CHAPTER 1

What Is International Corporate Finance?

The only trouble with going abroad is that you have to leave home to do it.

An English aristocrat when Britannia ruled the waves!

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As we enter the third millennium, information technology—by crushing the cost of communications—is accelerating the globalization of manufacturing, commerce, and especially finance. News traveling at the speed of light through the Internet reaches an estimated 250,000 computer terminals in trading rooms around the world, morphing national financial markets into one huge, efficient global marketplace for capital. Indeed, the relentless rise of the digital cyber-economy is weakening the grip of the nation-state as government policies are subjected to a continuing referendum by financial markets. And yet die-hard sovereigns are holding firmly to their prerogatives of having a national *currency*, a national *regulatory framework*, and a national *tax code* of their own and much more. International business's vastly expanded global reach is redefining the risks and opportunities faced by financial executives, whether they are at the helms of international trading firms; old-fashioned brick-and-mortar multinational corporations (MNCs) such as IBM, Nestlé, or Toyota; or "virtual" multinational enterprises such as Google or eBay.

In this first chapter, we explain what is unique about international corporate finance. To do so, it is helpful to sketch how the process of globalization fueled by the relentless rise of the multinational enterprise is reshaping the global economy, thereby providing a backdrop against which to better identify the unique dimensions of international corporate finance. At the end of this chapter, the reader should have become convinced that the study of international corporate finance is a sine qua non condition of success in tomorrow's business world. The old divide between domestic and international finance is blurring, so much so that our English aristocrat would no longer need to leave home to go abroad, because abroad has become home—at least in the world of finance.

In this introductory chapter the reader will gain an understanding of:

- What globalization is and how the multinational corporation is its handmaiden.
- What makes international corporate finance uniquely different from domestic corporate finance.

- How the exchange rate variable uniquely complicates financial decision making.
- How the locus of decision making in the finance function migrates as firms morph from strictly domestic entities to fully developed multinational corporations.
- What the international control conundrum is about.
- How multinational corporations can uniquely leverage their financial systems to minimize taxes and lower their cost of capital.

THE UNEVEN REACH OF GLOBALIZATION

Globalization is about the increasing integration of national economies as cross-border movements of labor, goods, and services, as well as money, continue at an unabated pace. In the words of Narayana Murthy, president and CEO of Infosys—an up-and-coming Indian multinational—"I define globalization as producing where it is most cost-effective, selling where it is most profitable, and sourcing capital where it is cheapest, without worrying about national boundaries." In his best-selling book *The World Is Flat*, Thomas L. Friedman argues that the world economy has become a level playing field.

The reality is, however, somewhat more nuanced. Globalization is a multifaceted process that has evolved unevenly, with certain markets becoming dramatically more integrated than others. If one breaks down the world economy into three principal markets for (1) *labor*, (2) *goods and services*, and (3) *capital*, we immediately sense that globalization is an uneven three-speed process upholding major price differences across national markets. If the world were indeed a level playing field, there would be no price differences in the cost of labor, goods, services, or capital, and what is known as the Law of One Price would hold true. Yet, globalization is at best sluggish in the labor markets where most international migration is still being curbed by severe national immigration quotas: Wages are lower in Vietnam than in China, China's wages are lower than Poland's, and Poland's wages are lower than wages in Switzerland. Globalization is healthy, but the movements of goods and services are still regulated, with most countries maintaining tariff and nontariff barriers. Meanwhile, it is unbridled and nearly all-encompassing in the market for capital. This process has been fueled by four forces:

1. *Technology aided by the marriage of computers and telecommunications*. As the cost of transportation, communications, and computing continues to decline exponentially, overcoming the natural barriers of spatial distance has become cheaper. The "death of distance" has enabled a nimbler division of labor among trading nations, allowing domestic and multinational corporations to leverage economies of scale better through outsourcing and offshoring.
2. *Economic liberalization and deregulation*. The falling of regulatory barriers that traditionally hampered the cross-national flow of goods and services as well as foreign direct and portfolio investment is proving to be a powerful catalyst for increasing integration in markets of goods, services, and capital. Multiple rounds of multilateral negotiations within the framework of the

General Agreement on Tariffs and Trade (GATT) and now the World Trade Organization (WTO) have resulted in steady lowering of tariff and nontariff barriers as well as the reduction of trade subsidies. Over the past 35 years, world trade in goods and services has grown more than twice as fast as world gross domestic product (GDP). Similarly, with the breakdown of the Bretton Woods international monetary system of fixed exchange rates, countries have progressively dismantled exchange controls and restored currency convertibility, thereby fueling foreign direct investment and international portfolio investment.

