PART I
ENVIRONMENT OF INTERNATIONAL FINANCIAL MANAGEMENT
What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage.

Adam Smith (1776)

CHAPTER LEARNING OBJECTIVES

● To understand the nature and benefits of globalization.
● To explain why multinational corporations are the key players in international economic competition today.
● To understand the motivations for foreign direct investment and the evolution of multinational corporations (MNCs).
● To identify the stages of corporate expansion overseas by which companies gradually become MNCs.

KEY TERMS

absolute advantage  international diversification
comparative advantage  internalization
competitive advantage  internationalization
creative destruction  investment decision
economies of scale  investment flows
efficient market  licensing
foreign direct investment (FDI)  market efficiency
global economy  market imperfections
global manager  multinational corporation (MNC)
globalization  terms of trade [from appendix]
global-scanning capability
A key theme of this book is that companies today operate within a global marketplace and can ignore this fact only at their peril. The internationalization of finance and commerce has been brought about by the great advances in transportation, communications, and information processing technology. This development introduces a dramatic new commercial reality—the global market for standardized consumer and industrial products on a previously unimagined scale. It places primary emphasis on the one great thing all markets have in common: the overwhelming desire for dependable, world-class products at aggressively low prices. The international integration of markets also introduces the global competitor, making firms insecure even in their home markets.

The transformation of the world economy has dramatic implications for business. American management, for example, is learning that the United States can no longer be viewed as a huge economy that does a bit of business with secondary economies around the world. Rather, the United States is merely one economy, albeit a very large one, that is part of an extremely competitive, integrated world economic system. To succeed, U.S. companies need great flexibility; they must be able to change corporate policies quickly, as the world market creates new opportunities and challenges. Big Steel, which was virtually the antithesis of this modern model of business practice, paid the price for failing to adjust to the transformation of the world economy. Similarly, non-U.S. companies are finding that they must increasingly turn to foreign markets to source capital and technology and sell their products.

Today’s financial reality is that money knows no national boundary. The dollar has become the world’s central currency, with billions switched at the flick of an electronic blip from one global corporation to another, from one central bank to another. The international mobility of capital has benefited firms by giving them more financial options, while at the same time complicating the job of the chief financial officer by increasing its complexity.

Because we operate in an integrated world economy, all students of finance should have an international orientation. Indeed, rarely does a company today, in any country, not have a supplier, competitor, or customer located abroad. Moreover, its domestic suppliers, competitors, and customers likely have their own foreign choices as well. Thus, a key aim of this book is to help you bring to bear on key business decisions a global perspective, manifested by questions such as, where in the world should we locate our plants? which global market segments should we seek to penetrate? and where in the world should we raise our finances? The right answers to these questions would help a manager make decisions that utilize resources from around the world in order to operate efficiently and effectively, obtain superlative performance, and achieve competitive advantage in an increasingly competitive business world.

In this world-oriented corporation, a person’s passport is not the criterion for promotion. Nor is a firm’s citizenship a critical determinant of its success. Success depends on a new breed of businessperson: the global manager. In a world in which change is the rule and not the exception, the key to international competitiveness is the ability of management to adjust to change and volatility at an ever faster rate. In the words of General Electric’s former Chairman Jack Welch, I’m not here to predict the world. “I’m here to be sure I’ve got a company that is strong enough to respond to whatever happens.”

The rapid pace of change means that new global managers need detailed knowledge of their operations. Global managers must know how to make the products, where the raw materials and parts come from, how they get there, the alternatives, where the funds come from, and what their changing relative values do to the bottom line. They must also

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understand the political and economic choices facing key nations and how those choices will affect the outcomes of their decisions.

In making decisions for the global company, managers search their array of plants in various nations for the most cost-effective mix of supplies, components, transport, and funds. All this is done with the constant awareness that the options change and the choices must be made again and again.

The problem of constant change disturbs some managers. It always has. But today's global managers have to anticipate it, understand it, deal with it, and turn it to their company's advantage. The payoff to thinking globally is a quality of decision making that enhances the firm's prospects for survival, growth, and profitability.

1.1 Globalization and its Consequences

During the past three decades, fundamental political, technological, regulatory, and economic forces have radically changed the global competitive environment. A brief list of some of these forces would include the following:

- Massive deregulation;
- The collapse of Communism;
- The sale of hundreds of billions of dollars of state-owned firms around the world in massive privatizations designed to shrink the public sector;
- The revolution in information technologies;
- The rise in the market for corporate control with its waves of takeovers, mergers, leveraged buyouts, and private equity transactions;
- The jettisoning of statist policies and their replacement by free-market policies in many Third World nations; and
- The unprecedented number of nations submitting themselves to the exacting rigors and standards of the global marketplace.

These forces have combined to usher in an era of brutal price and service competition. The United States is further along than other nations in adapting to this new world economic order, largely because its more open economy has forced its firms to confront rather than hide from competitors. Facing vicious competition at home and abroad, U.S. companies, including such corporate landmarks as IBM, General Motors, Walt Disney, Xerox, American Express, Coca-Cola, and Kodak, have been restructuring and investing heavily in new technologies and marketing strategies to boost their productivity and expand their markets. In addition, the United States has gone further than any other industrialized country in deregulating its financial services, telecommunications, airlines, and trucking industries. The result: Even traditionally sheltered U.S. industries have become far more competitive in recent years, and so has the U.S. workforce. The heightened competitiveness of U.S. firms has in turn compelled European and Japanese rivals to undergo a similar process of restructuring and renewal.

1.1.1 Criticism and Consequences of Globalization

Yet despite the many advantages of operating in a world economy, many powerful interest groups feel threatened by globalization and have fought it desperately. Politicians and labor leaders, unlike corporate leaders, usually take a more parochial view of globalization. Many instinctively denounce local corporations that invest abroad as job “exporters,” even though most welcome foreign investors in their own countries as job
creators. However, many U.S. citizens today view the current tide of American asset sales to foreign companies as a dangerous assault on U.S. sovereignty. They are unaware, for example, that foreign-owned companies account for more than 20% of industrial production in Germany and more than 50% in Canada, and neither of these countries appears to have experienced the slightest loss of sovereignty. Regardless of their views, however, the global rationalization of production will continue, as it is driven by global competition. The end result will be higher living standards brought about by improvements in worker productivity and private sector efficiency.

The economic purpose of free trade is to allocate resources to their highest valued use. This process is not painless. Like technological innovation, globalization unleashes the forces of creative destruction, a process described by economist Joseph Schumpeter more than 50 years ago. Schumpeter’s oft-repeated phrase conveys the essence of capitalism: continuous change—out with the old, in with the new. When competing for customers, companies adopt new technologies, improve production methods, explore new markets, and introduce new and better products. In this constantly churning world, some industries advance, others recede, jobs are gained and lost, businesses boom and go bust, some workers are forced to change jobs and even occupations. But the process of globalization creates more winners than losers. Consumers clearly benefit from lower prices and expanded choice. But workers and businesses overall also benefit from doing things that they are best suited for and by having new job and investment opportunities. The end result is economic progress, with economies emerging from the turmoil more efficient, more productive, and wealthier.

Ultimately, the consequences of globalization are an empirical issue. If the anti-free traders were right, the United States, with one of the most liberal trading regimes in the world and facing intense competitive pressure from low-cost imports across a range of industries, would be losing jobs by the millions. Instead, as Exhibit 1.1 shows, 

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2 The importance of foreign investment in the United States is indicated by a few facts: Four of America’s six major music labels are now foreign-owned, Goodyear is the last major American-owned tire manufacturer; in 2006, Japanese auto companies had the capacity to build 4.3 million cars a year in their U.S. plants, over 25% of the total in a typical sales year; four of Hollywood’s largest film companies are foreign-owned; and in July 1995, Zenith, the last of the 21 American-owned, companies manufacturing televisions in the United States was purchased by the South Korean firm LG Group.
the United States created over 45 million jobs since 1980, when the competitive pressure from foreign imports intensified dramatically. The unemployment rate also fell during this period, from 7.2% in 1980 to 4.5% in 2006. Moreover, according to the foes of globalization, intensifying competition from low-cost foreign workers is driving down average worker compensation (wages and benefits) in the United States, both in absolute terms and also relative to foreign workers. Once again, the facts are inconsistent with the claims. Exhibit 1.2 shows that U.S. worker compensation has steadily risen and it shows why. The answer is productivity: As output per hour (the standard measure of worker productivity) has gone up so has inflation-adjusted worker compensation. The key to higher compensation, therefore, is increased productivity, not trade protectionism. In fact, increased trade leads to higher productivity and, therefore, higher average wages and benefits. Moreover, Exhibit 1.3 shows that over time the income advantage Americans enjoy relative to the world overall has risen not fallen, from 5.4 in 1970 to 6.7 in 2006. These empirical facts point to a larger reality: Globalization is not a zero-sum game, where for some to win others must lose. Instead, international trade and investment expand the total economic pie, enabling nations to get richer together.
The share of workers employed in manufacturing in the United States has declined steadily since 1960, from 26% then to about 10.8% in 2006. It is an article of faith among protectionists that these manufacturing jobs have been lost to low-cost labor in China, India, Mexico, Brazil, and the rest of the developing world. According to the doomsayers, the answer to these job losses and the hollowing out of American industry is protectionism.

