

PART I

The Global Financial Environment

Part I of this text (chapters 1–4) presents an overview of the global financial environment. Chapter 1 develops the goal of the multinational company to be used in the financial decision-making process and examines the role of global finance in achieving this goal. Chapter 2 examines motives for world trade and foreign investment. Before considering foreign trade and foreign investment separately in the coming chapters, we will discuss key trade and investment theories in this chapter. 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.

CHAPTER 1

Introduction

Opening Case 1: TIAA-CREF Goes Global with Corporate Governance

Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF) is one of the largest financial service providers in the world, and has provided a variety of financial services to the faculty and staff of America's education and research communities for more than 80 years. As one of the world's largest institutional investors, TIAA-CREF historically acted on behalf of shareholders to improve the way US companies operate. Now, it is applying this expertise abroad with stock holdings in international companies. With the CREF Stock Account holding more than \$200 billion in net assets and equity investments, TIAA-CREF is one of the largest proactive shareholder activists in the US market. In the past few years, its experienced corporate governance team has expanded efforts to ensure fair representation for shareholders of the international companies whose stock is held in the CREF Stock Account, the CREF Global Equities Account, and CREF's other international investments.

First stop: Western Europe. With international holdings in about 30 countries worldwide, TIAA-CREF has the luxury of starting with any region, but the team picked Western Europe, and for good reasons. TIAA-CREF approaches Western Europe as one economic entity because of the European Union, which makes corporate governance changes easier to initiate on a regional basis than in other parts of the world. "Europe is a market that is ripe for accepting change," says Peter Clapman, TIAA-CREF senior Vice President and Chief Counsel. Although European and US corporations are increasingly similar, European shareholders lack representation – such as in voting rights and disclosure practices. "In many countries, there are companies where there is an absence of one share–one vote for shareholders. And disclosure practices,

such as timely quarterly data, are not as good as in the US," says Clapman. "There is also a lesser degree of accountability to corporate boards."

TIAA-CREF works for generalized, improved European corporate governance standards both on its own and through global organizations. In fact, TIAA-CREF intends to use greater resources in corporate governance programs in Western Europe in order to foster changes in both national policies and in specific companies. Its corporate governance team focuses on issues on a country-by-country basis, meeting with government regulators, stock exchange officers, and company executives. As in its dealings with US companies, TIAA-CREF initially approaches European executives behind the scenes, without much fanfare, to discuss the need to make changes. Respecting cultural differences takes top priority. "We have to be careful that our approach is calibrated to respect their culture, while at the same time making them understand our concerns and appreciate that it is to their benefit to reasonably accommodate our requests," Clapman stated.

Although maintaining cultural sensitivity abroad, TIAA-CREF still files resolutions to seek change on behalf of shareholders if companies ignore its concerns. In France, for example, the government tried to force a company to transfer a percentage of assets for political influence. TIAA-CREF successfully stopped the action by filing a shareholder resolution, which had support from shareholders and others within the country. In another instance, in 2000 an Italian telephone company planned to sell some of its assets at an unreasonably low price to a major corporate shareholder. TIAA-CREF communicated with regulators in Italy and stifled the corporate action.

Clapman believes that corporate governance initiatives will continue to improve in Europe and expand to Asia and Latin America, because countries and companies increasingly recognize that they will not otherwise receive necessary capital from investors. A recent study by the consulting firm McKinsey & Company, in cooperation with the World Bank and Institutional Investor's regional institutes, indicates that investors are willing to pay, on average, a premium of about 20 percent for shares in a well-governed European company. The average varies from 17.9 percent for companies in the United Kingdom to 19.8 percent in France, 20.2 percent in Germany, and 22 percent in Italy. In Asia, the average premium in well-established markets, such as Korea and Japan, is 24.2 percent and 20.2 percent, respectively.

TIAA-CREF's governance team discusses shareholder issues with the International Corporate Governance Network and the Organization for Economic Cooperation and Development, both of which have major European representation. For its part, Western Europe has become receptive to TIAA-CREF's efforts, but "there is still room to grow," says Clapman. "It is two steps forward, one step back, but the momentum is there."