3. *Privatization and emerging capital markets*. The dislocation of the Soviet empire and its many satellites has unleashed the "invisible hand" of free market forces where command economies once struggled under the yoke of state bureaucracies. Emerging capital markets—fueled by the rapid privatization of major telecom companies, banks, and utilities, along with large-scale international portfolio investment—are energizing the efficient allocation of capital to productive investments and facilitating foreign direct investment.
4. *Market for financial derivatives*. The explosive growth of derivatives markets for forwards, futures, options, and swaps has allowed them to become effective conduits for transferring currency, commodity, interest rate, and credit risks to players best equipped to bear those risks.

THE RISE OF THE MULTINATIONAL CORPORATION

The growth of international trade, which now accounts for 30 percent of global GNP whereas it stood at only 11.6 percent in 1970,[1] is second only to the spectacular rise in foreign direct investment embodied in the multinational corporation (see International Corporate Finance in Practice 1.1).

Integration of the world market for goods and services happens to a significant extent within the multinational corporation itself, with as much as 40 percent of all cross-border trade in goods and services being of an *intracorporate* nature (between sister affiliates of the same firm domiciled in different countries) rather than of an *arm's-length* nature (between independent firms). Supply chains now span the entire world. For example, consumer electronics may be designed in the United States, components manufactured in Japan and China and then assembled in Vietnam or the Philippines, and the finished product marketed around the world.

Lenin predicted that foreign direct investment would be the weapon of colonial imperialism and would signal the final stage of capitalism. By an ironic twist of history, foreign direct investment was growing about four times faster than the world gross product and at about three times the pace of world trade when the Soviet empire (the cradle of Marxism-Leninism) finally collapsed in 1989. Indeed, the torrential flow of foreign direct investment personified by huge, ubiquitous, and stateless multinational corporations has continued unabated and is no longer the prerogative of only old imperialist powers of the rich North. In fact, countries such

[1] This is computed as global imports/global GNP, where global imports are the sum total of imports by each national economies. See *World Economic Outlook database* and *WEO aggregates* (International Monetary Fund, various years).

INTERNATIONAL CORPORATE FINANCE IN PRACTICE 1.1
WHAT ARE MULTINATIONAL CORPORATIONS (MNCs)?

A multinational corporation is a parent company that (1) engages in foreign production and other activities through its own operating subsidiaries, branches, and affiliates located in several different countries; (2) exercises direct control over the policies of those subsidiaries, branches, and affiliates; and (3) strives to design and implement business strategies in production, marketing, and finance that transcend national boundaries and allow them to capture economies of scale.

Many MNCs are owned by a mixture of domestic (the country in which the firm is headquartered) and foreign shareholders. Some of them are partially state-owned, such as China's CITIC or France's EDF (Electricité de France). Most large MNCs are headquartered in the United States, Western Europe, or Japan—for example, in 2008, General Electric (GE) was the largest multinational corporation as ranked by the value of its foreign assets (US$401 billion) and it employed 171,000 individuals in its foreign operations. However, these are increasingly challenged by MNCs based in emerging-market countries—for example, India's Infosys (information technology).

Multinational corporations are responsible for a sizable share of world trade and most foreign direct investment. As mammoth oligopolistic companies, MNCs possess market power that makes them global actors in their own right that loom large on the world economic stage. Unlike firms in purely competitive industries, MNCs enjoy managerial discretion in charting their strategic paths so much so that their actions may force nation-state changes in national policies.

as Brazil, Russia, India, and China (the BRICs), long shackled by communism, state socialism, or isolationist authoritarian governments, are not only playing host to foreign direct investors but are themselves becoming the proud homes of emerging-market multinationals: China-based Lenovo acquired IBM's PC business in 2005, and Indian Tata Motors took over the iconic British Jaguar and Land Rover in 2009, while Haier became one of the key global players in the white goods industry and Brazil-based Embraer competes head-on with Boeing and Airbus. But why do firms venture into distant and often unfriendly lands? There are at least three major motivations for doing so:

1. *Resource seekers.* From time immemorial, firms have sought access to natural resources that were either not available or only available in limited supply in their home countries. The French and the British East India companies and the Hudson Bay trading companies first chartered in the seventeenth century are the ancestors of modern multinationals; they were often established by their sovereign and closely aligned with colonization. It was not until the industrial revolution that oil and mining companies as well as agribusiness ventures emerged as

powerful foreign direct investors that often grew under the mantle of the British, Dutch, and French colonial empires.

