Because learning changes everything.®

Chapter One

Globalization and the Multinational Firm

Overview

Why study International Finance?

What's special about International Finance?

Goals for international financial management.

Globalization of the world economy.

Multinational corporations.

Why Study International Finance?

The world economy is highly globalized and increasingly integrated in.

- the markets for goods and services.
- the financial markets.

Today, all the major economic functions are globalized:

- Consumption.
- Production.
- Investment.

What's Special about International Finance?

Four major dimensions set international finance apart from domestic finance:

1. Foreign exchange risk.
2. Political risks.
3. Market imperfections.
4. Expanded opportunity set.

These are largely because sovereign nations have the right to issue currencies, formulate their own economic policies, impose taxes, and regulate movements of people, goods, and capital across their borders.

Foreign Exchange Risk

Foreign exchange risk stems from uncertain future exchange rates.

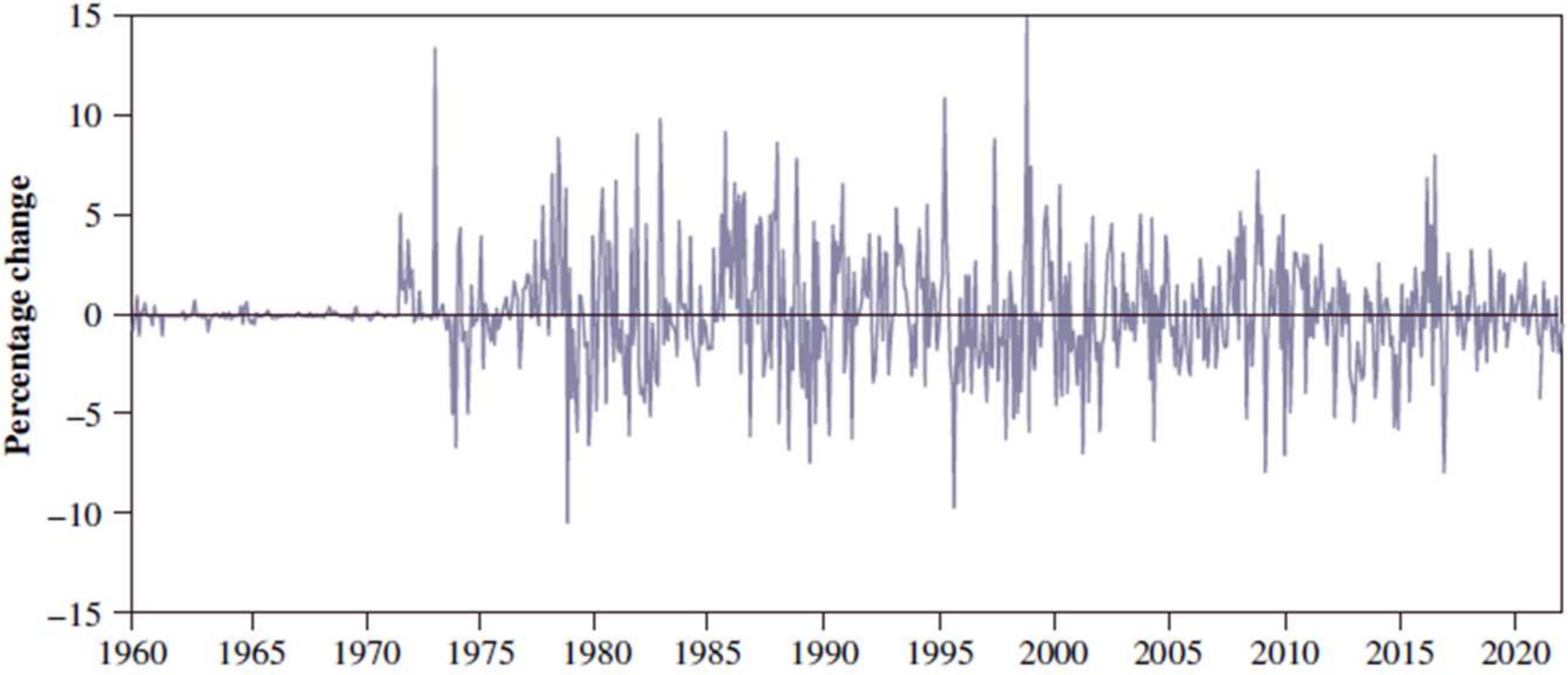
- For example, profits made in a foreign currency may disappear once converted into the domestic currency due to unanticipated exchange rate movements.
- Exchange rates among major currencies (for example, U.S. dollar, Japanese yen, British pound, and euro) fluctuate continuously in an unpredictable manner.
- Exchange rate uncertainty influences all major economic functions, including consumption, production, and investment.