Source: www.tiaa-cref.org.

Globalization stands for the idea of integrating the world marketplace, creating a so-called "borderless world" for goods and services. In addition, to some extent, we already have such a world. Consider physical communications (mail, the telephone, the Internet, and airline and ocean shipping networks); entertainment (film and TV, music, news, and sports); economic and business

exchange (banking and insurance networks, dependable foreign-exchange and stock markets, and reciprocal trade arrangements); and even ideas and competing spiritual values through evangelical Christianity, Islam, and others (Harry 2001).

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 that 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 six 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 that 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 last section gives an overview of the book.

● 1.1 Reasons to Study International Finance

A college student, such as yourself, should study international finance. “I am not an international finance major,” you say. “Why should I have to take a course in international finance?” That is 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

The world has recently 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 mechanisms, 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 rules. 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. In fact, the market reforms of some former communist countries, such as the Czech Republic, Hungary, and Poland, have become so advanced that they were able to join the European Union in 2004.

THE 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. As a result, some countries classified as developing countries until not too long ago – Mexico and South Korea – are now members of the Organization for Economic Cooperation and Development (OECD), which is often called “the rich man’s club” because it consists of 30 of the wealthiest nations in the world.

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 as political, regulatory, technological, and economic forces radically change the global competitive environment. Some of these forces include the collapse of communism, the privatization of state-owned enterprises around the world, the revolution in information technologies, massive deregulation, the adoption of global standards by many developing countries, and the wave of mergers, leveraged buyouts, and takeovers.

Advances in information technologies and reductions in trade barriers have played a particularly important role in the globalization process of the world economy. Reductions in technological barriers have occurred as transportation and communication costs have dropped. “This death of distance” (OECD 1999) facilitates international production activities, enlarges trading areas, and enables companies to exploit international cost differentials. Government-made barriers have also fallen as tariffs and nontariff barriers have been reduced in a series of multilateral negotiations and trading blocs since World War II. These falling technological and government-made barriers have caused trade and foreign direct investment to increase several times faster than world output since 1985.

There are also many examples of the growing importance of international operations for individual companies. Coca Cola, Dow Chemical, ExxonMobile, DaimlerChrysler, Hewlett Packard, IBM, Johnson & Johnson, 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. Nestlé, Philips Electronics, Ford, and IBM have more workers overseas than in their own home countries. In 2002, Nestlé SA, for example, had 245,000 workers overseas compared with only 10,000 workers in its home country, Switzerland.

By the same token, global finance has also become increasingly important as it serves world trade and foreign investment. International earning assets for the Bank of America, 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 that 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 will be seriously handicapped if they do not understand the economic dynamics and policy issues of finance, trade, and investment flows among nations.

Global Finance in Action 1.1

Have the September 11, 2001, Attacks Ended Globalization?

The last great period of globalization ended effectively in 1914, when an act of violence – the assassination of Archduke Ferdinand in Sarajevo – touched off World War I. More than a half-century passed before cross-border trade and investment would again play such a prominent role in the global economy. After the September 11 attacks against the World Trade Center in New York and the Pentagon in Washington, DC, economists worried that the year 2001 would go down in history as another high-water mark in an era of globalization. Recession, security concerns at home, and resentment abroad seemed to neutralize forces that drove America's search for new markets and cheap supplies overseas during the 1990s.

A survey in November 2001 of 171 business executives at large US multinational companies by PricewaterhouseCoopers found that their commitment to international expansion rose after the September 11 attacks. Twenty-seven percent of the respondents planned some form of geographical expansion during the year ahead, up 19 percent before the attacks. Starbucks Corp., for example, opened more than 70 international stores between the end of September and the end of November, an 8 percent increase. Dell Computer Corp., meanwhile, picked up market share abroad, although Gateway retreated.