British Petroleum, Compagnie Francaise des Pétroles (Total), Union Minière du Katanga, Rio Tinto, Anaconda, Kennecott, and United Fruit trace their roots back to the nineteenth century and came to represent for many the evil of capitalism and imperialism. Because resource seekers have long been the villains of international business, they have been the prime targets of political risk, nationalization, and expropriation. More recently, the relentless drive by Chinese state-owned companies to secure access to foreign sources of energy, minerals, and other natural resources follows the same economic logic of their yesteryear Western counterparts.

2. *Market seekers*. Access to foreign markets often unsatisfactorily served through exports is a primary driver of foreign direct investment by manufacturers of industrial products and consumer branded goods. Household names of long-established multinationals include U.S. firms such as IBM, Ford Motor Company, and Procter & Gamble, but also European companies such as Unilever, Nestlé, Michelin, L.M. Ericsson, and many others. The ascent of the multinational enterprise really started after World War II and initially was a U.S. phenomenon that primarily targeted Western Europe.

   In the 1960s European firms jumped on the multinational bandwagon, investing heavily in the United States and the more dynamic economies of East Asia and Latin America. They were joined in the 1970s by Japanese firms such as Toyota, Hitachi, Komatsu, and Sony, and in the 1980s by South Korean firms such as Samsung and Hyundai. The past decade has witnessed the onslaught of a new breed of multinationals domiciled in emerging market countries: Wipro, Haier, Tata Motors, Lenovo, Cemex, and Petrobras are fast becoming household names.

   Yet multinational corporations are hardly a new phenomenon and can trace their roots to the nineteenth-century industrial revolution: Early improvements in transportation and communications facilitated cross-border investments by American firms in Europe. Business historian Mira Wilkins recounts how in 1855 Singer licensed a French company to manufacture its new sewing machines and in 1867 set up the first plant overseas in Glasgow (Scotland).[2] Similarly, in 1879, Westinghouse started to manufacture brakes in a Paris plant. In 1889 Eastman established a new company in London to manufacture films to be used by Kodak cameras imported from the United States. Noticeably, early foreign direct investments by U.S. manufacturers were predicated on exploiting a competitive advantage due to new products, new manufacturing methods, and new marketing policies, rather than simple exporting of capital for acquisition.

3. *Cost minimizers*. The search for lower labor costs and more generally efficient gains guides many market-seeking multinationals to establish assembly operations or call centers in low-wage countries such as Mexico, China, Vietnam, or India. This is especially true of labor-intensive manufacturing processes characteristic of consumer electronics, garments, or footwear.

[2] Mira Wilkins, *The Emergence of Multinational Enterprise* (Harvard University Press, 1970).

WHAT IS DIFFERENT ABOUT INTERNATIONAL CORPORATE FINANCE?

The reader will recall from his or her first corporate finance course that financial management is about *maximizing shareholder wealth*—that is, managers, on behalf of the firm's owners, should make all business decisions and manage the firm's resources with the objective of making its shareholders wealthier than before (see International Corporate Finance in Practice 1.2). More formally, shareholders' wealth maximization is all about increasing the firm's market value, defined as the present value of future net free cash flows (FCF) discounted at the firm's weighted average cost of capital (WACC). This is typically achieved in by making two types of decisions:

1. *Value-maximization investment decisions*, also known as capital budgeting, or the allocation of scarce resources (capital) among a company's present and potential activities/projects to uses that maximize shareholders' wealth. Such decisions run the gamut from modernization of plant and equipment to new product launches, entering new foreign markets, and acquisitions of new business firms, but also to wise credit granting to customers (accounts receivable), efficient management of inventory (raw materials, work in progress, or finished goods), and so forth. These are the decisions most closely linked to the asset side of the firm's balance sheet.
2. *Cost-minimizing funding/financing decisions*, or the acquisition of funds—beyond internally generated financing—necessary to support investment. In effect, this is a quintessential procurement decision whereby the firm searches for the least costly sources of funds. Should the firm borrow short-term or long-term at a fixed or variable interest rate? Should it source debt (bank loans or bonds) or equity (straight or preferred) or lean on its suppliers (accounts or notes payable) for more favorable credit terms? What is the optimal mix of debt and equity financing that minimizes the firm's weighted average cost of capital? Such decisions are closely associated with the liabilities and owners' equity side of the balance sheet.

