and Other financial institutions
  - Linkages – the interbank networks that provide the actual medium for exchange e.g. LIBOR

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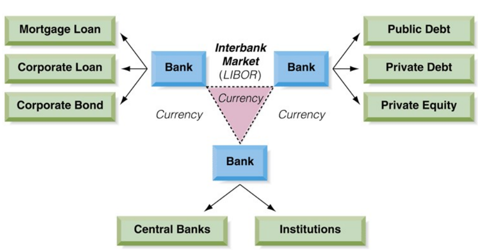
Global Capital Markets

The global capital market is a collection of institutions (central banks, commercial banks, investment banks, not for profit financial institutions like the IMF and World Bank) and securities (bonds, mortgages, derivatives, loans, etc.), which are all linked via a global network — the *Interbank Market*. This interbank market, in which securities of all kinds are traded, is the critical pipeline system for the movement of capital.



The exchange of securities — the movement of capital in the global financial system — must all take place through a vehicle — currency. The exchange of currencies is itself the largest of the financial markets. The interbank market, which must *pass-through* and exchange securities using currencies, bases all of its pricing through the single most widely quoted interest rate in the world — LIBOR (the London Interbank Offer Rate).

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The Multinational Enterprise (MNE)

- Have operations in more than one country
- Include for profit, non-profit firms, and NGOs
- Reliance on emerging markets for growth
- New world markets:
  - BRICs (Brazil, Russia, India, China and South Africa) + From the beginning of 2024, Iran, Saudi Arabia, Egypt, Argentina, the UAE and Ethiopia will join the current five members.
  - BIITS (Brazil, India, Indonesia, Turkey, and South Africa)
  - MINTs (Mexico, Indonesia, Nigeria, and Turkey)

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Globalization and Creating Value in the MNE

- Transnational firms are those with ownership thoroughly dispersed internationally and, as a result, are often managed from a global perspective.
- Multinational firms (MNEs) are those with operations in more than one country. MNEs include for profit, non-profit firms, and NGOs. Today, MNEs rely on emerging markets for raw materials, cheaper labor, and outsourced manufacturing. MNEs also rely on emerging markets for sales and profits.
- Building firm value in a global business requires
  1. An open marketplace
  2. Strategic management
  3. Access to capital

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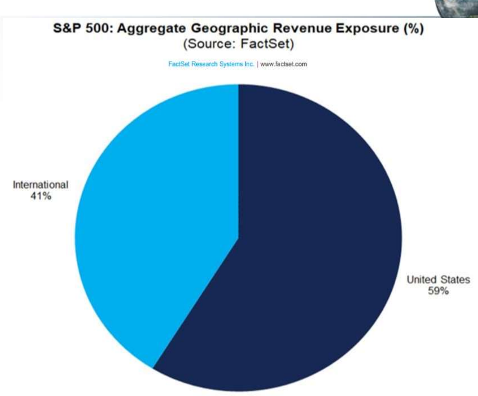
S&P 500 Sales - 2023



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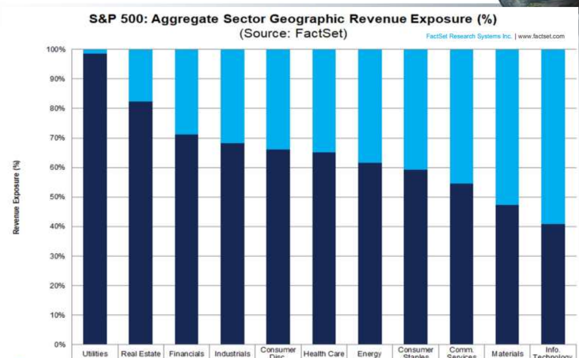
S&P 500 Sales - 2023



	Utilities	Real Estate	Financials	Industrials	Consumer Disc.	Health Care	Energy	Consumer Staples	Comm. Services	Materials	Info. Technology
International	2%	18%	29%	32%	34%	35%	38%	41%	45%	53%	59%
United States	98%	82%	71%	68%	66%	65%	62%	59%	55%	47%	41%

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Theories of International Business

Why are firms motivated to expand their business internationally?

1. Product Cycle Theory
   - As a firm matures, it may recognize additional opportunities outside its home country.
2. Imperfect Markets Theory
   - The markets for the various resources used in production are “imperfect.”
3. Theory of Comparative Advantage
   - Specialization by countries can increase production efficiency.

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International Product Life Cycle

➊ Firm creates product to accommodate local demand. → ➋ Firm exports product to accommodate foreign demand. → ➌ Firm establishes foreign subsidiary to establish presence in foreign country and possibly to reduce costs.

→ ➍a. Firm differentiates product from competitors and/or expands product line in foreign country.

or

→ ➍b. Firm’s foreign business declines as its competitive advantages are eliminated.