Foreign Exchange Risk Example

Suppose \$1 = ¥100 today, and you invest \$1,000 to buy 50 shares of Toyota at ¥2,000 per share. One year later, the share price has increased by ten percent, and your investment is worth ¥110,000. If the yen has depreciated to \$1 = ¥120 by that time, how much is your investment worth in dollar terms?

- Initial investment in dollars: **\$1,000**.
- Initial investment in yen: \$1,000 × (¥100/\$) = ¥100,000.
- Maturity value in yen: ¥110,000 (after 10% increase).
- Maturity value in dollars: ¥110,000 / (¥120/\$) = **\$916.67**.

Monthly Percentage Change in Japanese Yen—U.S. Dollar Exchange Rate



Source: Bank for International Settlements, *US dollar exchange rates.*

Access the text alternative for slide images.

Political Risk

Political risk arises from the fact that a sovereign country can change the “rules of the game” and the affected parties may not have effective recourse.

- Multinational corporations and international investors are exposed to political risks when they operate in certain foreign countries or hold foreign assets.
- Political risks range from unexpected changes in tax rules to outright expropriation of assets held by foreigners.
- Especially relevant in those countries without a tradition of the rule of law, where the rights of shareholders and investors may not be protected.

Market Imperfections

Market imperfections are frictions and impediments hampering free movements of people, goods, services, and capital across national boundaries and preventing markets from functioning perfectly:

- Legal restrictions.
- Transaction and transportation costs.
- Information asymmetry.
- Discriminatory taxation.

World markets are highly imperfect.

- Motivates MNCs to locate production overseas.
- Restricts the extent to which investors can diversify their portfolios.

Example of Market Imperfections: Nestlé

Nestlé used to issue two different classes of common stock, *bearer* shares and *registered* shares.