As firms expand beyond their own domestic borders, they are confronted with a myriad of new opportunities on both the investment and the funding sides, thereby redefining the parameters and the scope of the corporate finance function. How financial managers should identify, gauge, and leverage these new opportunities to better achieve the firm's global strategic goals is the subject of this book. New decisions are now confronting the globally minded chief financial officer:

- How should foreign subsidiaries be financed?
- When and how should earnings be repatriated from foreign subsidiaries?
- How should similar investment opportunities in different countries be analyzed and compared?
- Where should financial decision making be located between the parent and its many far-flung foreign subsidiaries?
- How should managerial incentive and control systems be designed to be congruent with the firm's overall strategy but also account for foreign countries' idiosyncrasies?

Not only is the scope of international financial management far broader than it is for domestic financial management, but it is also compounded by a number of risk

INTERNATIONAL CORPORATE FINANCE IN PRACTICE 1.2 SHAREHOLDERS' WEALTH MAXIMIZATION AND CORPORATE GOVERNANCE SYSTEMS AROUND THE WORLD

If shareholders' wealth maximization is the dominant gospel of financial management in Anglo-Saxon countries where capital markets and a dispersed shareholder base play the leading role in financing firms, this is not necessarily the case in other major capital exporting countries, where banks, family groups, or even the state are the dominant owners.

In Japan, interlocking business groups formerly known as *keiretsu* focus on the health of the business group ahead of its individual firms and often emphasize market share more than share price maximization. *Chaebols* in South Korea mimic the Japanese model and may also maximize long-term growth more than short-term profits. Family groups in Southeast Asia, India, and Mexico often hold controlling interest in publicly listed firms and may expropriate minority shareholders by abusing their power and appropriating unfairly more than their share of the firm's profits. European firms often consider interests of stakeholders (primarily employees) on par with shareholders' interests. Many multinationals in countries like France, Russia, Brazil, and China are still partly state-owned and may put national interests ahead of shareholders' wealth.

Even in Anglo-Saxon countries, there is no guarantee that managers will indeed manage the firm in the best interests of its owners/shareholders. After all, managers are human beings whose personal goals may not be congruent with the firm's overarching goal of value creation. Thus managers may act in their self-interest rather than pursue policies aligned with the best interests of the firm's shareholders. For example, managers may use company resources to benefit themselves rather than their shareholders by squandering money on lavish offices, large personal staff, corporate jets, country club memberships, and other wasteful perquisites.

Clearly, corporate governance—the charter that governs the relationship between the firm's owners and its managers—varies greatly across countries, reflecting legal, cultural, and sociopolitical national idiosyncrasies. The central problem, however, remains how to strengthen corporate governance to best protect outside investors (often minority shareholders) from expropriation by the controlling shareholders to ensure that the former are fairly rewarded for their investment. Indeed, resolving the governance conundrum equitably has far-reaching implications for efficient allocation of corporate resources, corporate financing, realistic corporate valuation, development of capital markets, and economic growth.

Needless to say, multinational corporations pursuing cross-border mergers and acquisitions or entering into joint-venture or licensing agreements with foreign firms should be well apprised of the nuances of national corporate governance systems.[3] Similarly, asset managers, whether they are pension funds or hedge funds, need a keen understanding of how idiosyncratic local corporate governance may bias valuation.

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[3] Chapters 12 and 13 are devoted to Asian and Islamic finance and banking.