The truth turns out to be more complex. In fact, manufacturing jobs are disappearing worldwide. A study of employment trends in 20 economies found that between 1995 and 2002, more than 22 million factory jobs disappeared. Moreover, the United States...
has not even been the biggest loser. As Exhibit 1.5 shows, the distinction goes to Brazil, which lost almost 20% of its manufacturing jobs during that period. China, the usual villain, saw a 15% drop. In fact, the real culprit is higher productivity.

All over the world, factories are becoming more efficient. With new equipment, better technology, and better manufacturing processes factories can turn out more products employing fewer workers. Indeed, between 1995 and 2002, factory production worldwide jumped by 30% even as factory employment fell by 11%. In the United States, even as millions of factory jobs were lost, factory output has more than doubled in the past 30 years. Indeed, despite China being acclaimed as the new workshop of the world, the United States remains the world’s largest manufacturer. Because of its higher productivity, the United States manufactures twice as many goods as China even though China has around six times as many manufacturing workers.

Manufacturing is being transformed the same way that farming was. In 1910, one out of every three American workers was a farmer. By 2000, with the advent of tractors and other technology, it was less than one in 33 even as U.S. food output has increased dramatically. As such, postponing the expiration date of some U.S. manufacturing jobs through protectionist policies diverts resources from new, growing industries toward keeping dying U.S. industries alive for a little while longer.

It is also important to distinguish between the outsourcing of manufacturing and the outsourcing of the value added associated with manufactured products. Consider, for example, the wireless mouse named Wanda sold by Logitech International SA, a Swiss-American company headquartered in California. The mice are made in Suzhou, China, and sold to American consumers for around $40. As Exhibit 1.6 shows, of this amount, Logitech takes about $8, distributors and retailers take around $15, and parts suppliers get $14. China’s take from each mouse is just $3, which must cover wages, power, transport, and other overhead costs. Indeed, Logitech’s Fremont, California, marketing staff of 450 earns far more than the 4,000 Chinese workers in Suzhou.4

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A multinational corporation (MNC) is a company engaged in producing and selling goods or services in more than one country. It ordinarily consists of a parent company located in the home country and at least five or six foreign subsidiaries, typically with a high degree of strategic interaction among the units. Some MNCs have upward of 100 foreign subsidiaries scattered around the world. The United Nations Conference on Trade and Development (UNCTAD) estimated in its World Investment Report for 2006 that at least 77,000 companies around the world can be classified as multinational. These parent companies, and their estimated 770,000 foreign affiliates, generated about $4.5 trillion in value added, employed 62 million people, and exported goods and services valued at more than $4 trillion in 2005.5

What differentiates the multinational enterprise from other firms engaged in international business is the globally coordinated allocation of resources by a single centralized management. MNCs make decisions about market-entry strategy; ownership of foreign operations; and design, production, marketing, and financial activities with an eye to what is best for the corporation as a whole. A true MNC emphasizes group performance rather than the performance of its individual parts. For example, in 2003, Whirlpool Corporation launched what it billed as the world’s cheapest washing machine, with an eye on low-income consumers who never thought they could afford one. Whirlpool designed and developed the Ideale washing machine in Brazil, but it manufactures the Ideale in China and India, as well as Brazil, for sale in those and other developing countries.

Exhibit 1.6: How Logitech’s $40 Mouse is Dissected

1.2 The Rise of the Multinational Corporation

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Every year, *Fortune* publishes a list of the most admired U.S. corporations. Year in and year out, most of these firms are largely multinational in philosophy and operations. In contrast, the least admired tend to be national firms with much smaller proportions of assets, sales, or profits derived from foreign operations. Although multinationality and economic efficiency do not necessarily go hand in hand, international business is clearly of great importance to a growing number of U.S. and non-U.S. firms. The list of large American firms that receive 50% or more of their revenues from abroad and that have a sizable fraction of their assets abroad reads like a corporate *Who’s Who*: General Electric, Apple Computer, Procter & Gamble, IBM Corp., Colgate-Palmolive, Coca-Cola Co., Nike Inc., Hewlett-Packard Co., McDonald’s Corp., ExxonMobil Corp., Avon Products Inc., and 3M. In 2006, General Electric obtained 87% of its revenues from outside the U.S.

Industries differ greatly in the extent to which foreign operations are of importance to them. For example, oil companies and banks are far more heavily involved overseas than are tobacco companies and automakers. Even within industries, companies differ in their commitment to international business. For example, in 2006, ExxonMobil had 69.1% of its sales, 70.8% of its assets, and 71.6% of its profits abroad. The corresponding figures for Valero, the largest refiner in North America, were 12%, 13%, and 7.5%. Similarly, General Motors generated 37.8% of its revenues overseas, in contrast to the 49.3% of revenues from overseas operations for Ford. Other examples of the importance of foreign operations to U.S. business are shown in Exhibit 1.7.

The degree of internationalization of the American economy is often surprising. For example, Hollywood’s revenues from foreign markets have been increasing in the past decade, with more films in recent years grossing upwards of $200 million from foreign markets alone. The film industry illustrates other dimensions of internationalization as well, many of which are reflected in *Total Recall*, a film that was made by a Hungarian-born producer and a Dutch director, starred an Austrian-born leading man (now the governor of California) and a Canadian villain, was shot in Mexico, and was distributed by a Hollywood studio owned by a Japanese firm.

Exhibit 1.8 provides further evidence of the growing internationalization of American business. It shows that overseas investment by U.S. firms and U.S. investment by foreign firms are in the hundreds of billions of dollars each year. Foreign direct investment by foreign firms is a large fraction of their total investment, and foreign direct investment by American firms is a large fraction of their total investment. The extent of internationalization of American business is a testament to the fact that the United States is a major player in the global economy.

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### Exhibit 1.7: Selected Large U.S. Multinationals

<table>
<thead>
<tr>
<th>Fortune 2007 Rank</th>
<th>Foreign Revenue ($ billions)</th>
<th>Foreign Revenue (% of total)</th>
<th>Foreign Assets ($ billions)</th>
<th>Foreign Assets (% of total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Electric</td>
<td>1</td>
<td>$77.8</td>
<td>87.0%</td>
<td>$310.5</td>
</tr>
<tr>
<td>Apple Computer</td>
<td>7</td>
<td>$10.8</td>
<td>53.6%</td>
<td>$1.5</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>9</td>
<td>$23.5</td>
<td>44.2%</td>
<td>$18.8</td>
</tr>
<tr>
<td>Procter &amp; Gamble</td>
<td>10</td>
<td>$38.8</td>
<td>56.8%</td>
<td>$60.3</td>
</tr>
<tr>
<td>Goldman Sachs Group</td>
<td>11</td>
<td>$17.3</td>
<td>45.9%</td>
<td>N/A</td>
</tr>
<tr>
<td>Microsoft</td>
<td>12</td>
<td>$14.6</td>
<td>32.9%</td>
<td>$0.8</td>
</tr>
<tr>
<td>3M</td>
<td>14</td>
<td>$14.1</td>
<td>61.4%</td>
<td>$2.5</td>
</tr>
<tr>
<td>American Express</td>
<td>17</td>
<td>$8.8</td>
<td>32.3%</td>
<td>$48.2</td>
</tr>
<tr>
<td>PepsiCo</td>
<td>19</td>
<td>$13.0</td>
<td>36.9%</td>
<td>$11.3</td>
</tr>
<tr>
<td>Wal-Mart Stores</td>
<td>19</td>
<td>$77.1</td>
<td>22.3%</td>
<td>$56.0</td>
</tr>
</tbody>
</table>


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investment (FDI) is the acquisition abroad of companies, properties or physical assets such as plant and equipment. The stock of FDI by U.S. companies reached $2.05 trillion in 2005 while direct investment by foreign companies in the United States exceeded $1.625 trillion that year.\(^7\) Worldwide, the stock of FDI reached $10.1 trillion in 2005, as shown in Exhibit 1.9. Moreover, these investments have grown steadily over time,
facilitated by a combination of factors: falling regulatory barriers to overseas investment; rapidly declining telecommunications and transport costs; and freer domestic and international capital markets in which vast sums of money can be raised, companies can be bought, and currency and other risks can be hedged. These factors have made it easier for companies to invest abroad, to do so more cheaply, and to experience less risk than ever before.

