Chapter 1
Globalization and the Multinational Enterprise

In this course we shall study International Financial Management with emphasis on MNE.

- **MNE**: Multinational Enterprise
- MNE is a firm that has operating subsidiaries, branches or affiliates located in foreign countries.
- MNEs are owned by a mixture of domestic and foreign shareholders. As the MNE grows, the ownership of some of these firms become so dispersed that they are called Transnational Corporations.

Why it is important to study the MNEs?

- MNEs face significant foreign exposure and risk.
- Firms with total domestic operations may not have to face direct foreign exposure still they face indirect financial risk through their relationship with customers and suppliers.
- It has, therefore, became increasingly important even for the managers of a totally domestic operations to also learn about international financial risk, especially those related to foreign exchange rates and the credit risks related to trade payments.

This Chapter's Learning Objectives

- Examine the requirements for the creation of value
- Consider the basic theory, comparative advantage, and its requirements for the explanation and justification for international trade and commerce
- Discover what is different about international financial management

Learning Objectives (continued…)

- Detail which market imperfections give rise to the multinational enterprise
- Consider how globalization process moves a business from domestic focus to financial relationships and composition global in scope
- Examine possible causes to the limitations to globalization in finance
Globalization and Creating Value in the MNE

- Transnational firms are those with ownership thoroughly dispersed internationally and as a result are often managed from a global perspective
- Building firm value in a global business requires
  - An open marketplace
  - Strategic management
  - Access to capital
- The firm value pyramid illustrates the concept of building firm value

Exhibit 1.1 Creating Firm Value in Global Markets

The Theory of Comparative Advantage

- The Theory of Comparative Advantage provides a basis for explaining and justifying international trade in a model assumed to enjoy
  - Free trade
  - Perfect competition
  - No uncertainty
  - Costless information
  - No government interference

The Theory of Comparative Advantage

- Because the factors of production cannot be transported, the benefits of specialization are realized through international trade
- The terms of trade, the ratio at which quantities of goods are exchanged, shows the benefits of excess production
- Neither Country A nor Country B is worse off than before trade, and typically both are better off (albeit perhaps unequally)

The Theory of Comparative Advantage

- The features of the theory are as follows;
  - Exporters in Country A sell goods or services to unrelated importers in Country B
  - Firms in Country A specialize in making products that can be produced relatively efficiently, given Country A’s endowment of factors of production (land, labor, capital, and technology)
  - Country B does the same with different products (based on different factors of production)

The Theory of Comparative Advantage

- For example of the benefits of free trade based on comparative advantage, assume Thailand is more efficient than Brazil at producing both sports shoes and stereo equipment
- With one unit of input (a mix of land, labor, capital, and technology), efficient Thailand can produce either 12 shipping containers of shoes or 6 shipping containers of stereo equipment
- Brazil, being less efficient in both, can produce only 10 containers of shoes or 2 containers of stereo equipment with one unit of input
The Theory of Comparative Advantage

- A production unit in Thailand has an absolute advantage over a production unit in Brazil in both shoes and stereo equipment.
- Thailand has a larger relative advantage over Brazil in producing stereo equipment (6 to 2) than shoes (12 to 10).
- As long as these ratios are unequal, comparative advantage exists.
- The following exhibit illustrates total world (in this example) production and consumption if there was no trade and if each country completely specialized in one product.

Exhibit 1.2 The Theory of Comparative Advantage: A numerical Example of Brazil and Thailand

<table>
<thead>
<tr>
<th>Production if No Trade</th>
<th>Shoe Production (cnr)</th>
<th>Stereo Production (cnr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand produces and consumes</td>
<td>1/300 x 3 = 1,000</td>
<td>1/300 x 1 = 3,000</td>
</tr>
<tr>
<td>Brazil produces and consumes</td>
<td>1/300 x 10 = 3,000</td>
<td>1/300 x 1 = 3,000</td>
</tr>
<tr>
<td>Total world production and consumption</td>
<td>6,000</td>
<td>6,000</td>
</tr>
</tbody>
</table>