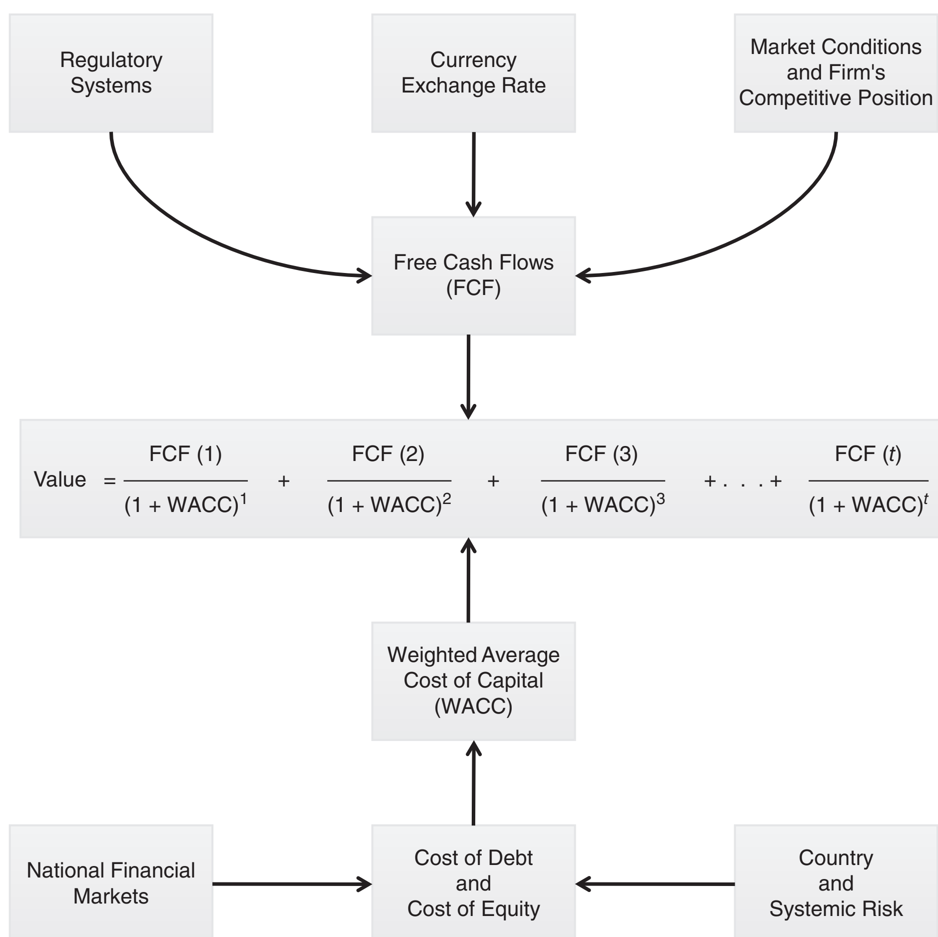

EXHIBIT 1.1 International Valuation

factors unique to international financial management as sovereign nations issue their own currencies, implement their own economic policies, and apply their own tax and regulatory rules. See Exhibit 1.1 for the different factors shaping free cash flows (FCF) and the weighted average cost of capital (WACC) at which they should be discounted.

RISKS IN THE WONDERLAND OF INTERNATIONAL FINANCE

As firms chart new territories by opening export markets or building plants in foreign countries, they expose themselves to a myriad of risk factors that need to be carefully calibrated and incorporated in financial decision making.

Foreign Exchange Risk

For most firms, investment and funding decisions are carried out in the home currency context, which means only one currency to contend with. As soon as firms

widen their market horizons and become active in international business, first by exporting some of their products or importing components or subassemblies and later by setting up operations in foreign countries, they expand their opportunity set. This brings with it new rewards and new risks.

Most obvious is the unique variable incorporated in most decisions that the firm tackles, namely the fickle and all too often misbehaving foreign exchange rate. Generally, foreign exchange risk can raise the cost of capital for the multinational firm, as international portfolio investors may require a risk premium in valuing debt and equity. Conversely, when foreign projects are analyzed—such as building a new plant to serve an emerging market or acquiring an existing business—a higher discount rate may be applied to capture the impact of volatile exchange rates on future cash flows. More specifically, consider the following transactions:

- *Imports and exports.* Foreign exchange risk is invariably associated with import and export transactions when future payment to or from a foreign firm is denominated in a foreign currency. Consider the case of U.S.-domiciled Alaska Airlines purchasing five Airbus A320s at a cost of 100 million euros (€100 million) each, to be paid on delivery 24 months from the date of the purchase order. Such a transaction exposure (account payable is denominated in euros) may result in substantial cash-flow loss/gain depending upon the movement of the euro against the U.S. dollar over the next 24 months. For example, if, when the order was first booked, the exchange rate stood at €1 = $1.25, but on delivery day—24 months later—the euro has appreciated to €1 = $1.50, Alaska Airlines would end up paying $25 million more per A320 than initially contemplated.
- *International financing.* Similarly, foreign exchange risk is at the core of the international financing decision. Consider the case of the U.S. retailer JCPenney seeking to minimize the cost of financing its US$300 million working capital requirement. Should the U.S. retailer source a short-term bank loan from a Japanese bank at 1.5 percent annually denominated in yen or stay home with a 6 percent loan from Bank of America denominated in U.S. dollars? On the face of it, yen financing seems dirt cheap if we assume that the dollar price of one yen (the exchange rate) stays constant over the financing period. But what if the yen were to appreciate by more than 4.5 percent (6% – 1.5% = 4.5%) over the next year? The effective cost of yen financing would end up being more expensive than dollar financing.
- *Foreign direct investment.* A multinational corporation such as General Motors, attempting to decide whether a car assembly operation in Malaysia should be expanded by 25 percent to capitalize on the rebound of the Malaysian economy in the aftermath of the 1997 Asian financial crisis, is confronted with a long-term foreign exchange risk exposure. The project returns an attractive 19 percent in Malaysian ringgit—but its return in dollar terms is clouded by the possible weakness of the Malaysian currency over the life of the project. Would the project in fact create value for GM-USA?
- *Lost in translation.* Another dimension of foreign exchange risk is the uncertainty that it creates in the financial reporting process. Exchange rates are used periodically (every quarter) in translating or consolidating the financial

statements of foreign subsidiaries with the parent's to report an all-inclusive measure of global performance to financial markets—the much cherished earnings per share. Earnings per share are the tip of an informational iceberg (consolidated balance sheet, income statement, and cash-flow statement being the iceberg), which may show erratic movements from quarter to quarter as exchange rates fluctuate (sometimes wildly) over the reporting cycle, unless the multinational corporation seeks to smooth its income stream by hedging selectively its translation exposure.