1.2.1 Rationale for Multinational Corporations

Based in part on the development of modern communications and transportation technologies, the rise of the multinational corporation was unanticipated by the classical theory of international trade as first developed by Adam Smith and David Ricardo. According to this theory, which rests on the doctrine of comparative advantage, each nation should specialize in the production and export of those goods that it can produce with highest relative efficiency and import those goods that other nations can produce relatively more efficiently.

Underlying this theory is the assumption that goods and services can move internationally but factors of production, such as capital, labor, and land, are relatively immobile. Furthermore, the theory deals only with trade in commodities—that is, undifferentiated products; it ignores the roles of uncertainty, economies of scale, transportation costs, and technology in international trade; and it is static rather than dynamic. Despite all these defects, however, it is a valuable theory, and it still provides a well-reasoned theoretical foundation for free-trade arguments (see Appendix 1A). But
the growth of the MNC can be understood only by relaxing the traditional assumptions of classical trade theory.

Classical trade theory implicitly assumes that countries differ enough in terms of resource endowments and economic skills for those differences to be at the center of any analysis of corporate competitiveness. Differences among individual corporate strategies are considered to be of only secondary importance; a company’s citizenship is the key determinant of international success in the world of Adam Smith and David Ricardo.

This theory, however, is becoming increasingly irrelevant to the analysis of businesses in the countries currently at the core of the world economy—the United States, Japan, the nations of Western Europe, and to an increasing extent, the most successful East Asian countries. Within this advanced and highly integrated core economy, differences among corporations are becoming more important than aggregate differences among countries. Furthermore, the increasing capacity of even small companies to operate in a global perspective makes the old analytical framework even more obsolete.

Not only are the “core nations” more homogeneous than before in terms of living standards, lifestyles, and economic organization, but their factors of production tend to move more rapidly in search of higher returns. Natural resources have lost much of their previous role in national specialization as advanced, knowledge-intensive societies move rapidly into the age of artificial materials and genetic engineering. Capital moves around the world in massive amounts practically at the speed of light; increasingly, corporations raise capital simultaneously in several major markets. Labor skills in these countries no longer can be considered fundamentally different; many of the students enrolled in American business schools are foreign, while training has become a key dimension of many joint ventures between international corporations. Technology and know-how are also rapidly becoming a global pool, with companies like Microsoft, General Electric, Morgan Stanley, Electronic Data Systems, Cisco Systems, McKinsey & Co., and IBM shifting software writing, accounting, engineering, and other skilled services to countries like India and China.

Against this background, the ability of corporations of all sizes to use these globally available factors of production is a far bigger factor in international competitiveness than broad macroeconomic differences among countries. The very existence of the multinational enterprise is based on the international mobility of certain factors of production. Capital raised in London on the Eurodollar market may be used by a Swiss-based pharmaceutical firm to finance the acquisition of German equipment by a subsidiary in Brazil. A single Barbie doll is made in 10 countries—designed in California, with parts and clothing from Japan, China, Hong Kong, Malaysia, Indonesia, Korea, Italy, and Taiwan, assembled in Mexico—and sold in 144 countries. Information technology also makes it possible for worker skills to flow with little regard to borders. In the semiconductor industry, the leading companies typically locate their design facilities in high-tech corridors in the United States, Japan, and Europe. Finished designs are transported quickly by computer networks to manufacturing plants in countries with more advantageous cost structures. In effect, the traditional world economy in which products are exported has been replaced by one in which value is added in several different countries.

The movement and deployment of factors of production across borders, and therefore, the rise of the multinational corporation, may be prompted by several considerations, including the search for the best production locations in terms of cost-efficiency, or the best markets in terms of profitability. Below are some of the major reasons for the evolution of MNCs.

**Search for Raw Materials** Raw-material seekers were the earliest multinationals, the villains of international business. They were the firms—the British, Dutch, and French
East India Companies, the Hudson’s Bay Trading Company, and the Union Miniere Haut-Katanga—that first grew under the protective mantle of the British, Dutch, French, and Belgian colonial empires. Their aim was to exploit the raw materials that could be found overseas. The modern-day counterparts of these firms, the multinational oil and mining companies, were the first to make large foreign investments, beginning in the early years of the twentieth century. Hence, large oil companies such as British Petroleum and Standard Oil, which went where the dinosaurs died, were among the first true multinationals. Hard-mineral companies such as International Nickel, Anaconda Copper, and Kennecott Copper were also early investors abroad.

**Market Seeking**  The market seeker is the archetype of the modern multinational firm that goes overseas to produce and sell in foreign markets. Examples include IBM, Volkswagen, and Unilever. Similarly, branded consumer-products companies such as Nestlé, Levi Strauss, McDonald’s, Procter & Gamble, and Coca-Cola have been operating abroad for decades and maintain vast manufacturing, marketing, and distribution networks from which they derive substantial sales and income.

While foreign markets may be attractive in and of themselves, MNCs possess certain firm-specific advantages, which may include unique products, processes, technologies, patents, specific rights or specific knowledge, and skills. MNCs find that the advantages that were successfully applied in domestic markets can also be profitably used in foreign markets. Firms such as Wal-Mart, Toys ’R’ Us, and Price/Costco take advantage of unique process technologies, largely in the form of superior information gathering, organizational, and distribution skills, to sell overseas.

The exploitation of additional foreign markets may be possible at considerably lower costs. For example, after developing a drug successfully, pharmaceutical companies enter several markets, obtain relevant patents and permissions, and begin marketing the product in several countries within a short period of time. Marketing of the product in multiple countries enables the pharmaceutical company to extract revenues from multiple markets and therefore, cover the high costs of drug development in a shorter period of time as compared to marketing within a single country.

In some industries, foreign market entry may be essential for obtaining economies of scale, or the unit cost decreases that are achieved through volume production. Firms in industries characterized by high fixed costs relative to variable costs must engage in volume selling just to break even. These large volumes may be forthcoming only if the firms expand overseas. For example, companies manufacturing products such as computers that require huge R&D expenditures often need a larger customer base than that provided by even a market as large as the United States in order to recapture their investment in knowledge. Similarly, firms in capital-intensive industries with enormous production economies of scale may also be forced to sell overseas in order to spread their overhead over a larger quantity of sales.

L.M. Ericsson, the Swedish manufacturer of telecommunications equipment, is an extreme case. The manufacturer is forced to think internationally when designing new products because its domestic market is too small to absorb the enormous R&D expenditures involved and to reap the full benefit of production scale economies. Thus, when Ericsson developed its revolutionary AXE digital switching system, it geared its design to achieve global market penetration.

Some companies, such as Coca-Cola, McDonald’s, Nestlé, and Procter & Gamble, take advantage of enormous advertising expenditures and highly developed marketing skills to differentiate their products and keep out potential competitors that are wary of the high marketing costs of new-product introduction. Expansion into emerging markets enables these firms to enjoy the benefits of economies of scale as well as exploit
the premium associated with their strong brand names. Companies such as Nestle and Procter & Gamble expect sales of brand-name consumer goods to soar as disposable incomes rise in developing countries in contrast to the mature markets of Europe and the United States. The costs and risks of taking advantage of these profitable growth opportunities are also lower today now that their more free-market-oriented governments have reduced trade barriers and cut regulations. In response, foreign direct investment in emerging markets by multinationals has soared over the past decade (see Exhibit 1.10).

Cost Minimization Over time, if competitive advantages in product lines or markets gets eroded due to local and global competition, MNCs seek and enter new markets with little competition or seek out lower production cost sites through their global-scanning capability. Costs can then be minimized by combining production shifts with rationalization and integration of the firm’s manufacturing facilities worldwide. This strategy usually involves plants specializing in different stages of production, for example, in assembly or fabrication, as well as in particular components or products.

Necessary complements to the integration of worldwide operations are flexibility, adaptability, and speed. Indeed, speed has become one of the critical competitive weapons in the fight for world market share. The ability to develop, manufacture, and distribute products or services quickly enables companies to capture customers who demand constant innovation and rapid, flexible response. Exhibit 1.11 illustrates the combination of globally integrated activities and rapid response times of Dell Inc., which keeps not more than 2 hours of inventory in its plants, while sourcing for components across the globe and assembling built-to-order computers for its customers within 5 days.