Complete Specialization

<table>
<thead>
<tr>
<th>Shoe Production (cnr)</th>
<th>Stereo Production (cnr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand produces only stereo equipment</td>
<td>10,000 x 6 = 60,000</td>
</tr>
<tr>
<td>Brazil produces only shoes</td>
<td>10,000 x 10 = 100,000</td>
</tr>
<tr>
<td>Total world production and consumption</td>
<td>100,000</td>
</tr>
</tbody>
</table>

The Theory of Comparative Advantage

- Clearly the world in total is better off because there are now 10,000 containers of shoes (instead of just 6,000), as well as 6,000 containers of stereo equipment (instead of just 5,600).
- However, the goods are not distributed across international boundaries.

Exhibit 1.3 Trade at Thailand’s domestic “Price”

<table>
<thead>
<tr>
<th>Shoe Production plus/minus trade (cnr)</th>
<th>Stereo Production plus/minus trade (cnr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand produces 6,000 containers of stereo equipment and exports 3,600 containers</td>
<td>0 + 3,600 = 3,600</td>
</tr>
<tr>
<td>Brazil produces 10,000 containers of shoes and exports 3,600 containers</td>
<td>10,000 – 3,600 = 6,400</td>
</tr>
<tr>
<td>World production and consumption</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Exhibit 1.4 Trade at Brazil’s domestic “Price”

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<th>Shoe Production plus/minus trade (cnr)</th>
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</tr>
<tr>
<td>World production and consumption</td>
<td>10,000</td>
</tr>
</tbody>
</table>
Exhibit 1.5 Trade at a Price Reached by Free Bargaining

<table>
<thead>
<tr>
<th>Country</th>
<th>Shipping (thousands of dollars)</th>
<th>Handling (thousands of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>6,000 containers of shoes</td>
<td>6,000 containers of shoes</td>
</tr>
<tr>
<td>Brazil</td>
<td>10,000 containers of shoes</td>
<td>10,000 containers of shoes</td>
</tr>
<tr>
<td>World</td>
<td>10,000</td>
<td>6,000</td>
</tr>
</tbody>
</table>

The Theory of Comparative Advantage: Limitations

- Although international trade might have approached the comparative advantage model during the nineteenth century, it certainly does not today:
  - Countries do not appear to specialize only in those products that could be most efficiently produced by that country’s particular factors of production
  - At least two of the factors of production (capital and technology) now flow easily between countries (rather than only indirectly through traded goods and services)
  - Modern factors of production are more numerous than this simple model
  - Comparative advantage shifts over time

Exhibit 1.6 Global Outsourcing of Comparative Advantage

The Theory of Comparative Advantage

- Comparative advantage is still, however, a relevant theory to explain why particular countries are most suitable for exports of goods and services that support the global supply chain of both MNEs and domestic firms
- The comparative advantage of the 21st century, however, is one which is based more on services, and their cross border facilitation by telecommunications and the Internet

Exhibit 1.7 What is Different About International Financial Management?

<table>
<thead>
<tr>
<th>Concept</th>
<th>International</th>
<th>Domestic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Culture and Institutions</td>
<td>Each foreign country is unique and not always understood by MNE management</td>
<td>Each country has a known base case</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>Foreign countries’ regulations and institutional practices are all uniquely different</td>
<td>Regulations and institutions are well known</td>
</tr>
<tr>
<td>Exchange rate risk</td>
<td>MNEs face foreign exchange risks due to their subsidiaries, as well as exposure to political risk</td>
<td>Foreign exchange risks from exposure to political and economic conditions</td>
</tr>
<tr>
<td>Political risk</td>
<td>MNEs face political risks because of their foreign subsidiaries and high profile</td>
<td>Negligible political risks</td>
</tr>
<tr>
<td>Differentiation of domestic financial instruments</td>
<td>MNEs utilize modified financial instruments such as options, futures, swaps, and letters of credit</td>
<td>Limited use of financial instruments and derivatives because of lower foreign exchange and political risks</td>
</tr>
<tr>
<td>Differentiation of domestic financial instruments</td>
<td>MNEs use modified financial instruments for the capital budgeting and cost of capital because of foreign exchange problems</td>
<td>Positional financial theory applies</td>
</tr>
</tbody>
</table>