Furthermore, policy-makers have generally moved toward free trade since September 11, 2001. China, the world's most populous nation, has officially entered the World Trade Organization. In Doha, Qatar, 142 nations agreed in November 2001 to start a new round of talks to lower trade barriers. In addition, the US Congress voted to extend to President George W. Bush "fast track" authority to negotiate trade

deals that lawmakers can approve or disapprove but cannot amend. The very same forces that drove globalization during the 1990s signal no turning back on the road to “a borderless world.”

Source: Jon E. Hilsenrath, “Globalization Persists in Precarious New Age,” *The Wall Street Journal*, Dec. 31, 2001, p. 1A.

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 Euro Disneyland. 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 that confront 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. The setting of priorities by 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 USA and the UK. 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 should strive 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 2003).

1.2.2 *The 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 that 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 large MNCs, such as General Electric and the Royal Dutch/Shell Group, can invest their 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 Citigroup, the world's largest bank in 2003, cannot acquire its funds from 200 countries. Nevertheless, MNCs can still raise their funds in many countries thanks to recent financial globalization. This financial 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 that 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 the 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 as strategic planner is emerging. 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 headhunters 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.

● 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, privatiza-

tion of state-owned businesses and banks, and the growing economic power of the global triad – Asia, the USA, and Europe (Baker 1997). There are approximately 60,000 multinational companies in the world with 500,000 foreign affiliates. These multinational companies and their foreign affiliates account for roughly 25 percent of global output, one third of it in host countries (*The Economic Report of the President to Congress* 2004). 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 USA, 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) multi-domestic 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 is no global company by that definition (see *Global Finance in Action* 1.2).

Global Finance in Action 1.2

Is Globalization Myth or Reality?

The answer to this question depends on whether you look at globalization in tangible terms (i.e., production and trade volumes) or in intangible terms (i.e., information and knowledge). Professor Alan R. Rugman, at Indiana University in Bloomington, Indiana, argues that multinational business enterprises (MNEs) – which are the agents of international business – largely operate within their home-based markets in each part of the “triad” of North America, the European Union, and Japan/Asia. Empirical evidence suggests that even the 20 most “international” MNEs (those with the highest ratio of foreign-to-total sales) are mainly home-triad based in their activities.

Globalization has been defined in business schools as producing and distributing goods and services of a homogeneous type and quality on a worldwide basis – simply put, providing the same output to countries everywhere. To back up their claims, some analysts often point to the fact that foreign sales account for more than 50 percent of the annual revenues of companies such as Dow Chemical, ExxonMobile, and IBM. Accurate as they may be, those figures do not explain that most of sales of “global” companies are made on a “triad” regional basis. For example, more than 85 percent of all automobiles produced in North America are built in North American factories; over 90 percent of the cars produced in the EU are sold there; and more than 93 percent of all cars registered in Japan are manufactured domestically. The same holds true for specialty chemicals, steel, energy, transportation, and heavy electrical equipment. Furthermore, MNEs cannot develop homogeneous products for world markets or dominate local markets no matter how efficient production techniques are. MNEs have to adapt their products for the local market. For example, there is no worldwide, global car. Rather, there are regionally based American, European, and Japanese factories that are supported by local regional suppliers.

“Rugman’s perspective is based on homogeneity of markets and comparative advantage concepts whereby commodity and unskilled labor markets are major drivers of world trade and commerce,” Professor Paul Simmons, at Florida State University in Tallahassee, Florida, points out. “Unfortunately, this perspective is more suited to trade concepts of the 18th and 19th centuries where economists argued the value of absolute and comparative advantage.” Market homogeneity is not the major determinant of globalization; it is market interdependency. Supply and demand imbalances create linkages between markets. A standardized product or service in all markets is only one of several options available to satisfy those linkages. A definition of globalization that focuses on the ability of firms to leverage certain resources and compete in worldwide markets suggests that globalization does exist in interdependent markets.