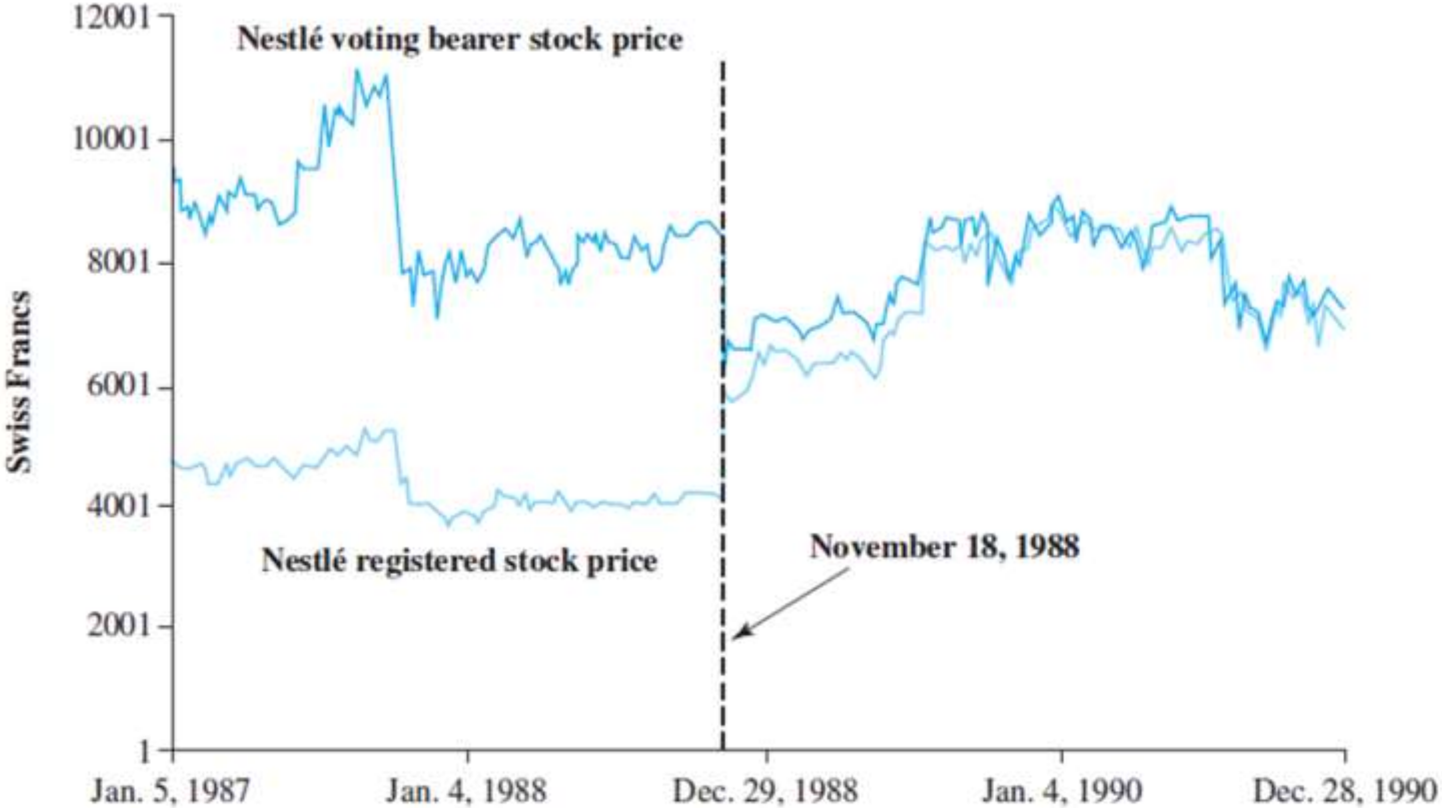
- Foreigners were only allowed to hold *bearer* shares.
- Swiss residents could buy *registered* shares.

The bearer shares were more expensive than registered shares.

On November 18, 1988, Nestlé lifted restrictions imposed on foreigners, allowing them to hold registered shares as well as bearer shares.

- Price spread between the two share types narrowed drastically.

Daily Prices of Nestlé’s Bearer and Registered Shares



Source: Loderer, Claudio, and Andreas Jacobs. 1995. *“The Nestlé Crash.” Journal of Financial Economics,* 37, no. 3: pp. 315–39, Elsevier Science S.A.

Access the text alternative for slide images.

Expanded Opportunity Set

Firms and investors may benefit from an **expanded opportunity set** when they venture into global markets.

- Firms can locate production anywhere in the world to maximize their performance, gain from greater economies of scale, and raise funds in any market to lower cost of capital.
- Investors can benefit from diversifying internationally due to lower risk or higher return (or both) of international portfolios compared to domestic portfolios.

“It just doesn’t make sense to play in only one corner of the sandbox.”

Goals for International Financial Management [1]

- Global financial managers focus on how to maximize the benefits from the global opportunity set, while controlling political and exchange rate risks and managing various market imperfections.
- Fundamental goal of sound financial management is **shareholder wealth maximization**, which means the firm makes all business decisions and investments with an eye toward making the owners of the firm (that is, shareholders) better off financially.
- Generally accepted as the ultimate goal in countries like the U.S., U.K., Australia, and Canada, but not as widely embraced in other parts of the world.

Goals for International Financial Management 2

- Continental Europe (for example, France and Germany):

  Shareholders are viewed as one among many "stakeholders" of the firm, others being employees, suppliers, customers, and banks etc.

- Japan:

  Managers have typically sought to maximize the value and growth of the *keiretsu*—a family of firms to which individual firms belong.

Corporate Governance

Managers may pursue their own private interests at the expense of shareholders when they are not closely monitored.

- This “agency problem” is a major weakness of the public corporation.

Corporate governance is the financial and legal framework for regulating the relationship between a firm’s management and its shareholders.

Corporate governance problems can be especially rife where the legal protection of shareholders is weak or nonexistent.