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Imperfect Markets: Rationale for the MNE

- MNEs strive to take advantage of imperfections in national markets. These imperfections for products translate into market opportunities such as economies of scale, managerial or technological expertise, financial strength and product differentiation.
- Firms become multinational for one or several of the following reasons:
  1. Market seekers: Produce in foreign markets either to satisfy local demand or export to markets other than their own
  2. Raw material seekers: Search for cheaper or more raw materials outside their own market
  3. Production efficiency seekers: Produce in countries where one or more of the factors of production are cheaper
  4. Knowledge seekers: Gain access to new technologies or managerial expertise
  5. Political safety seekers: Establish operations in countries considered unlikely to expropriate or interfere with private enterprise

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Theory of Comparative Advantage

- The theory of competitive advantage provides a basis for explaining and justifying international trade in a model assumed to enjoy:
  - Free trade
  - Perfect competition
  - No uncertainty
  - Costless information
  - No government interference

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Theory of Comparative Advantage

- The features of the theory are as follows;
  - 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 (land, labor, capital, and technology).
  - Country B does the same with different products (based on different factors of production).

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Theory of Comparative Advantage

- Because the factors of production cannot be transported, the benefits of specialization are realized through international trade.
- The terms of trade, the ratio at which quantities of goods are exchanged, shows the benefits of excess production.
- Neither Country A nor Country B is worse off than before trade, and typically both are better off (albeit perhaps unequally).

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Theory of Comparative Advantage

Example

- Assume Thailand is more efficient than Brazil at producing both sports shoes and stereo equipment.
- With one unit of production (a mix of land, labor, capital, and technology), efficient Thailand can produce either 12 shipping containers of shoes or 6 shipping containers of stereo equipment.
- Brazil, being less efficient in both, can produce only 10 containers of shoes or 2 containers of stereo equipment with one unit of input.

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Theory of Comparative Advantage

- A production unit in Thailand has an absolute advantage over a production unit in Brazil in both shoes and stereo equipment.
- Thailand has a larger relative advantage over Brazil in producing stereo equipment (6 to 2) than shoes (12 to 10).
- As long as these ratios are unequal, comparative advantage exists.

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Theory of Comparative Advantage

- Total world (in this example) production and consumption if there was no trade and if each country completely specialized in one product:

Production if No Trade

	Shoe Production (ctrs)	Stereo Production (ctrs)
Thailand produces and consumes	300 × 12 = 3,600	700 × 6 = 4,200
Brazil produces and consumes	300 × 10 = 3,000	700 × 2 = 1,400
Total world production and consumption	6,600	5,600

Complete Specialization

	Shoe Production (ctrs)	Stereo Production (ctrs)
Thailand produces only stereo equipment		1,000 × 6 = 6,000
Brazil produces only shoes	1,000 × 10 = 10,000	
Total world production and consumption	10,000	6,000

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Theory of Comparative Advantage

- Clearly the world in total is better off because there are now 10,000 containers of shoes (instead of just 6,000), as well as 6,000 containers of stereo equipment (instead of just 5,600). However, the goods are not distributed across international boundaries!
- Trade can resolve that distribution problem.
  - While total production of goods has increased with the specialization process, international trade at a certain range of prices (containers of shoes for a container of stereo equipment) can be distributed between the countries.
  - This exchange ratio will determine how the larger output is distributed.

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Theory of Comparative Advantage

- Trade at Thailand's domestic "Price"

	Shoe Production plus/minus trade (ctrs)	Stereo Production plus/minus trade (ctrs)
Thailand produces 6,000 containers of stereo equipment and exports 1,800 containers	0 + 3,600 = 3,600	6,000 − 1,800 = 4,200
Brazil produces 10,000 containers of shoes and exports 3,600 containers	10,000 − 3,600 = 6,400	0 + 1,800 = 1,800
World production and consumption	10,000	6,000

- Trade at Brazil's domestic "Price"

	Shoe Production plus/minus trade (ctrs)	Stereo Production plus/minus trade (ctrs)
Thailand produces 6,000 containers of stereo equipment and exports 1,400 containers	0 + 7,000 = 7,000	6,000 − 1,400 = 4,600
Brazil produces 10,000 containers of shoes and exports 7,000 containers	10,000 − 7,000 = 3,000	0 + 1,400 = 1,400
World production and consumption	10,000	6,000

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Theory of Comparative Advantage

- Trade at a Price Reached by Free Bargaining

	Shoe Production plus/minus trade (ctrs)	Stereo Production plus/minus trade (ctrs)
Thailand produces 6,000 containers of stereo equipment and exports 1,600 containers	0 + 6,400 = 6,400	6,000 – 1,600 = 4,400
Brazil produces 10,000 containers of shoes and exports 6,400 containers	10,000 – 6,400 = 3,600	0 + 1,600 = 1,600
World production and consumption	10,000	6,000

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Theory of Comparative Advantage: Limitations

- Although international trade might have approached the comparative advantage model during the nineteenth century, it certainly does not today;
  - Countries do not appear to specialize only in those products that could be most efficiently produced by that country's particular factors of production.
  - At least two of the factors of production (capital and technology) now flow easily between countries (rather than only indirectly through traded goods and services).
  - Modern factors of production are more numerous than this simple model.
  - Comparative advantage shifts over time.