Global branding is an illustrative example. Whether franchising or product branding, firms seek interconnectivity throughout their competitive domains to leverage their intangible assets. Everyone is familiar with McDonald’s. Strict control of key

operational aspects in food preparation and delivery are consistent globally despite varied additions to menu offerings that accommodate local tastes and customs. McDonald's expects customer experiences in any of its locations to generate certain expectations between locations because of its brand identity. Thus, the interdependence of knowledge and information among the various locations are circuitous to McDonald's competitive success. The most relevant definition of globalization, therefore, is the ability to transfer information and knowledge globally. Products and services may be produced, delivered, and traded on a regional basis, but global diffusion of knowledge makes this possible. Globalization exists because bits and bytes – that is, process knowledge and other intangible assets – can be transferred globally at minimal costs. The result is greater integrated trade flows.

Sources: Alan M. Rugman, "Multinational enterprises are regional, not global," *Multinational Business Review*, Spring 2003, pp. 3–12; Alan M. Rugman, "The myth of global strategy," *AIB Newsletter*, Second Quarter 2001, pp. 11–14; and Paul Simmonds, "Globalization: another viewpoint," *AIB Newsletter*, Second Quarter 2001, pp. 15–16.

1.3.3 *The performance of multinational companies*

Evidence indicates that US MNCs earn more money as they boost their presence in foreign markets. In 1974, for example, *Business International* reported that 90 percent of 140 Fortune 500 companies surveyed achieved higher profitability on foreign assets. This trend continued into the 1990s, but the percentage of those companies with higher profitability on foreign assets has declined in recent years (Ball et al. 2004). The US Department of Commerce found that the return on assets for nonfinancial US MNCs has exceeded the return on assets for all US non-financial companies from 1989 to 2003, but that the excess of the return on assets for US MNCs over the return on assets for US domestic companies has declined since 1991. Apparently, the cost and competition drivers to globalization have reduced the differences between overseas and home-country profits, but all analysts predict that US MNCs will earn more money than US domestic companies for years to come.

Foreign-based companies with a higher degree of international business have also experienced superior performance in recent years. Foreign-owned companies in the world's most highly developed countries are generally more productive and pay their workers more than comparable locally owned businesses, according to the Organization for Economic Cooperation and Development (OECD). The Paris-based organization also says that the proportion of the manufacturing sector under foreign ownership in European Union countries rose substantially during the 1990s, a sign of increasing economic integration. The finding underlines the increasing importance in the world economy of large companies with bases scattered across the globe. Gross output per employee, a measure of productivity, in most OECD countries, tends to be greater in multinational companies than in locally owned companies (Marsh 2002). 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

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 that you may 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.

1.4.1 *The risk–return trade-off*

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

The risk–return trade-off 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 1.1 shows how the financial manager assesses the various risk–return trade-offs available and incorporates them into the wealth maximization goal. Given the risk–return trade-offs, various financial decisions are made to maximize stockholder wealth. Practically all financial decisions involve such trade-offs. Such decisions include foreign-exchange risk management, global reporting and controlling, global financing decision, and global investment decision.

An investor's risk–return trade-off 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 trade-offs.

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 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 possible revenue opportunities 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 trade-off than a domestic company.

Figure 1.2 shows that international business pushes out the opportunity set, thus allowing MNCs to reduce risk, increase return, or attain both. As shown in figure 1.2, we can think of three possible cases in which 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.