One strategy that is often followed by firms for which cost is the key consideration is to develop a global-scanning capability to seek out lower-cost production sites or production technologies worldwide. In fact, firms in competitive industries have to continually seize new, nonproprietary, cost-reduction opportunities, not to earn excess returns but to make normal profits and survive.
Honda and other automakers attempting to break into Asia’s small but potentially fast-growing auto markets face a problem: it is tough to start small. Automakers need big volumes to take full advantage of economies of scale and justify the cost of building a modern car plant. But outside of Japan and China, few Asian countries offer such scale. Companies such as General Motors and Ford are relying on an export strategy in all but the largest Asian markets to overcome this hurdle GM, for example, exports cars throughout Asia from a large plant in Thailand. However, the success of an export strategy depends on Asian countries fully embracing free trade, something that may not happen soon. Honda has decided to follow a different strategy. It is essentially building a car factory that spans all of Asia, putting up plants for different components in small Asian markets all at once: a transmission plant in Indonesia, engine-parts manufacturing in China, and other components operations in Malaysia. Honda assembles cars at its existing plants in the region. Its City subcompact, for example, is assembled in Thailand from parts made there and in nearby countries. By concentrating production of individual components in certain countries, Honda expects to reap economies of scale that are unattainable by setting up major factories in each of the small Asian markets. A sharp reduction in trade barriers across Asia that took effect in 2003 has made it easier for Honda to trade among its factories in Asia. Nonetheless, Asian countries are expected to still focus on balancing trade so that, in any given nation, an increase in imports is offset by an increase in exports. If so, Honda’s web of Asian manufacturing facilities could give it an advantage over its rivals in avoiding trade friction.

Cost minimizer is a fairly recent category of firms doing business internationally. These firms seek out and invest in lower cost production sites overseas (for example, Hong
Kong, Taiwan, and Ireland) to remain cost-competitive both at home and abroad. Many of these firms are in the electronics industry. Examples include Texas Instruments, Intel, and Seagate Technology. Increasingly, companies are shifting services overseas, not just manufacturing work. For example, as of June 2007, GE has about 13,000 employees in India to handle local market sales, software operations, accounting, claims processing, customer service, and sourcing of components for GE’s global manufacturing locations. Similarly, companies such as AOL (customer service), American Express (finance and customer service), and British Airways (accounting) have set up call centers and are shifting work to countries such as India, Jamaica, Hungary, Morocco, and the Philippines for savings of up to 60%.

The offshoring of services can be done in two ways: internally, through the establishment of wholly owned foreign affiliates, or externally, by outsourcing a service to a third-party provider. Exhibit 1.12 categorizes and defines different variants of offshoring and outsourcing.

<table>
<thead>
<tr>
<th>Location of Production</th>
<th>Internalized</th>
<th>Internalized or Externalized Production</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home Country</td>
<td>Production kept in-house at home</td>
<td>Production outsourced to third-party service provider at home.</td>
</tr>
<tr>
<td>Foreign Country</td>
<td>Production by foreign affiliate, e.g., Infineon’s center in Dublin, DHL’s IT center in Prague, British Telecom’s call centers in Bangalore and Hyderabad</td>
<td>Production outsourced to third-party provider abroad To local company e.g., Bank of America’s outsourcing of software development to Infosys in India To Foreign affiliate of another MNC e.g., A U.S. company outsourcing data processing services to ACS in Ghana</td>
</tr>
</tbody>
</table>

**EXHIBIT 1.12 • OFFSHORING AND OUTSOURCING: SOME DEFINITIONS**

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**MINI-CASE The Debate Over Outsourcing**

In early 2004, White House economist Gregory Mankiw had the misfortune of stating publicly what most economists believe privately—that outsourcing of jobs is a form of international trade and is good for the U.S. economy because it allows Americans to buy services less expensively abroad. Critics of outsourcing immediately called on President Bush to fire Dr. Mankiw for being insensitive to workers who have lost their jobs. It is obvious to these critics that outsourcing, exporting white-collar American jobs to foreign countries, is a major cause of U.S. unemployment. Related criticisms are that outsourcing costs the U.S. good jobs and is a one-way street, with the U.S. outsourcing jobs to foreign countries and getting nothing in return.

These critics fail to see the other side of the coin. First, outsourcing increases U.S. productivity and enables U.S. companies to realize net cost savings on the order of 30 to 50%. Through outsourcing, a firm can cut its costs while improving its quality, time-to-market, and capacity to innovate, and use the abilities of its remaining workers in other, more productive tasks, thereby making it more competitive. Second, it will come as a real surprise to most critics that far more private services are outsourced by foreigners to the United States than away from it. In other words, just as U.S. firms use the services of foreigners, foreign firms make even greater use of the services of U.S. residents. Private
services include computer programming, management consulting, engineering, banking, telecommunications, legal work, call centers, data entry, and so on. Exhibit 1.13 shows that in 2006, for example, U.S. firms bought about $114 billion of those services from foreigners but the value of the services Americans sold to foreigners was far higher, over $177 billion, resulting in a trade surplus in private services of about $63 billion. Lastly, outsourced jobs are responsible for less than 1% of unemployment. Recent estimates are that white-collar outsourcing costs the United States about 100,000 jobs each year.\footnote{See, for example, Jon E. Hilsenrath, “Behind Outsourcing Debate: Surprisingly Few Hard Numbers,” \textit{The Wall Street Journal}, April 12, 2004, A1.} In contrast, the U.S. economy loses an average of 15 million jobs annually. However, those jobs are typically replaced by even more jobs, with about 17 million new jobs created each year.\footnote{These estimates appear in “Trade and Jobs,” Remarks by Governor Ben S. Bernanke at the Distinguished Speaker Series, Fuqua School of Business, Duke University, Durham, North Carolina, March 30, 2004.}

This creation of new jobs and workers’ ability to move into them are the hallmarks of a flexible economy—one in which labor and capital move freely among firms and industries to where they can be most productive. Such flexibility is a significant strength of the U.S. economy and results in higher productivity, which is the only way to create higher standards of living in the long run. Protectionism would only diminish that flexibility. Rather, the focus should be on increasing flexibility, which means improving the performance of the U.S. education system and encouraging the entrepreneurship and innovation that give the United States its competitive edge.

\textbf{Questions}

1. What are the pros and cons of outsourcing?
2. How does outsourcing affect U.S. consumers and producers?
3. What is the likely long-term impact of outsourcing on American jobs?
4. Several states are contemplating legislation to ban outsourcing of government work to foreign firms. What would be the likely consequences of such legislation?

\textbf{EXHIBIT 1.13  \textit{* More Work is Outsourced to the United States than Away from It \textit{}}}

Knowledge Seeking Some firms enter foreign markets to gain information and experience that are expected to prove useful elsewhere. For instance, Beecham, an English firm (now part of GlaxoSmithKline), deliberately set out to learn from its U.S. operations how to be more competitive, first in the area of consumer products and later in pharmaceuticals. This knowledge proved highly valuable in competing with American and other firms in its European markets.

The flow of ideas is not all one-way, however. As Americans have demanded better-built, better-handling, and more fuel-efficient small cars, Ford of Europe has become an important source of design and engineering ideas and management talent for its U.S. parent, notably with the hugely successful Taurus.

In industries characterized by rapid product innovation and technical breakthroughs by foreign competitors, it is imperative to track overseas developments constantly. Japanese firms excel here, systematically and effectively collecting information on foreign innovation and disseminating it within their own research and development (R&D), marketing, and production groups. The analysis of new foreign products as soon as they reach the market is an especially long-lived Japanese technique. One of the jobs of Japanese researchers is to tear down a new foreign product and analyze how it works as a base on which to develop a product of their own that will outperform the original. In a bit of a switch, Data General's Japanese operation is giving the company a close look at Japanese technology, enabling it to quickly pick up and transfer back to the United States new information on Japanese innovations in the areas of computer design and manufacturing.

Keeping Domestic Customers Suppliers of goods or services to multinationals often will follow their customers abroad in order to guarantee them a continuing product flow. Otherwise, the threat of a potential disruption to an overseas supply line—for example, a dock strike or the imposition of trade barriers—can lead the customer to select a local supplier, which may be a domestic competitor with international operations. Hence, comes the dilemma: Follow your customers abroad or lose not only their foreign but also their domestic business. A similar threat to domestic market share has led many banks, advertising agencies, and accounting, law, and consulting firms to set up foreign practices in the wake of their multinational clients' overseas expansion.

