Case IV.1 Plano Cruzado

On February 28, 1986, President Jose Sarney of Brazil announced the Plano Cruzado. At the time, Brazilian inflation was running at an annualized rate of more than 400%. The plan slashed inflation by freezing prices and wages. The purpose of the plan was to impose “shock treatment” on the economy and break the cycle of “inertial inflation” caused by high inflationary expectations. However, in a move that foreshadowed the splits that bedeviled the Plan, workers were granted pay hikes of 8% to 15%, just before the freeze. At the same time, government spending went largely unchecked, and the public-sector deficit—financed largely by printing more cruzados—grew to 4.5% of gross domestic product.

In November, the Plan achieved its first incontrovertible success: Government parties swept the congressional and gubernatorial races. Price controls were eased just after the election. However, the government found it politically impossible to remove subsidies to state industries because these industries formed the base for political power. Instead, large price hikes for state companies were granted by imposing huge increases in indirect taxes and tariffs on their products, and an attempt was made to disguise the effect of these increases on inflation by altering the basket of goods on which inflation was calculated. “They wanted me to tamper with inflation—simple as that,” commented the head of the National Statistics Office, who immediately resigned.

Questions
1. What were the likely consequences for Brazil of controlling prices while running the money supply? Consider the effect on production and the availability of products in the stores.
2. How did the Plano Cruzado affect Brazil’s huge trade surplus?
3. What would be your forecast of the Plan’s effect on Brazil’s ability to service its foreign debts?
4. President Sarney terminated Plano Cruzado in February 1987, one year after it began. What impact do you think the Plan had in reducing inflation expectations? How would you go about measuring the effect of the Plan on inflation expectations?
5. What was the likely price response to the removal of price controls?
6. If you were a banker, how would seeing such a Plan put into effect affect your willingness to lend money to Brazil? Explain.

Source: Based on a report in the Wall Street Journal, February 13, 1987, p. 27.

Case IV.2 Multinational Manufacturing, Inc.

Part I

Multinational Manufacturing, Inc. (MMI), is a large manufacturing firm engaged in the production and sale of a widely diversified group of products in a number of countries throughout the world. Some product lines enjoy outstanding success in new fields developed on the basis of an active research and development program; other product lines, whose innovative leads have disappeared, face very severe competition.
Each domestic product line and foreign affiliate is a separate profit center. Headquarters influences these centers primarily by evaluating their managers on the basis of certain financial criteria, including return on investment, return on sales and growth in earnings.

Division and affiliate executives are held responsible for planning and evaluating possible new projects. Each project is expected to yield at least 15%. Projects requiring an investment below $250,000 (about one-third of the projects) are approved at the division or affiliate level without formal review by headquarters management. The present cutoff rate was established three years ago as part of a formal review of capital budgeting procedures. The conclusion at the time was that the company’s weighted average cost of capital was 15%, and it should be applied when calculating net present values of proposed projects. In announcing the policy, Mr. Thomas Black, Vice President—Finance, said, “It’s about time that we introduced some modern management techniques in allocating our capital resources.”

Now Mr. Black is concerned that the policy introduced three years ago is having some unintended consequences. Specifically, top management gets to review only obvious investment candidates. Low-risk, low-return projects and high-risk, high-return projects seem to be systematically screened out along the way. The basis for this screening is not entirely clear, but it appears to be related to the way in which managerial performance is evaluated. Local executives seem to be concerned that low-potential projects will hurt their performance appraisal, while high-potential projects can turn out poorly. The president of one foreign affiliate said privately when asked why he never submitted projects at the extremes of risk and return, “Why should I take any chances? When headquarters says it wants 15%, it means 15% and nothing less. My crystal ball isn’t good enough to allow me to accurately estimate sales and costs in this country, especially when I never know what the government is going to do.”

Questions: Part I

Make recommendations to Mr. Black concerning the following points:

1. Should MMI lower the hurdle rate in order to encourage the submission of more proposals, or should it drop the hurdle rate concept completely?
2. Should MMI invest in lower-return projects that are less risky and/or in high-risk projects that appear promising? What is the relevant measure of risk?
3. How should MMI factor in the additional political and economic risks it faces overseas in conducting these project analyses?
4. Why are projects at the extremes of risk and return not reaching top management for review?
5. What actions, if any, should Mr. Black take to correct the situation?

Part II

In line with this current review of capital budgeting procedures, Mr. Black is also reconsidering certain financial policies that he recently recommended to MMI’s board of directors. These policies include the maintenance of a debt/total assets ratio of 35% and a dividend payout rate equal to 60% of consolidated earnings. In order to achieve these ratios for the firm overall, each affiliate has been directed to use these ratios as guidelines in planning its own capital structure and payout rate.

This directive has been controversial. The executives of several foreign affiliates have raised questions about the appropriateness of applying these guidelines at the local level. The general managers of some of the largest affiliates have been particularly vocal in their objections, stating that it simply was not possible for overall policies relative to capital structure proportions to be given much consideration in financial planning at the local level. They pointed out that differences in the economic and political environment in which the various affiliates operate are far too great to force
them into a financial straitjacket designed by headquarters. In their view, they must be left free to respond to their own unique set of circumstances.

The executives of the Brazilian affiliate, for example, felt that their financing should not follow the same pattern as that of the overall firm because inflationary conditions made local borrowing especially advantageous in Brazil. Executives of other foreign affiliates stressed the need for varying capital structures in order to cope with the exchange risks posed by currency fluctuations. The general manager of the Mexican affiliate, which is owned on a 50–50 basis with local investors, has argued forcefully that, despite effective headquarters control over the policies of this operation, joint ventures such as his cannot and should not be financed in the same manner as firms wholly owned by MMI. In addition, the tax manager of MMI has expressed his concern that implementing a rigid policy of repatriating 60% of each affiliate’s earnings in the form of dividends will impose substantial tax costs on MMI. Moreover, Mr. Black recently attended a seminar at which it was pointed out that overseas affiliates can sometimes be financed in such a way that their susceptibility to political and economic risks is diminished.

Questions: Part II

Make recommendations to Mr. Black concerning the policies that should be adopted as guides in planning the capital structure and dividend payout policies of foreign affiliates, taking into account the following key questions:

1. What are the pros and cons of using the following sources of funds to finance the operations of the foreign affiliates: equity funds versus loans from MMI, retained earnings of the affiliates, and outside borrowings? Consider cost, political and economic risks, and tax consequences in your answer.

2. Given these considerations, under what circumstances, if any, should the capital structure of foreign affiliates include more or less debt than the 35% considered desirable for the firm as a whole?

3. How will the resultant capital structures affect the required rates of return on affiliate projects? The actual rates of return?

4. How should MMI’s dividend policy be implemented at the affiliate level?