Country Risk

A multinational firm is exposed to country risk—also known as political risk—when unforeseen events in the host country impair the firm's operations in that country. Indeed, international portfolio investors will require a country risk premium in evaluating such operations. That premium, in turn, will impact the value of the multinational firm's investment. Changes in the host country's political environment may result in reformed or new regulations as well as taxation or ownership guidelines that will impact the local subsidiary's performance. For example, the August 2009 nationalization of the Mexican firm Cemex's cement plants by the host government in Venezuela was an extreme form of country risk. The Chavez leftist government had announced its intention to nationalize the cement industry earlier in the spring of 2009 and had successfully forced both French Lafarge and Swiss Holcim cement multinationals to sell a majority stake in their local operations to the Venezuelan government.

Similarly, the January 2002 meltdown of the Argentine economy, with its abolition of the currency board that had constitutionally enshrined the Argentine peso = U.S. dollar peg, led to the abrogation of dollar-denominated tariff structure for foreign-owned telecommunications companies such as Telefonica S.A. of Spain. As a result, Telefonica S.A., which had been guaranteed a pricing schedule denominated in U.S. dollars (since 1 dollar = 1 peso) and had heavily borrowed in U.S. dollars, was now forced to price its services in a much-devalued peso and, facing price controls, had a much heavier debt burden.[4] In addition, scattered political violence and vandalism against brick-and-mortar facilities in Buenos Aires resulted in a major loss of income and damaged plant, property, and equipment.

In the same vein, Enron—better known for its ignominious collapse in 2001—signed a contract in 1992 to build the largest power plant in India. After having spent more than $300 million in design and engineering costs, Enron abandoned the undertaking in 1995 when various political parties and environmental groups were able to kill the project in the local courts of the state of Maharashtra. Enron had discovered the importance of legal contract enforceability or lack thereof.

[4] Telefonica had a peso-denominated revenue stream with which it had to pay interest and principal on a much revalued dollar denominated debt. The currency mismatch between peso-denominated revenue and dollar-denominated cost that resulted from the abrupt devaluation of the peso was made worse by tight price controls on peso-denominated rates that Telefonica was charging its customers in Argentina.

More generally, changes in the rules of the game that impact foreign direct investors' operations include:

- Imposition of exchange controls that restrict repatriation of dividends or payment of royalties by a foreign subsidiary to its parent.
- Restrictions on the availability of foreign exchange and discriminatory currency rates for importing parts or subassemblies.
- Imposition of price controls on local sales or local procurement requirements for parts, subassemblies, or raw materials.
- Expropriation and/or nationalization without adequate compensation in extreme cases.

Mildly Segmented Global Financial Markets

Closely related to the pervasive exchange risk conundrum is the notion that funding decisions are made in the context of national capital markets, with each offering a different cost of capital for both debt and equity financing. Such discrepancies are the results of national monetary policies creating different inflation expectations and therefore different yield curves, with central banks meddling in foreign exchange markets (resulting in currency overvaluation or undervaluation). They are also due to differences across countries in corporate governance systems (see International Corporate Finance in Practice 1.2) and various market imperfections such as asymmetries in tax regimes, disclosure, and reporting requirements, or other man-made distortions in money or capital markets. This is the notion of *capital market segmentation* that motivates the search for the lowest possible source of financing. In other words, national capital markets are less than fully integrated, and cross-currency cost of capital discrepancies warrant systematic scanning of funding options. Cross-listing of shares when issuing equity capital is a good illustration of the fact that the cost of equity capital is far from uniform across capital markets. Jazztel, an up-and-coming Spanish telecom company in the late 1990s challenging the monopolist Telefonica S.A., should have naturally scheduled its initial public offering on the Spanish Bolsa; instead it decided to list on the New York NASDAQ in 1999, presumably to lower its cost of equity capital.