Exploiting Financial Market Imperfections An alternative explanation for foreign direct investment relies on the existence of financial market imperfections. The ability to reduce taxes and circumvent currency controls may lead to greater project cash flows and a lower cost of funds for the MNC than for a purely domestic firm.

An even more important financial motivation for FDI is likely to be the desire to reduce risks through international diversification. This motivation may be somewhat surprising because the riskiness inherent in the multinational corporation is usually taken for granted. Exchange rate changes, currency controls, expropriation, and other forms of government intervention are some of the risks that purely domestic firms rarely, if ever, encounter. Thus, the greater a firm's international investment, the riskier its operations should be.

Yet, there is good reason to believe that being multinational may actually reduce the riskiness of a firm. Much of the systematic or general market risk affecting a company is related to the cyclical nature of the national economy in which the company is domiciled. Hence, the diversification effect due to operating in a number of countries whose economic cycles are not perfectly in phase should reduce the variability of MNC earnings. Several studies indicate that this result, in fact, is the case. Thus, because foreign cash

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13 See, for example, Benjamin I. Cohen, Multinational Firms and Asian Exports (New Haven, Conn.: Yale University Press, 1975); and Alan Rugman, “Risk Reduction by International Diversification,” Journal of International Business Studies, Fall 1976, pp. 75–80.
flows generally are not perfectly correlated with those of domestic investments, the greater riskiness of individual projects overseas can well be offset by beneficial portfolio effects. Furthermore, because most of the economic and political risks specific to an MNC are unsystematic, they can be eliminated through diversification.

1.3 The Process of Overseas Expansion by Multinationals

Studies of corporate expansion overseas indicate that firms become multinational by degree, with FDI being a late step in a process that begins with exports. For most companies, the globalization process does not occur through conscious design, at least in the early stages. It is the unplanned result of a series of corporate responses to a variety of threats and opportunities appearing at random abroad. From a broader perspective, however, the globalization of firms is the inevitable outcome of the competitive strivings of members of oligopolistic industries. Each member tries both to create and to exploit monopolistic product and factor advantages internationally while simultaneously attempting to reduce the competitive threats posed by other industry members.

To meet these challenges, companies gradually increase their commitment to international business, developing strategies that are progressively more elaborate and sophisticated. The sequence normally involves exporting, setting up a foreign sales subsidiary, securing licensing agreements, and eventually establishing foreign production. This evolutionary approach to overseas expansion is a risk-minimizing response to operating in a highly uncertain foreign environment. By internationalizing in phases, a firm can gradually move from a relatively low-risk, low-return, export-oriented strategy to a higher risk, higher return strategy emphasizing international production. In effect, the firm is investing in information, learning enough at each stage to improve significantly its chances for success at the next stage. Exhibit 1.14 depicts the usual sequence of overseas expansion.

1.3.1 Exporting

Firms facing highly uncertain demand abroad typically will begin by exporting to a foreign market. The advantages of exporting are significant: Capital requirements and start-up costs are minimal, risk is low, and profits are immediate. Furthermore, this initial step provides the opportunity to learn about present and future supply and demand conditions, competition, channels of distribution, payment conventions, financial institutions, and financial techniques. Building on prior successes, companies then expand their marketing organizations abroad, switching from using export agents and other intermediaries to dealing directly with foreign agents and distributors. As increased communication with customers reduces uncertainty, the firm might set up its own sales subsidiary and new service facilities, such as a warehouse, with these marketing activities culminating in the control of its own distribution system.

EXHIBIT 1.14 • TYPICAL FOREIGN EXPANSION SEQUENCE
1.3.2 Overseas Production

A major drawback to exporting is the inability to realize the full sales potential of a product. By manufacturing abroad, a company can more easily keep itself abreast of market developments, adapt its products and production schedules to changing local tastes and conditions, fill orders faster, and provide more comprehensive after-sales service. Many companies also set up R&D facilities along with their foreign operations; they aim to pick the best brains, wherever they are. The results help companies keep track of the competition and design new products. For example, the Japanese subsidiary of Loctite, a U.S. maker of engineering adhesives, devised several new applications for sealants in the electronics industry.

Setting up local production facilities also shows a greater commitment to the local market, a move that typically brings added sales and provides increased assurance of supply stability. Certainty of supply is particularly important for firms that produce intermediate goods for sale to other companies. A case in point is SKF, the Swedish ball-bearing manufacturer. It was forced to manufacture in the United States to guarantee that its product, a crucial component in military equipment, would be available when needed. The Pentagon would not permit its suppliers of military hardware to be dependent on imported ball bearings because imports could be halted in wartime and are always subject to the vagaries of ocean shipping.

Thus, most firms selling in foreign markets eventually find themselves forced to manufacture abroad. Foreign production covers a wide spectrum of activities from repairing, packaging, and finishing to processing, assembly, and full manufacture. Firms typically begin with the simpler stages, for example, packaging and assembly, and progressively integrate their manufacturing activities backward—to production of components and subassemblies.

Because the optimal entry strategy can change over time, a firm must continually monitor and evaluate the factors that bear on the effectiveness of its current entry strategy. New information and market perceptions change the risk-return trade-off for a given entry strategy, leading to a sequence of preferred entry modes, each adapted on the basis of prior experience to sustain and strengthen the firm’s market position over time.

Associated with a firm’s decision to produce abroad is the question of whether to create its own affiliates or to acquire going concerns. A major advantage of an acquisition is the capacity to effect a speedy transfer overseas of highly developed but underutilized parent skills, such as a novel production technology. Often the local firm also provides a ready-made marketing network. This network is especially important if the parent is a late entrant to the market. Many firms have used the acquisition approach to gain knowledge about the local market or a particular technology. The disadvantage is the cost of buying an ongoing company. In general, the larger and more experienced a firm becomes, the less frequently it uses acquisitions to expand overseas. Smaller and relatively less-experienced firms often turn to acquisitions.

Regardless of its preferences, a firm interested in expanding overseas may not have the option of acquiring a local operation. Michelin, the French manufacturer of radial tires, set up its own facilities in the United States because its tires are built on specially designed equipment; taking over an existing operation would have been out of the question. Similarly, companies moving into developing countries often find they are forced to begin from the ground up because their line of business has no local counterpart.

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14 Once that equipment became widespread in the industry, Michelin was able to expand through acquisition which it did in 1989, when it acquired Uniroyal Goodrich.
1.3.3 Licensing

An alternative, and at times a precursor, to setting up production facilities abroad is to license a local firm to manufacture the company's products in return for royalties and other forms of payment. The principal advantages of licensing are the minimal investment required, faster market-entry time, and fewer financial and legal risks. But the corresponding cash flow is also relatively low, and there may be problems in maintaining product quality standards. The licensor may also face difficulty controlling exports by the foreign licensee, particularly when, as in Japan, the host government refuses to sanction restrictive clauses on sales to foreign markets. Thus, a licensing agreement may lead to the establishment of a competitor in third-country markets, with a consequent loss of future revenues to the licensing firm. The foreign licensee may even become such a strong competitor that the licensing firm will face difficulty entering the market when the agreement expires, leading to a further loss of potential profits.

For some firms, licensing alone is the preferred method of penetrating foreign markets. Other firms with diversified innovative product lines follow a strategy of trading technology for both equity in foreign joint ventures and royalty payments.

1.3.4 Trade-offs Between Alternative Modes of Overseas Expansion

There are certain general circumstances under which each approach, exporting, licensing, or local production, will be the preferred alternative for exploiting foreign markets.

Multinationals often possess intangible capital in the form of trademarks, patents, general marketing skills, and other organizational abilities. If this intangible capital can be embodied in the form of products without adaptation, then exporting generally will be the preferred mode of market penetration. Where the firm's knowledge takes the form of specific product or process technologies that can be written down and transmitted objectively, then foreign expansion usually will take the licensing route.

Often, however, this intangible capital takes the form of organizational skills that are inseparable from the firm itself. A basic skill involves knowing how best to service a market through new product development and adaptation, quality control, advertising, distribution, after-sales service, and the general ability to read changing market needs and translate them into salable products. Because it would be difficult, if not impossible, to unbundle these services and sell them apart from the firm, the firm would attempt to exert control directly via the establishment of foreign affiliates. However, internalizing the market for an intangible asset by setting up foreign affiliates makes economic sense if, and only if, the benefits from circumventing market imperfections outweigh the administrative and other costs of central control.