Globalization of the World Economy: Major Trends and Developments

I. Emergence of Globalized Financial Markets.

II. Emergence of the Euro as a Global Currency.

III. Europe’s Sovereign Debt Crisis of 2010.

IV. Trade Liberalization and Economic Integration.

V. Privatization.

VI. Global Financial Crisis of 2008 to 2009.

VII. Brexit.

VIII. COVID-19 Pandemic.

IX. Climate Change.

Emergence of Globalized Financial Markets

Forces that contributed to the emergence of globalized financial markets:

Deregulation of financial markets.

Financial innovations such as.

- Currency futures and options.
- Multi-currency bonds.
- Cross-border stock listings.
- International mutual funds.

Advances in technology.

Emergence of the Euro as a Global Currency

Momentous event in the history of world financial system.

Currently, more than 340 million Europeans in 20 countries use the common currency on a daily basis.

The common monetary policy for the euro zone is formulated by the **European Central Bank** (ECB), located in Frankfurt.

The euro enabled the emergence of continentwide capital markets in Europe.

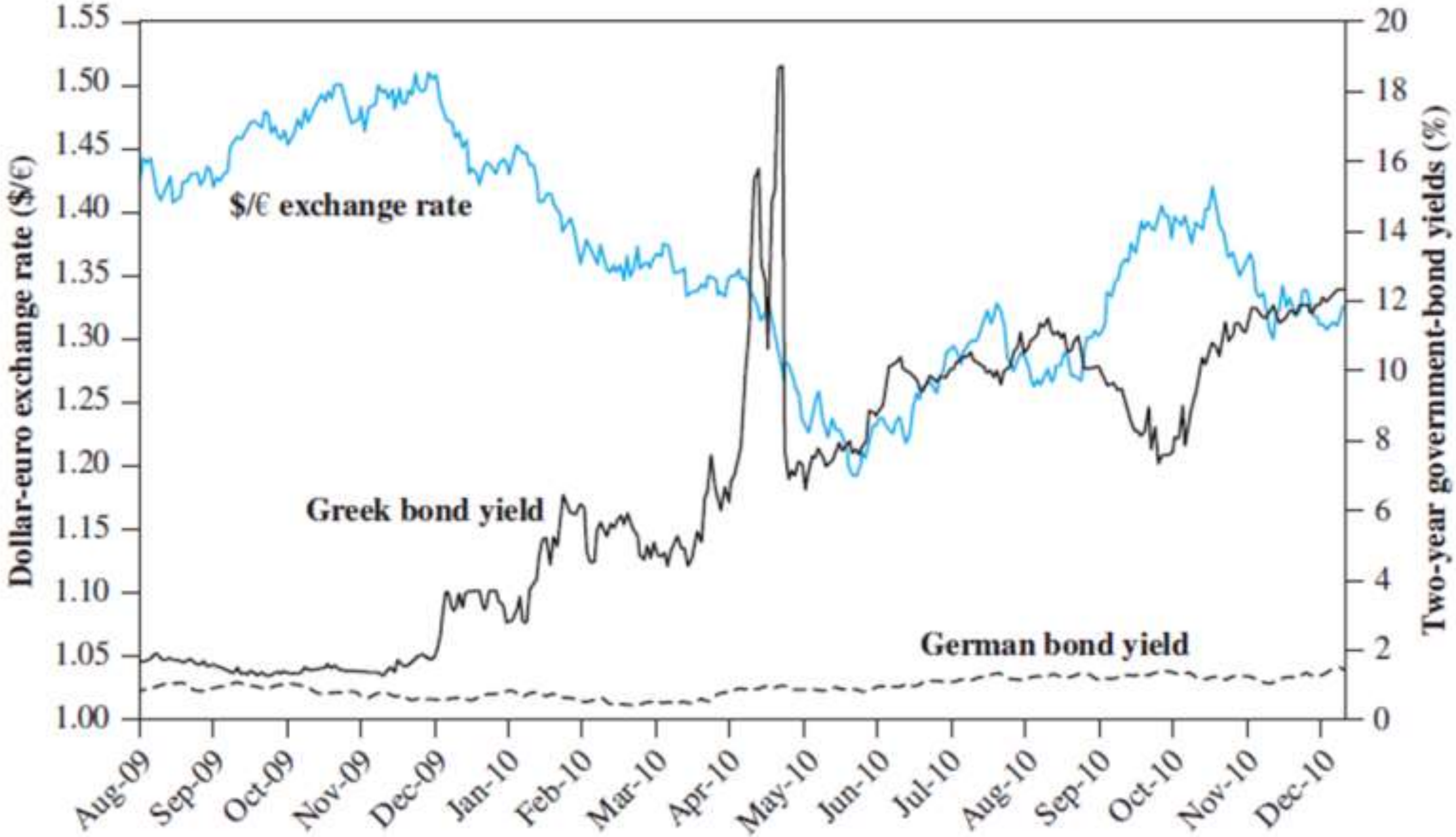
The **transaction domain** of the euro may become larger than that of the U.S. dollar in the future if the new EU members adopt the euro eventually.