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Theory of Comparative Advantage

- Comparative advantage is still, however, a relevant theory to explain why particular countries are most suitable for exports of goods and services that support the global supply chain of both MNEs and domestic firms.
- The comparative advantage of the 21st century, however, is one which is based more on services, and their cross border facilitation by telecommunications and the Internet.

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Global Outsourcing of Comparative Advantage

MNEs based in many industrial countries are outsourcing intellectual functions to providers based in traditional emerging market countries.

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The Globalization Process

- Globalization process:
  - The evolutionary process of firms from domestic to multinational.
  - Structural and managerial changes and challenges experienced by a firm as it moves from domestic to global in operations.
- Global Transition I: Move from the domestic phase to the international trade phase.
- Global Transition II: Move from the international trade phase to the multinational phase.
- Example: Trident, a young firm that manufactures and distributes an array of telecommunication devices.

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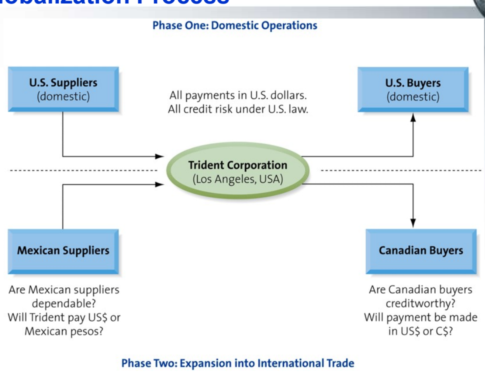
Trident Corp: Initiation of the Globalization Process



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International Trade Phase

- Global Transition I: International Trade Phase
  - Exporting and importing products increases the demands and requirements of a domestic only business.
  - Foreign exchange risks: Trident may have to quote prices and receive payments in foreign currencies. Trident will now experience significant risks from the daily volatility in exchange rates.
  - Credit risk management: Trident also faces risks associated with credit quality and evaluation of international counterparts.

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Multinational Phase

- Global Transition II: The move from the international trade phase to the multinational phase.
  - Trident's continued globalization will require it to identify the sources of it competitive advantages.
  - Trident will eventually need to establish foreign sales and services affiliates.
  - This step is followed by the establishment of manufacturing operations or licensing agreements abroad.
  - Once Trident owns assets and enterprises in foreign countries, it has entered the multinational phase of globalization.
  - The variety of strategic alternatives available to Trident is called the foreign direct investment sequence.

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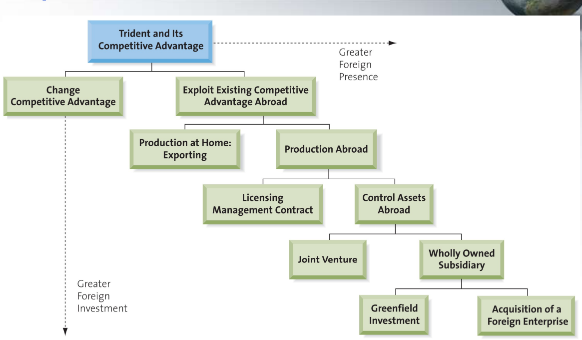
Trident's Foreign Direct Investment Sequence



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What is Different About International Financial Management?

Concept	International	Domestic
Culture, history and institutions	Each foreign country is unique and not always understood by MNE management	Each country has a known base case
Corporate governance	Foreign countries' regulations and institutional practices are all uniquely different	Regulations and institutions are well known
Foreign exchange risk	MNEs face foreign exchange risks due to their subsidiaries, as well as import/export and foreign competitors	Foreign exchange risks from import/ export and foreign competition (no subsidiaries)
Political risk	MNEs face political risks because of their foreign subsidiaries and high profile	Negligible political risks
Modification of domestic finance theories	MNEs must modify finance theories like capital budgeting and cost of capital because of foreign complexities	Traditional financial theory applies
Modification of domestic financial instruments	MNEs utilize modified financial instruments such as options, futures, swaps, and letters of credit	Limited use of financial instruments and derivatives because of fewer foreign exchange and political risks

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Summary

- The evolution of firms from domestic to multinational is called the globalization process. This globalization process results in a firm becoming increasingly influenced by exchange rate movements and other global political and economic forces in general.
- Strategic motives drive the decision to invest abroad and become an MNE. Firms could be seeking new markets, raw materials, production efficiencies, access to technology or political safety.
- Imperfections in national markets for products, factors of production and financial assets translate into market opportunities for MNEs.
- The theory of competitive advantage is based on one country possessing a relative advantage in the production of goods compared to another country.

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