A useful means to judge whether a foreign investment is desirable is to consider the type of imperfection that an investment is designed to overcome. Internalization, and hence FDI, is most likely to be economically viable in those settings where the possibility of contractual difficulties make it especially costly to coordinate economic activities via arm's-length transactions in the marketplace.

Such “market failure” imperfections lead to both vertical and horizontal direct investment. Vertical integration—direct investment across industries that are related to different stages of production of a particular good—enables the MNC to substitute internal production and distribution systems for inefficient markets. For instance, vertical

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integration might allow a firm to install specialized cost-saving equipment in two locations without the worry and risk that facilities may be idled by disagreements with unrelated enterprises. **Horizontal direct investment**—investment that is cross-border but within an industry—enables the MNC to utilize an advantage such as know-how or technology and avoid the contractual difficulties of dealing with unrelated parties. Examples of contractual difficulties are the MNC's inability to price know-how or to write, monitor, and enforce use restrictions governing technology-transfer arrangements. Thus, FDI makes most sense when a firm possesses a valuable asset and is better off directly controlling the use of the asset rather than selling or licensing it.

### 1.4 Theme and Organization of the Book

Although all functional areas can benefit from a global perspective, this book concentrates on developing financial policies that are appropriate for a multinational firm. The main objective of multinational financial management is to maximize shareholder wealth as measured by share price. This means making financing and investment decisions that add as much value as possible to the firm. It also means that companies must manage effectively the assets under their control.

The focus on shareholder value stems from the fact that shareholders are the legal owners of the firm and management has a fiduciary obligation to act in their best interests. Although other stakeholders in the company do have rights, these are not coequal with the shareholders' rights. Shareholders provide the risk capital that cushions the claims of alternative stakeholders. Companies that build shareholder value also find it easier to attract equity capital. Equity capital is especially critical for companies that operate in a riskier environment and for companies that are seeking to grow.

This book considers the links between financial management and other functional areas. Financial management is traditionally separated into two basic functions: the acquisition of funds and the investment of those funds. The first function, also known as the **financing decision**, involves generating funds from internal sources or from sources external to the firm at the lowest long-run cost possible. The **investment decision** is concerned with the allocation of funds over time in such a way that shareholder wealth is maximized. Many of the concerns and activities of multinational financial management, however, cannot be categorized so neatly.

Internal corporate fund flows such as loan repayments often are undertaken to access funds that are already owned, at least in theory, by the MNC itself. Other flows, such as dividend payments, may take place to reduce taxes or currency risk. Capital structure and other financing decisions frequently are motivated by a desire to reduce investment risks as well as financing costs. Furthermore, exchange risk management involves both the financing decision and the investment decision. Throughout this book, therefore, the interaction between financing and investment decisions is stressed because the right combination of these decisions is the key to maximizing the value of the firm to its shareholders.

This book also concentrates on the development of analytical approaches to deal with the major environmental problems and decisions involving overseas investment and financing. In carrying out these financial policies, however, conflicts between corporations and nation-states will inevitably arise. Therefore, this book also examines the modifications to financial policies that may be necessary for better alignment with national objectives in an effort to reduce such conflicts.

Financial executives in MNCs face many factors that have no domestic counterparts. These factors include exchange and inflation risks; international differences in tax rates; multiple money markets, often with limited access; currency controls; and political risks, such as sudden or creeping expropriation.
In summary, this book emphasizes the many opportunities associated with being multinational without neglecting the corresponding risks.

This book is divided into five parts:

- Part I: Environment of International Financial Management
- Part II: Foreign Exchange and Derivatives Markets
- Part III: Foreign Exchange Risk Management
- Part IV: Foreign Markets and Investments
- Part V: Financing and Controlling Multinational Operations

The following sections briefly discuss these parts and their chapters.

1.4.1 Environment of International Financial Management

Part I examines the environment in which international financial decisions are made. Chapter 2 in Part I discusses the basic factors that affect currency values. It also explains the basics of central bank intervention in foreign exchange markets, including the economic and political motivations for such intervention. Chapter 3 describes the international monetary system and shows how the choice of system affects the determination of exchange rates. Chapter 4 is crucial because it introduces five key equilibrium relationships among inflation rates, interest rates, and exchange rates in international finance that form the basis for much of the analysis in the remainder of the book. Chapter 5 analyzes the balance of payments and links between national economies.

1.4.2 Foreign Exchange and Derivatives Markets

Part II explores the foreign exchange and derivative markets used by multinational corporations to manage their currency and interest rate risks. Chapter 6 describes the foreign exchange market and how it functions. Foreign currency futures and options contracts are discussed in Chapter 7. Chapter 8 analyzes interest rate and currency swaps, interest rate forwards and futures, and how these derivatives can be used to manage risk.

1.4.3 Foreign Exchange Risk Management

Part III discusses foreign exchange risk management, a traditional area of concern that is receiving even more attention today. Chapter 9 discusses the likely impact that an exchange rate change will have on a firm (its exposure) from an accounting perspective and then analyzes the costs and benefits of alternative financial techniques to hedge against those exchange risks. Chapter 10 examines exposure from an economic perspective and presents marketing, logistic, and financial policies to cope with the competitive consequences of currency changes. As part of the analysis of economic exposure, the relationship between inflation and currency changes and its implications for corporate cash flows is recognized.

1.4.4 Foreign Markets and Investment

Part IV analyzes the foreign investment decision process. Chapter 11 discusses the subject of country risk analysis, the assessment of the potential risks and rewards associated with making investments and doing business in a foreign country. Chapter 12 describes the alternative external, medium- and long-term debt financing options available to a multinational corporation, with a special focus on eurocurrency and eurobond markets. Chapter 13 begins by discussing the nature and consequences of international portfolio investing—the purchase of foreign stocks and bonds. Chapter 14 presents techniques for evaluating foreign investment proposals, emphasizing how to adjust cash flows for the
1.4 THEME AND ORGANIZATION OF THE BOOK

various political and economic risks encountered abroad, such as inflation, currency fluctuations, and expropriations. It also discusses how companies can manage political risks by appropriately structuring the initial investment and making suitable modifications to subsequent operating decisions.

1.4.5 Financing and Controlling Multinational Operations

Part V examines topics related to managing an MNCs finances. Chapter 15 covers international financing decisions, including trade financing and short-term financing. Chapter 16 describes the mechanisms available to an MNC to shift funds and profits among its various units, while considering the tax and other consequences of these maneuvers. The aim of these maneuvers is to create an integrated global financial planning system.

Questions

1. Explain how globalization may affect even a small business in your local area.
2. Opponents of globalization and outsourcing argue that locating manufacturing activities abroad causes a loss of U.S. jobs. However, when total employment figures are tallied, it is found that rather than a net loss of jobs, employment has actually increased. Also, the average wages of workers has also increased. How would you account for this discrepancy between what the critics say and what statistics reveal?
3. Elaborate on the benefits of a proactive approach to globalization and global competition.
4. What are the various reasons for the emergence of multinational firms?
5. Given the added political and economic risks that appear to exist overseas, are multinational firms more or less risky than purely domestic firms in the same industry? Consider whether a firm that decides not to operate abroad is insulated from the effects of economic events that occur outside the home country.
6. How is the nature of IBM's competitive advantages related to its becoming a multinational firm?
7. If capital markets were perfect, that is, capital could move freely across national borders, would MNCs still exist? Why? Or, why not?
8. What are the various ways in which domestic firms enter international markets? What are the benefits and risks of each strategy of foreign market entry?
9. Why do firms from each of the following categories become multinational? Identify the competitive advantages that a firm in each category must have to be a successful multinational.
   a. Raw-materials seekers
   b. Market seekers
   c. Cost minimizers
10. What factors help determine whether a firm will export its output, license foreign companies to manufacture its products, or set up its own production or service facilities abroad? Identify the competitive advantages that lead companies to prefer one mode of international expansion over another.
11. Time Warner is trying to decide whether to license foreign companies to produce its films and records or to set up foreign sales affiliates to sell its products directly. What factors might determine whether it expands abroad via licensing or by investing in its own sales force and distribution network?

Internet Resources


Chapter 1 • Introduction: Multinational Enterprise and Multinational Financial Management


http://www.economist.com Web site of The Economist. Contains stories on the economic and political situations of countries and international business developments, along with various national and international economic and financial data.


http://fisher.osu.edu/fin/fdl/osudata.htm Web site run by the Finance Department of Ohio State University. Contains a detailed listing of and links to many different Web sites related to finance and economics.

http://www.census.gov/ Contains the International Data Base (IDB), which is a computerized data bank with statistical tables of demographic, and socioeconomic data for 227 countries and areas of the world.

http://www.economy.com/dismal/ Covers over 65 economic releases from over 15 countries. Also contains numerous stories dealing with international finance and economics.

http://www.reportgallery.com Web site that contains links to annual reports of over 2,200 companies, many of which are multinationals.