Europe’s Sovereign-Debt Crisis of 2010

In December 2009, the new Greek government revealed that its budget deficit for the year would be 12.7% of G D P, not the 3.7% previously forecast.

- Investors sold off Greek government bonds, and the ratings agencies downgraded them to “junk.”
- Panic spread to other weak European countries (especially Ireland, Portugal, and Spain) and quickly escalated to a Europe-wide debt crisis.
- Revealed a profound weakness of the euro as the common currency: Euro-zone countries have achieved *monetary integration*, but without *fiscal integration*.

The Greek Drama



Source: Bloomberg.

Access the text alternative for slide images.

Trade Liberalization and Economic Integration

The principal argument for international trade is based on the **theory of comparative advantage.**

- It is mutually beneficial for countries if they specialize in producing the goods they can produce most efficiently and trade those goods among them.
- It is about *relative* advantage, not *absolute* advantage.
- International trade is an "increasing-sum game," not a "zero-sum" game, and will enhance the welfare of the world's citizens.

Over the years, international trade has been liberalized at both the global and regional levels.

Long-Term Openness in Perspective (exports/GDP, in percent)

County	1870	1913	1929	1950	1973	2020
United States	2.5	3.7	3.6	3.0	5.0	10.1
Canada	12.0	12.2	15.8	13.0	19.9	29.4
Australia	7.4	12.8	11.2	9.1	11.2	24.0
United Kingdom	12.0	17.7	13.3	11.4	14.0	28.1
Germany	9.5	15.6	12.8	6.2	23.8	43.4
France	4.9	8.2	8.6	7.7	15.4	27.9
Spain	3.8	8.1	5.0	1.6	5.0	30.6
Japan	0.2	2.4	3.5	2.3	7.9	15.5
Korea, Rep.	0.0	1.0	4.5	1.0	8.2	36.4
Thailand	2.1	6.7	6.6	7.0	4.5	51.5
Argentina	9.4	6.8	6.1	2.4	2.1	16.6
Brazil	11.8	9.5	7.1	4.0	2.6	16.9
Mexico	3.7	10.8	14.8	3.5	2.2	40.2
World	5.0	8.7	9.0	7.0	11.2	26.5

Trade Liberalization and Economic Integration 1

At the global level:

General Agreement on Tariffs and Trade (GATT) is a multilateral agreement among member countries that has reduced many barriers to trade. It was founded in 1947.

The **World Trade Organization (WTO)** replaced the GATT. It has more power to enforce the rules of international trade. China joined the WTO in 2001.

WTO’s latest round of talks, the Doha Round, has stalled mainly over a divide between the developed and the developing countries.

Trade Liberalization and Economic Integration 2

At the regional level:

The **European Union (EU)** includes 27 member states that have eliminated barriers to the free flow of goods, capital, and people.

North American Free Trade Agreement (NAFTA) called for phasing out impediments to trade between Canada, Mexico, and the United States over a 15-year period beginning in 1994.

- In November 2018, the three countries signed a new accord, the **U.S.-Mexico-Canada-Agreement (USCMA).**

Recent Free Trade Agreements [1]

Trans-Pacific Partnership (TPP), signed in March 2018

- 11 Pacific Rim countries covering 500 million people.
- Designed to slash tariffs and facilitate trade among members.
- U.S. initially joined then withdrew under President Trump.