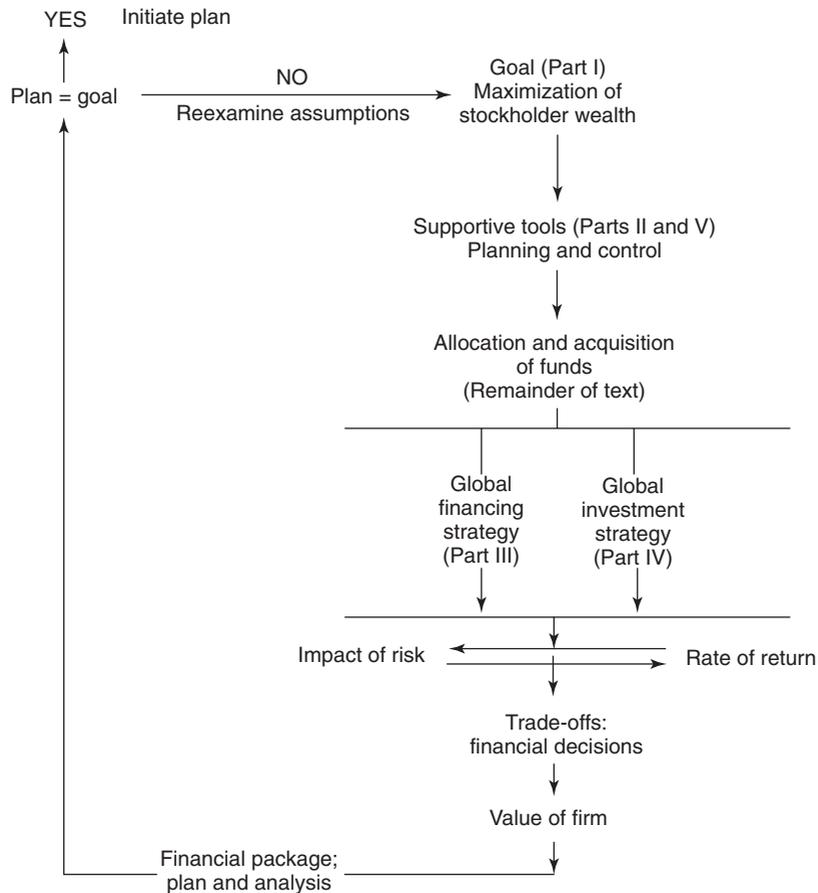


Figure 1.1 An integrated decision-making model in global finance

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 a condition, 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 the 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 the international

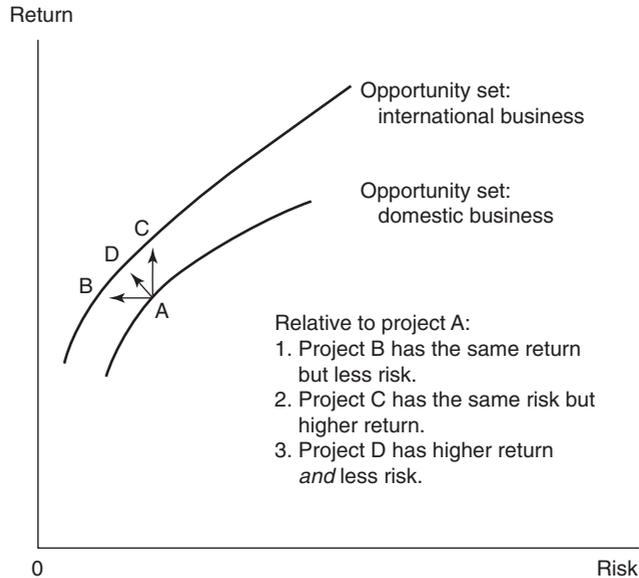


Figure 1.2 Expanded opportunity set for international business

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, have established automobile transplants in the USA to avoid US trade restrictions.

1.4.3 *The 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 Nestlé of Switzerland, have operations in countries as varied as the USA, 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, such as the USA 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 and the Americans are 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 USA 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 USA. Comparative advantage states that trade between the two countries – the USA exporting software and China exporting shoes – can boost living standards in both. This is because the USA 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 *The 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**, and they 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 and adopted the euro as its common currency in 1999, they 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 allows 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, 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 rate of returns 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 versus 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 carried out 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*

Few issues in the literature and in practice on corporate finance have received as much attention in recent years as corporate governance. In the USA and in other countries, there is new interest in how firms' decision-making structures are organized, the priorities of these structures, and the structures' effect on shareholders. **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 & Starks 1998). In the USA, corporate governance has evolved from a system with a few yet 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 anti-takeover 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 Any activity by an investor that tries to change the status quo through voice, without the control of the company, is known as **shareholder activism**. The voice reflected in the most common form of shareholder activism covers a broad spectrum of activities, such as a shareholder proposal for 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 & Titman 1998). In addition, as one corporate scandal after another broke in 2002, President George W. Bush signed into law the Sarbanes–Oxley Act on July 30, 2002, which would likely reduce agency problems (Nofsinger & Kim 2003).

