

CHAPTER 1

INTRODUCTION

Chapter 1 emphasizes the internationalization of business and economic activity that has occurred since the end of World War II. Although international business activities have existed for centuries, primarily in the form of exporting and importing, it is only in the postwar period that multinational firms have become preeminent. The distinguishing characteristic of the MNC is its emphasis on global, rather than affiliate, performance. Specifically, MNCs ask, "Where in the world should we build our plants, sell our products, raise capital, and hire personnel?" Thus the true multinational is characterized more by attitude than the physical reality of an integrated system of marketing and production activities worldwide. It involves looking beyond the boundaries of the home country, and treating the world as "our oyster." Good examples include the globalization of GE's medical systems division and Arco Chemical.

After stimulating student interest with this vision of the MNC, I then introduce the financial decisions that multinationals must make. I begin by discussing the key concepts and lessons from domestic finance that apply directly to international corporate finance. The lessons include the emphasis on cash flow rather than accounting earnings, the time value of money, the importance of taxes, and the unwillingness of investors to reward companies for activities (like corporate diversification) which investors could replicate for themselves at no greater cost.

The key concepts, which I point out will arise time and again in the course, are arbitrage, market efficiency, and the separation of risk into systematic risk, which must be rewarded, and unsystematic risk, which is not rewarded. The latter concept, of course, is the intuition underlying both the capital asset pricing model (CAPM) and the arbitrage pricing theory (APT). Although imperfect, the theoretical framework of domestic corporate finance provides a useful frame of reference, and understanding it is essential before proceeding with the more complex aspects of international financial management. I devote some time to explaining that total risk matters, even if the CAPM or APT holds. Otherwise the astute student will see a conflict between the irrelevance of unsystematic risk and hedging activities.

I then outline the key decision areas in international financial management: foreign exchange risk management, managing working capital and the internal financial system, financing foreign units, capital budgeting, and evaluation and control. I emphasize the additional parameters that MNC financial executives must cope with, including multiple currencies, rates of inflation, tax systems, and capital markets, as well as foreign exchange and political risks.

SUGGESTED ANSWERS TO "GENERAL ELECTRIC GLOBALIZES"

1. What advantages does General Electric seek to attain from its international business activities?

ANSWER. Aside from gaining access to markets worldwide, GE focuses on taking advantage of its global reach to find less expensive materials abroad and intellectual capital, thereby lowering its cost of designing and manufacturing products.

2. What actions is it taking to gain these advantages from its international activities?

ANSWER. GE is acquiring companies abroad, and setting up joint ventures with other foreign companies, to gain their assets and ability to service local customers. It is setting up manufacturing facilities abroad to access lower cost labor and materials and also sourcing more purchases abroad for the same reasons. It also is identifying and hiring engineering and scientific talent from around the world to boost its intellectual capital and is setting up R&D facilities where this talent can work.

3. What risks does GE face in its foreign operations?

ANSWER. Potential increased risks from global operations include, among other things, currency risks, higher receivables delinquencies and bad debts, delays or cancellation of sales and orders, higher local currency financing costs, and a slowdown in established financial services activities.

4. What profit opportunities for GE can arise out of these risks?

ANSWER. New profit opportunities for GE include, among other things, lower costs of goods sourced from countries with weakened currencies, more opportunities for lower cost outsourcing, expansion of industrial and financial services activities through purchases of companies or assets at reduced prices and lower U.S. debt financing costs.

SUGGESTED ANSWERS TO “THE DEBATE OVER OUTSOURCING”

1. What are the pros and cons of outsourcing?

ANSWER. PROS: Outsourcing allows Americans to buy services less expensively abroad, increases U.S. productivity, and enables U.S. companies to cut their costs while improving quality, time-to-market, and capacity to innovate. It also allows the United States to utilize its comparative advantage in financial, managerial, and technical services by specializing in and exporting such services as higher-end computer programming, management consulting, engineering, banking, telecommunications, and legal work.

CONS: As with any kind of trade, imports of services through outsourcing results in the loss of jobs for Americans previously employed in providing those services. Outsourcing may also put out of business U.S. companies that provide these services.

2. How does outsourcing affect U.S. consumers? U.S. producers?

ANSWER. As the answer to part a) points out, outsourcing allows companies to buy services less expensively abroad. Competitive pressures force companies to pass these savings along to consumers in the form of lower priced goods and services.

U.S. producers are able to boost productivity and cut costs while improving quality, time-to-market, and capacity to innovate. As such, American companies are better able to compete. This competition, however, forces companies to pass most of their savings from outsourcing through to their customers.

3. Longer term, what is the likely impact of outsourcing on American jobs?

ANSWER. The longer-term effect of outsourcing on U.S. jobs should be insignificant. Trade has little, if anything, to do with the quantity of jobs in an economy but rather the nature and distribution of those jobs in various occupations. Outsourcing should lead to higher average productivity of those jobs that Americans work at and, hence, to higher wages and benefits.

4. Several states are contemplating legislation that would ban the outsourcing of government work to foreign firms. What would be the likely consequences of such legislation?

ANSWER. Such legislation would result in less efficient and more expensive government. The end result would be higher taxes or, if taxpayers balk, fewer government services.

SUGGESTED ANSWERS TO “ARCO CHEMICAL DEVELOPS A WORLDWIDE STRATEGY”

1. What was ARCO Chemical’s rationale for globalizing?