African Continental Free Trade Agreement (AfCFTA)

- 49 African countries covering 1.2 billion people.
- Aims to stimulate intra-African trade and investment by reducing tariffs, protecting intellectual property rights, and lowering barriers to migration.

Recent Free Trade Agreements 2

Regional Comprehensive Economic Partnership (RCEP), signed in November 2020.

- 15 Asia-Pacific countries covering 2.5 billion people.
- World's largest free trade agreement.
- Aims to lower or eliminate tariffs and set rules on investment, competition, and intellectual properties.
- Unlike the TPP, it does not include provisions on labor and environmental standards.

Privatization

Privatization is the act of a country divesting itself of ownership and operation of business ventures by turning them over to the free market system.

- May be described as a denationalization process.
- Selling state-owned businesses brings in hard-currency foreign reserves to the national treasury.
- Often seen as a cure for bureaucratic inefficiency and waste.
- Some economists estimate privatization improves efficiency and reduces operating costs by as much as 20%.

Chinese Privatization

State-owned enterprises (SOEs) have been listed on organized stock exchanges, making them eligible for private ownership.

China launched two stock exchanges, the Shanghai Stock Exchange and the Shenzhen Stock Exchange, in the early 1990s

- As of 2021, approximately 4,400 companies are listed on China's stock exchanges.
- "A-shares" are primarily reserved for Chinese citizens, while foreigners may invest in "B-shares" or "H-shares."

Chinese government still retains the majority stakes in most public firms.