Internet Exercises

1. Who are the major trading partners of the United States? Which countries are the top five exporters to the United States? Which countries are the top five importers of U.S. goods? Good references are the WTO site and the BEA site.

2. Who are the major recipients of U.S. overseas investment? Which countries are the major sources of foreign investment in the United States? A good reference is the BEA site.

3. Go to the Web sites of companies such as the ones listed below and examine their international business activity. For example, what importance do these companies appear to place on international business? What percentage of sales revenues, assets, and income do these companies derive from their foreign operations? What percentage of their sales and income comes from exports? Is their foreign activity increasing or decreasing? How many countries and continents do these companies operate on? Which countries are listed as locations of the company's foreign
subsidiaries? What is the headquarters country of each company? Much of this information can be gleaned from the annual reports of the companies, which can be found at http://www.reportgallery.com.

Ford Motor Company
Walt Disney Company
General Electric
DaimlerChrysler
Philips Electronics
Unilever
IBM
Sony
Nestlé
Microsoft
Coca-Cola
ExxonMobil

4. Based on your review of The Economist, the Wall Street Journal, and the Financial Times, which countries appear to be giving foreign investors concerns? What are these concerns?

5. Visit the Bureau of Labor Statistics website at http://www.bls.gov. What are the sectors that have added the most jobs in the period 1990 to 2005?

6. Visit the website of Dell Inc. (www.dell.com). From the home page, visit Dell's site for three other countries. What similarities and differences do you see in the products, prices and other details when comparing the various country sites? How would you account for these similarities and differences?

APPENDIX 1A

THE ORIGINS AND CONSEQUENCES
OF INTERNATIONAL TRADE

Underlying the theory of international trade is the doctrine of comparative advantage. This doctrine rests on certain assumptions:

- Exporters sell undifferentiated (commodity) goods and services to unrelated importers.
- Factors of production cannot move freely across countries. Instead, trade takes place in the goods and services produced by these factors of production.

As noted at the beginning of Chapter 1, the doctrine of comparative advantage also ignores the roles of uncertainty, economies of scale, and technology in international trade; and it is static rather than dynamic. Nonetheless, this theory helps to explain why nations trade with each other, and it forms the basis for assessing the consequences of international trade policies.

To illustrate the main features of the doctrine of comparative advantage and to distinguish this concept from that of absolute advantage, suppose the United States and the United Kingdom produce the same two products, wheat and coal, according to the following production schedules, where the units referred to are units of production (labor, capital, land, and technology). These schedules show how many units it costs to produce each ton in each country.\(^{17}\)

<table>
<thead>
<tr>
<th></th>
<th>Wheat</th>
<th>Coal</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>2 units/ton</td>
<td>1 unit/ton</td>
</tr>
<tr>
<td>U.K.</td>
<td>3 units/ton</td>
<td>4 units/ton</td>
</tr>
</tbody>
</table>

These figures show clearly that the United States has an absolute advantage in both mining coal and growing wheat. That is, in using fewer units of production per ton produced, the United States is more efficient than the United Kingdom in producing both coal and wheat.

\(^{17}\) The traditional theory of international trade ignores the role of technology in differentiating products, but it leaves open the possibility of different production technologies to produce commodities.
However, although the United Kingdom is at an absolute disadvantage in both products, it has a **comparative advantage** in producing wheat. Put another way, the United Kingdom’s absolute disadvantage is less in growing wheat than in mining coal. This lesser disadvantage can be seen by redoing the production figures above to reflect the output per unit of production for both countries:

<table>
<thead>
<tr>
<th></th>
<th>Wheat</th>
<th>Coal</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>0.5</td>
<td>1</td>
</tr>
<tr>
<td>U.K.</td>
<td>0.33</td>
<td>0.25</td>
</tr>
</tbody>
</table>

Productivity for the United States relative to the United Kingdom in coal is 4:1 (1/0.25), whereas it is only 1.5:1 (0.5/0.33) in wheat.

In order to induce the production of both wheat and coal prior to the introduction of trade, the profitability of producing both commodities must be identical. This condition is satisfied only when the return per unit of production is the same for both wheat and coal in each country. Hence, prior to the introduction of trade between the two countries, the exchange rate between wheat and coal in the United States and the United Kingdom must be as follows:

- **U.S.** 1 ton wheat = 2 tons coal
- **U.K.** 1 ton wheat = 0.75 tons coal

**THE GAINS FROM TRADE**

Based on the relative prices of wheat and coal in both countries, there will be obvious gains to trade. By switching production units from wheat to coal, the United States can produce coal and trade with the United Kingdom for more wheat than those same production units can produce at home. Similarly, by specializing in growing wheat and trading for coal, the United Kingdom can consume more coal than if it mined its own. This example demonstrates that trade will be beneficial even if one nation (the United States here) has an absolute advantage in everything. As long as the degree of absolute advantage varies across products, even the nation with an across-the-board absolute disadvantage will have a comparative advantage in making and exporting some goods and services.

The gains from trade for each country depend on exactly where the exchange rate between wheat and coal ends up following the introduction of trade. This exchange rate, known as the **terms of trade**, depends on the relative supplies and demands for wheat and coal in each country. However, any exchange rate between 0.75 and 2.0 tons of coal per ton of wheat will still lead to trade because trading at that exchange rate will allow both countries to improve their ability to consume. By illustration, suppose the terms of trade end up at 1:1—that is, one ton of wheat equals one ton of coal.

Each unit of production in the United States can now provide its owner with either one ton of coal to consume or one ton of wheat or some combination of the two. By producing coal and trading for wheat, each production unit in the United States now enables its owner to consume twice as much wheat as before. Similarly, by switching from mining coal to growing wheat and trading for coal, each production unit in the United Kingdom will enable its owner to consume 0.33 tons of coal, 33% (0.33/0.33 = 100%) more than before.

**SPECIALIZED FACTORS OF PRODUCTION**

So far, we have assumed that the factors of production are unspecialized. That is, they can easily be switched between the production of wheat and coal. However, suppose that some factors such as labor and capital are specialized (that is, relatively more efficient) in terms of producing one commodity rather than the other. In that case, the prices of the factors of production that specialize in the commodity that is exported (coal in the United States, wheat in the United Kingdom) will gain because of greater demand once trade begins, whereas those factors that specialize in the commodity that is now imported (wheat in the United States, coal in the United Kingdom) will lose because of lower demand. This conclusion is based on the economic fact that the demand for factors of production is derived from the demand for the goods those factors produce.

The gains and losses to the specialized factors of production will depend on the magnitude of the price shifts after the introduction of trade. To take an extreme case: suppose the terms of trade become 1 ton of wheat equals 1.95 tons of coal; at this exchange rate, trade is still beneficial for both countries but far more so for the United Kingdom than the United States. The disparity in the gains from trade can be seen as follows: by producing coal and trading it for wheat, the United States can now consume approximately 2.5% more wheat per ton of coal than before. However, the United Kingdom gains enormously, too. Each unit of wheat traded for coal will now provide it 1.95 tons of coal, a 160% (1.95/0.75 = 2.56) increase relative to the earlier ratio.

These gains are all to the good. However, with specialization comes costs. In the United States, the labor and capital that specialized in growing wheat will be hurt. If they continue to grow wheat (which may make sense because they cannot easily be switched to mining coal), they will suffer approximately a 2.5% loss of income because the wheat they produce now will buy about 2.5% less coal than before (1.95 tons instead of 2 tons). At the same time, U.S. labor and capital that specializes in mining coal will be able to buy about 2.5% more wheat. Although gains and losses for specialized U.S. factors of production exist, they are relatively small. But the same cannot be said for U.K. gains and losses.

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18 With trade, the United States can now consume 1/1.95 = 0.5128 tons of wheat per ton of coal, which is 2.36% more wheat than the 0.5 tons it could previously consume (0.5128/0.50 = 1.0256).
As we saw earlier, U.K. labor and capital that specialize in growing wheat will be able to buy 160% more coal than before, a dramatic boost in purchasing power. Conversely, those factors that specialize in mining coal will see their wheat purchasing power plummet, from 1.33 (4/3) tons of coal before trade to 0.5128 (1/1.95) tons of wheat now. These figures translate into a drop of about 62% (0.5128/1.33 = 38%) in wheat purchasing power.