With multiple *currency habitats* and their tax and regulatory systems to contend with or to choose from, the funding decision becomes far more complicated. A six-month working capital loan can be sourced domestically or from Japan, Switzerland, or any country or lending source offering a possibly lower interest rate. As we will discover in a subsequent chapter, lower interest rates are only half of the equation, since a lower interest rate is often an indicator of a currency likely to appreciate over time. It is difficult enough to decide on short-term financing, but long-term debt financing is even more perplexing because of the daunting task of forecasting exchange rates over the longer term. In all cases, borrowing firms will also compare domestic/onshore with international/offshore financial markets, as the cost of capital may be slightly different between each market's onshore and offshore tiers.[5]

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[5] Offshore markets (also known as euro-currency markets) are unregulated money markets that operate beyond the jurisdiction of their home currency's central bank. For example, the euro-dollar market functions anywhere but in the United States. See Chapter 8 for further discussion.

Equity financing is no easier. Firms can list their stock in different markets hoping to capture a cheaper cost of equity capital. The 1980s and 1990s witnessed a flurry of large Latin American firms deciding to list on the New York Stock Exchange by issuing American depositary receipts. Similarly, Russian, Chinese, and Indian firms have aggressively sought equity financing from Western capital markets by listing their shares on the Frankfurt, London, New York, and Hong Kong stock exchanges. Whether addressing a short-term or a long-term financing decision, the firm can choose from different financial markets and achieve a lower cost of capital.

INTERNATIONALIZATION AND THE LOCUS OF THE FINANCE FUNCTION

The finance function is managed by the chief financial officer, who directly reports to the firm's chief executive officer and its board of directors. He or she is usually seconded by a treasurer, risk manager, and comptroller. Depending on the size and the scope of the firm's domestic and international activities, each subfunction will develop its own staff.

The *treasurer* oversees short-term funding decisions, cash and near-cash management, and account receivables collection. The *risk manager* is responsible for purchasing insurance coverage as well as overseeing foreign exchange risk management, often coupled with hedging interest rate and commodity price risks. The *comptroller* orchestrates the consolidation of financial statements from both foreign and domestic operations for reporting the firm's aggregate results to its shareholders, debtors, and other stakeholders.

For firms that are primarily domestic in scope, the finance function is clearly anchored at headquarters. However, as firms begin to stumble into international business, whether by chance or by design, they will struggle with international financial management decisions whose scope becomes increasingly more complicated. The internationalization process is likely to be very incremental, with well-identifiable phases along the way and increasing allocation of responsibility in financial decision making between the parent and its foreign subsidiaries.

- ***Stage I:** Exporting and importing*. Most firms never venture beyond the confines of their domestic market but may experience imports competition from foreign-based firms. To overcome their cost handicap against lower priced imports, firms may source key inputs or subassemblies from the same foreign countries as their import-competitors. More likely than not, the management of foreign-currency-denominated payables will require foreign exchange risk management expertise to mitigate the risk of exchange losses associated with such imports. The treasury function will add a foreign exchange manager who will work closely with the procurement manager to factor in exchange risk in paying for and financing imports. The firm's market horizons may still be domestic, but its financial manager's mind-set is beginning to become more international.

  Whether the result of a random inquiry by a foreign distributor or the result of its own systematic effort, the firm may pursue international sales and progressively develop in-house exports-management capability. Pricing in the currency of the target market and decisions to grant credit to foreign distributors will require special expertise in analyzing *foreign credit risk*, managing *foreign exchange risk*, and exports financing. Here again the foreign exchange manager

nested within the treasury function at headquarters will coordinate closely with the international sales department. Over time, as exports sales to a particular country reach a critical mass, a fully staffed foreign sales branch or subsidiary may be established in the target country, but treasury and foreign exchange risk management will remain housed at headquarters (see Exhibit 1.2, panel A).

- ***Stage II:** Foreign manufacturing*. As a foreign sales subsidiary matures, serious consideration may be given to establishing local manufacturing operations—perhaps in the form of local assembly—to reduce the impact of tariff barriers as is often the case in emerging markets. Now a more self-sufficient foreign subsidiary is constituted with its own financial function and a chief financial officer reporting to its own general manager but also coordinating more loosely with its parent chief financial officer. The locus of financial decision making will migrate to the foreign subsidiary as it asserts its financial independence from headquarters (see Exhibit 1.2, panel B).
- ***Stage III:** Multinational enterprise stage*. As a firm repeats its successful market entry in different countries, a complex multinational enterprise is progressively evolving with distributed responsibility for financial decision making. This gives the international financial management function its unique personality and complexity. As the locus of decision making migrates from parent to foreign subsidiaries to regional centers, the mind-set of financial managers is correspondingly reshaped from a home-country bias characteristic of firms in the exporting stage to a more decentralized host-country approach in stage II and more global and systemic orientation in stage III (see Exhibit 1.2, panel C). More specifically, the