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 layoff existing managers.

Second, these days many companies partially compensate their executives with stock options that 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 past two decades. These holdings have grown from approximately 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.

Fourth, a series of recent accounting scandals at companies such as Enron and WorldCom compelled the government to introduce a host of new laws and regulations so that managers may not pursue their own private interests at the expense of shareholders. For example, the Public Company Accounting Reform and Investor Protection Act of 2002, otherwise known as the Sarbanes–Oxley Act, sets up a new overseeing body to regulate auditors, creates new laws to increase corporate responsibility, and increases punishments for corporate white-collar criminals. The Act establishes a nonprofit organization called the Public Company Accounting Oversight

Board to oversee the audit of public companies and to protect the accuracy of audit reports. These and other reforms introduced after recent corporate scandals are expected to strengthen US corporate governance practices.

NATIONAL DIFFERENCES IN CORPORATE GOVERNANCE Although national legal systems in industrialized countries share many common elements, laws for corporate governance have notable differences. The UK and the USA are often viewed as prototypes of a market-oriented financial system (the AS model), whereas Continental Europe (France and Germany) and Japan are generally regarded as typical representatives of a bank- or relationship-based system (the 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. 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 would satisfy their respective stockholders.

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 USA, Japanese banks can hold common stock up to 5 percent of a company’s shares. In addition, the large cross-holdings of Japanese firms make corporate decision-making heavily influenced by close personal relationships between top executives, who sit on each other’s boards of directors. Individual shareholders have little voice and this results in relatively low return on capital.

● 1.6 Environmental Differences

From a financial manager’s point of view, what are the differences between MNCs and domestic companies? 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. However, these two types of companies 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 that 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 that 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 that cross national boundaries add dimensions of risk that are rarely confronted in domestic business operations. Ideally, a company should analyze these risks to understand their underlying causal forces, so that the company may 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 that 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 operate in several international environments. These environmental diversities require different concepts, analytic methods, and information. Therefore, 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

This book has five major parts. Part I (chapters 1–4) 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 goal of an MNC and the basics of international finance.

Part II (chapters 5–10) 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 11–14) 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 15–20) 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.

SUMMARY

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 manager's 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 trade-off, market imperfections, the portfolio effect, 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, 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 conditions of a perfect market than under conditions of an imperfect market?
- 7 Global companies can become so well known throughout the world that they lose their association with any single country. Can you match the following companies with the location of their headquarters?

1 Xerox	A Atlanta, Georgia, USA
2 Royal Philips Electronics	B Ludwigshafen, Germany
3 ABB	C Montreal, Canada
4 BASF	D Ludvika, Sweden
5 Alcan Aluminum	E Stamford, Connecticut, USA
6 Nestlé	F Eindhoven, the Netherlands
7 Coca Cola	G Vevey, Switzerland
- 8 What are the two major sets of external forces that are causing fundamental change in financial management?
- 9 Explain why management should focus on stockholder wealth maximization.
- 10 What is corporate governance? What are the changes that have 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 we all 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, distrib-

ution, and financing due to several factors: expansion of technology, liberalization of cross-border movements, increased global competition, and the 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?" and "Whose interests do they advocate?"

When Labor Secretary Robert Reich was an academic, he 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 USA?

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 that 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 USA. A US subsidiary of a Japanese firm, Brother Industries USA, makes portable electric typewriters in the USA. In 1993, it won a dumping case against Smith-Corona, a US company that makes its typewriters in Singapore.

Case Questions

- 1 What are the reasons for the recent growth in international business?
- 2 What are the 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 USA over opening the Japanese government procurement market to foreign computer makers (see Reich 1990).

- 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 President 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/, gives direct access to US Federal services, a virtual library of the 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; and M. Starr, "Who Is the Boss? The Globalization of US Employment Law," *Business Lawyer*, May 1996, pp. 635–52.