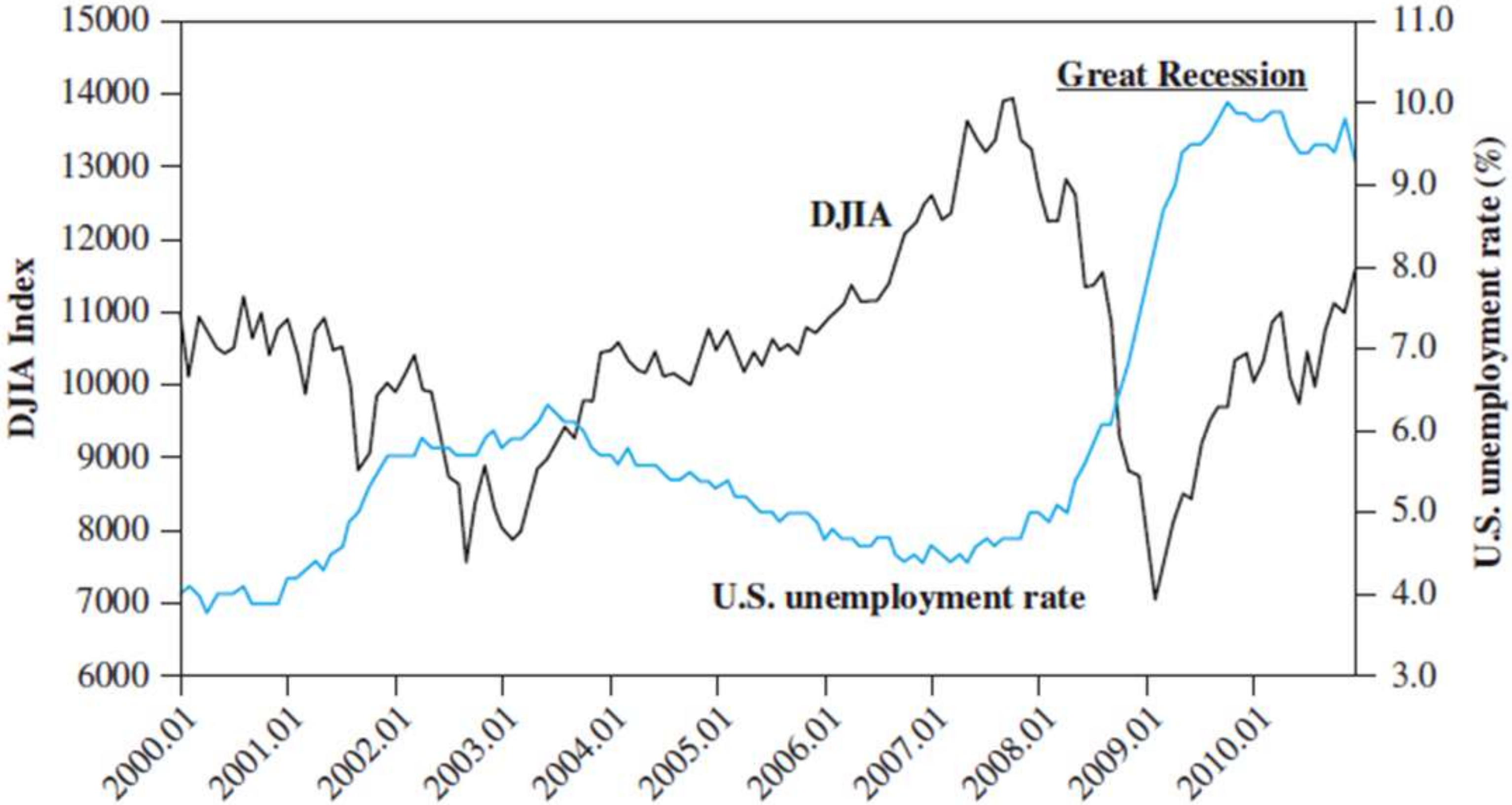
Global Financial Crisis of 2008 to 2009

The subprime mortgage crisis in the U.S. led to a severe credit crunch, which then escalated to a global financial crisis.

Factors that drove the financial crisis:

- Households and financial institutions borrowed too much and took too much risk.
- Crisis was amplified and transmitted globally by *securitization*.
- "Invisible hands" of free markets apparently failed to self-regulate excesses, contributing to the banking crisis.
- International financial markets have become highly interconnected and integrated.

U.S. Unemployment Rate and Dow Jones Industrial Average (DJIA)



Source: Bloomberg.

Access the text alternative for slide images.

Brexit 1

"Brexit" describes the unexpected outcome of the 2016 referendum, in which a majority of Britons voted to leave the EU.

Why did this happen?

- Stems from the resentment of the majority against the urban elites who are seen as disproportionately benefiting from globalization and the fear of losing the British national identity.
- 60% of Londoners vs. 45% of voters in the rest of England voted to remain in the EU.

Following a series of negotiations, the U.K's membership in the EU ended after 47 years on 31 January 2020.

Brexit 2

- Brexit revealed some of the serious difficulties associated with free trade and global integration process that produce clear winners and losers.
- Potential inflection point of the globalization process.
- Likely to weaken the United Kingdom and the EU, both economically and politically.
- London's position as the dominant center of European finance may deteriorate. It may even threaten the integrity of the EU in the long run.
- Similar populist nationalism is gaining power in other countries such as the U.S., Hungary, Poland, Italy, and Brazil.

COVID-19 Pandemic

COVID-19 was first confirmed in late December 2019 in Wuhan, China. As it spread worldwide, the WHO declared COVID-19 a pandemic on March 11, 2020.

- As of March 25, 2022, the global total cases reached 476 million, with 6.1 million deaths.
- Initial restrictions led to a relatively short global recession.
- Massive, synchronized government stimulus combined with supply chain shortages led to high inflation.
- Economic impact varied across countries, regions, and sectors.
- Longer-term legacies may include high inflation and increased inequalities in income.

Climate Change

The global warming poses a long-term threat to the global economy and the planetary ecosystem through:

- physical risks (for example, damaging crops).
- financial risks (for example, rising corporate defaults).

The Paris Climate Agreement of 2015 is designed to facilitate mitigation and adaptation to climate change. The goal was set to limit the global temperature increase to 1.5 degrees Celsius by the end of this century.

However, a 2021 scientific report estimated that the world will cross the benchmark of 1.5 degrees C in the 2030s.

The world faces a serious challenge posed by the narrowing window for addressing climate change.

Multinational Corporations

A multinational corporation (MNC) is a firm that is incorporated in one country and has production and sales operations in other countries.

MNCs benefit from economy of scale in many ways:

- Spreading R and D expenditures and advertising costs over their global sales.
- Pooling global purchasing power over suppliers.
- Utilizing their technological and managerial know-how globally with minimum additional costs.
- Accessing underpriced labor and special R and D capabilities in certain countries.

Because learning changes everything.®

www.mheducation.com