This example illustrates a general principle of international trade: The greater the gains from trade for a country overall, the greater the cost of trade to those factors of production that specialize in producing the commodity that is now imported. The reason is that in order for trade to make sense, imports must be less expensive than the competing domestic products. The less expensive these imports are, the greater will be the gains from trade. By the same token, however, less expensive imports drive down the prices of competing domestic products, thereby reducing the value of those factors of production that specialize in their manufacture.

It is this redistribution of income—from factors specializing in producing the competing domestic products to consumers of those products—that leads to demands for protection from imports. However, protection is a double-edged sword. These points are illustrated by the experience of the U.S. auto industry.

As discussed in the chapter, the onslaught of Japanese cars in the U.S. market drove down the price and quantity of cars sold by American manufacturers, reducing their return on capital and forcing them to be much tougher in negotiating with the United Auto Workers. The end result was better and less expensive cars for Americans but lower profits for Detroit automakers, lower wages and benefits for U.S. autoworkers, and fewer jobs in the U.S. auto industry.

The U.S. auto industry responded to the Japanese competition by demanding, and receiving, protection in the form of a quota on Japanese auto imports. The Japanese response to the quota, which allowed them to raise their prices (why cut prices when you can’t sell more cars anyway?) and increase their profit margins, was to focus on making and selling higher quality cars in the U.S. market (as these carried higher profit margins) and shifting substantial production to the United States. In the end, protection did not help U.S. automakers nearly as much as improving the quality of their cars and reducing their manufacturing costs. Indeed, to the extent that protection helped delay the needed changes while boosting Japanese automaker profits (thereby giving them more capital to invest), it may well have hurt the U.S. auto industry.

**Monetary Prices and Exchange Rates**

So far, we have talked about prices of goods in terms of each other. To introduce monetary prices into the example we have been analyzing, suppose that before the opening of trade between the two nations, each production unit costs $30 in the United States and £10 in the United Kingdom. In this case, the prices of wheat and coal in the two countries will be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Wheat</th>
<th>Coal</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>$60/ton</td>
<td>$30/ton</td>
</tr>
<tr>
<td>U.K.</td>
<td>£30/ton</td>
<td>£40/ton</td>
</tr>
</tbody>
</table>

These prices are determined by taking the number of required production units and multiplying them by the price per unit.

Following the introduction of trade, assume the same 1:1 terms of trade as before and that the cost of a unit of production remains the same. The prices of wheat and coal in each country will settle at the following, assuming that the exported goods maintain their prices and the prices of the goods imported adjust to these prices so as to preserve the 1:1 terms of trade:

<table>
<thead>
<tr>
<th></th>
<th>Wheat</th>
<th>Coal</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>$30/ton</td>
<td>$30/ton</td>
</tr>
<tr>
<td>U.K.</td>
<td>£30/ton</td>
<td>£30/ton</td>
</tr>
</tbody>
</table>

These prices present a potential problem in that there will be equilibrium at these prices only if the exchange rate is $1 = £1. Suppose, however, that before the introduction of trade, the exchange rate is $1 = £3. In this case, dollar-equivalent prices in both countries will begin as follows:

<table>
<thead>
<tr>
<th></th>
<th>Wheat</th>
<th>Coal</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>$60/ton</td>
<td>$30/ton</td>
</tr>
<tr>
<td>U.K.</td>
<td>£90/ton</td>
<td>£120/ton</td>
</tr>
</tbody>
</table>

This is clearly a disequilibrium situation. Once trade begins at these initial prices, the British will demand both U.S. wheat and coal, whereas Americans will demand no British coal or wheat. Money will be flowing in one direction only (from the United Kingdom to the United States to pay for these goods), and goods will flow only in the opposite direction. The United Kingdom will run a massive trade deficit, matched exactly by the U.S. trade surplus. Factors of production in the United Kingdom will be idle (because there is no demand for the goods they can produce) whereas U.S. factors of production will experience an enormous increase in demand for their services.

This is the nightmare scenario for those concerned with the effects of free trade: One country will sell everything to the other country and demand nothing in return (save money), leading to prosperity for the exporting nation and massive unemployment and depression in the importing country. However, such worries ignore the way markets work.

Absent government interference, a set of forces will swing into play simultaneously. The British demand for dollars (to buy U.S. coal and wheat) will boost the value of the dollar, making U.S. products more expensive to the British
and British goods less expensive to Americans. At the same time, the jump in demand for U.S. factors of production will raise their prices and hence the cost of producing U.S. coal and wheat. The rise in cost will force a rise in the dollar price of U.S. wheat and coal. Conversely, the lack of demand for U.K. factors of production will drive down their price and hence the pound cost of producing British coal and wheat. The net result of these adjustments in the pound:dollar exchange rate and the cost of factors of production in both countries is to make British products more attractive to consumers and U.S. products less competitive. This process will continue until both countries can find their comparative advantage and the terms of trade between coal and wheat are equal in both countries (say, at 1:1).

**Tariffs**

Introducing tariffs (taxes) on imported goods will distort the prices at which trade takes place and will reduce the quantity of goods traded. In effect, tariffs introduce a wedge between the prices paid by domestic customers and the prices received by the exporter, reducing the incentive for both to trade. To see this, suppose Mexican tomatoes are sold in the United States at a price of $0.30 per pound. If the United States imposes a tariff of, say, $0.15 per pound on Mexican tomatoes, then Mexican tomatoes will have to sell for $0.45 per pound to provide Mexican producers with the same pretariff profits on their tomato exports to the United States. However, it is likely that at this price, some Americans will forgo Mexican tomatoes and either substitute U.S. tomatoes or do without tomatoes in their salads. More likely, competition will preclude Mexican tomato growers from raising their price to $0.45 per pound. Suppose, instead, that the price of Mexican tomatoes, including the tariff, settles at $0.35 per pound. At this price, the Mexican tomato growers will receive only $0.20 per pound, reducing their incentive to ship tomatoes to the American market. At the same time, the higher price paid by American customers will reduce their demand for Mexican tomatoes. As a result fewer Mexican tomatoes will be sold in the U.S. market. Such a result will benefit American tomato growers (who now face less competition and can thereby raise their prices) and farmworkers (who can now raise their wages without driving their employers out of business) while harming U.S. consumers of tomatoes (including purchasers of Campbell’s tomato soup, Ragu spaghetti sauce, Progresso ravioli, and Heinz ketchup).

Ultimately, the effects of free trade are beneficial for an economy because it promotes increased competition among producers. This leads to lower prices for consumers, greater productivity and rising wages for workers, increased innovation, and higher living standards for the country overall.

**Questions**

1. In a satirical petition on behalf of French candlemakers, Frederic Bastiat, a French economist, called attention to cheap competition from afar: sunlight. A law requiring the shuttering of windows during the day, he suggested, would benefit not only candlemakers but “everything connected with lighting” and the country as a whole. He explained: “As long as you exclude, as you do, iron, corn, foreign fabrics, in proportion as their prices approximate to zero, what inconsistency it would be to admit the light of the sun, the price of which is already at zero during the entire day!”

   a. Is there a logical flaw in Bastiat’s satirical argument?
   b. Do Japanese automakers prefer a tariff or a quota on their U.S. auto exports? Why? Is there likely to be consensus among the Japanese carmakers on this point? Might there be any Japanese automakers who would prefer U.S. trade restrictions? Why? Who are they?
   c. What characteristics of the U.S. auto industry have helped it gain protection? Why does protectionism persist despite the obvious gains to society from free trade?

2. Review the arguments both pro and con on NAFTA. What is the empirical evidence so far?

3. Given the resources available to them, countries A and B can produce the following combinations of steel and corn.

<table>
<thead>
<tr>
<th></th>
<th>Country A</th>
<th>Country B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steel (tons)</td>
<td>Corn (bushels)</td>
<td>Steel (tons)</td>
</tr>
<tr>
<td>36</td>
<td>0</td>
<td>54</td>
</tr>
<tr>
<td>30</td>
<td>3</td>
<td>43</td>
</tr>
<tr>
<td>24</td>
<td>6</td>
<td>36</td>
</tr>
<tr>
<td>18</td>
<td>9</td>
<td>27</td>
</tr>
<tr>
<td>15</td>
<td>12</td>
<td>18</td>
</tr>
<tr>
<td>6</td>
<td>15</td>
<td>9</td>
</tr>
<tr>
<td>0</td>
<td>18</td>
<td>0</td>
</tr>
</tbody>
</table>

   a. Do you expect trade to take place between countries A and B? Why?
   b. Which country will export steel? Which will export corn? Explain.