Market Imperfections: A Rationale for the MNE

- Firms become multinational for one or several of the following reasons:
  - Market seekers – produce in foreign markets either to satisfy local demand or export to markets other than their own
  - Raw material seekers – search for cheaper or more raw materials outside their own market
  - Production efficiency seekers – produce in countries where one or more of the factors of production are cheaper
  - Knowledge seekers – gain access to new technologies or managerial expertise
  - Political safety seekers – establish operations in countries considered unlikely to expropriate or interfere with private enterprise
The Globalization Process

• The globalization process is the structural and managerial changes and challenges experienced by a firm as it moves from domestic to global in operations
• We will examine the case of Trident, a young firm that manufactures and distributes an array of telecommunication devices
  – Trident’s initial strategy is to develop a sustainable competitive advantage in the U.S. market
  – Trident is currently constrained by its small size, other competitors, and lack of access to cheap capital

The Globalization Process

• In Phase One, Trident is not itself international or global in its operations
• However, some of its competitors, suppliers or buyers may be
• This is one of the key drivers pushing Trident into Phase Two, the first transition of the globalization process
• This is the Global Transition I: The Domestic Phase to The International Trade Phase

The Globalization Process

• In the International Trade Phase, Trident responds to globalization factors by importing inputs from Mexican suppliers and making exports sales to Canadian buyers
• Exporting and importing products and services increases the demands of financial management over and above the traditional requirements of the domestic-only business
The Globalization Process

- First, direct foreign exchange risks are now borne by the firm
  - Pricing and payments may be in different currencies
  - The value of these foreign currency receipts and payments can change, creating a new source of risk
- Second, the evaluation of the credit quality of foreign buyers and sellers is now more important than ever; this is known as credit risk management
  - Potential for non-payment of exports and non-delivery of imports
  - Differences in business and legal systems and practices

- If Trident is successful in its international trade activities, it will soon need to establish foreign sales and service affiliates
- This step is often followed by establishing manufacturing operations abroad or by licensing foreign firms to produce and service Trident’s products
- This is the Global Transition II: The International Trade Phase to The Multinational Phase

The Globalization Process

- Trident’s continued globalization will require it to identify the sources of its competitive advantages
- This variety of strategic alternatives available to Trident is called the foreign direct investment sequence which includes the creation of foreign sales offices, licensing agreements, manufacturing, etc.
- Once Trident owns assets and enterprises in foreign countries it has entered the Multinational Phase of globalization

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The Limits to Financial Globalization

- The growth in the influence and self-enrichment of corporate insiders
- The next exhibit illustrates the agency problems

Exhibit 1.9 Trident’s Foreign Direct Investment Sequence

Exhibit 1.10 The Potential Limits of Financial Globalization
Financial management is an integral part of a firm’s strategy. This course analyzes how a firm’s financial management tasks evolve as it pursues global strategic opportunities and new constraints unfold.

The evolution of firms from domestic to multinational is called the globalization process. A firm may enter into international trade transactions, then international contractual arrangements and ultimately the acquisition of foreign subsidiaries. This final stage is when a firm truly becomes a multinational.

This globalization process results in a firm becoming increasingly influenced by exchange rate movements and other global political and economic forces in general.

The decision whether or not to invest abroad may require the MNE to enter into global licensing agreements, joint ventures, acquisitions or Greenfield investments.

The theory of competitive advantage is based on one country possessing a relative advantage in the production of goods compared to another country.

Imperfections in national markets for products, factors of production and financial assets translate into market opportunities for MNEs.

Strategic motives drive the decision to invest abroad and become an MNE. Firms could be seeking new markets, raw materials, production efficiencies, access to technology or political safety.