EXHIBIT 1.2 Locus of Financial Decision Making

Panel A: Stage I of Financial Development of a Multinational Enterprise

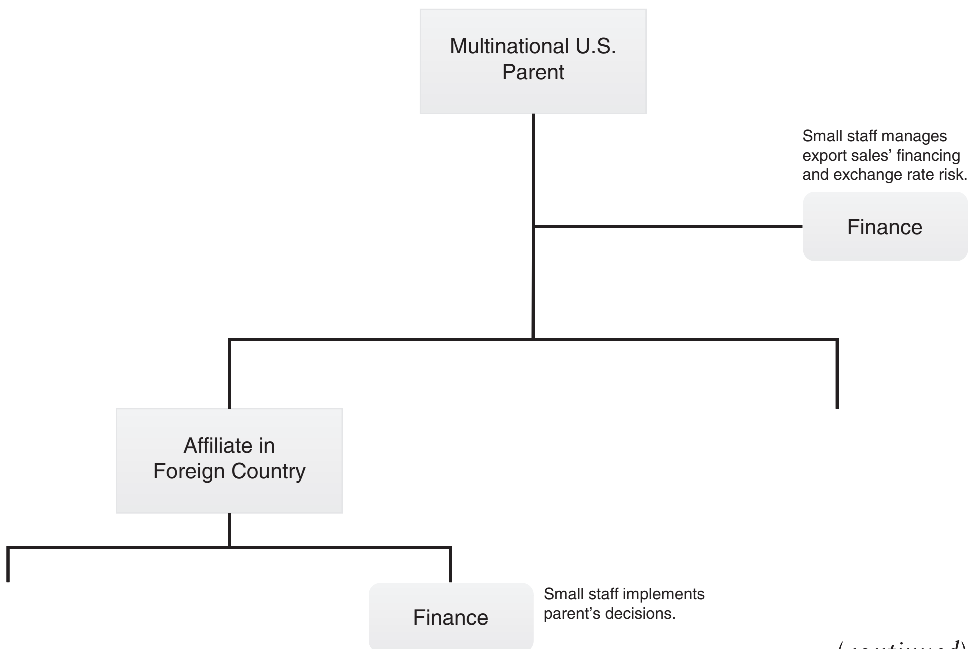

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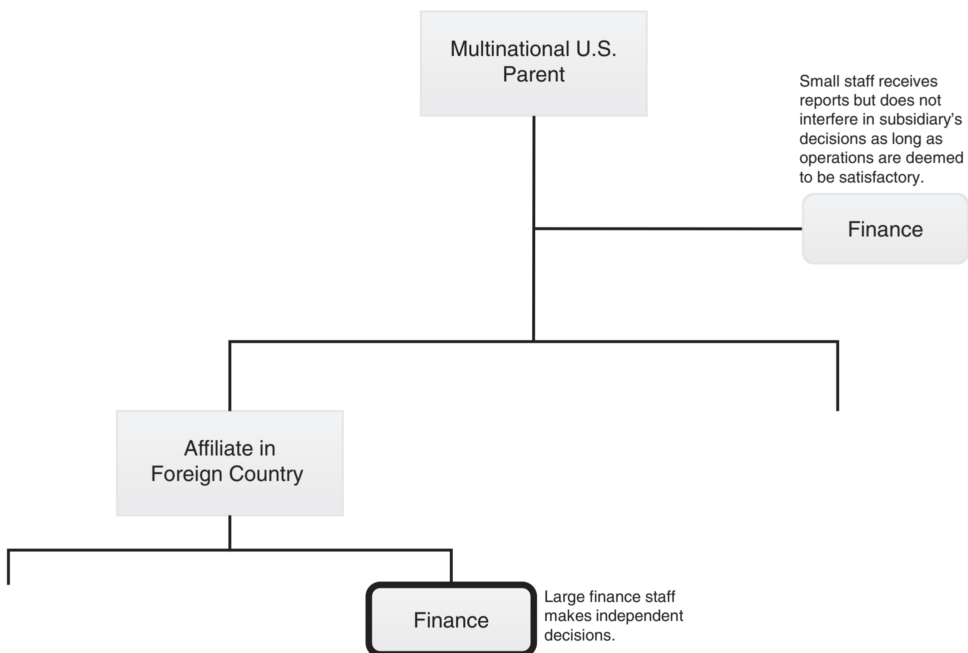
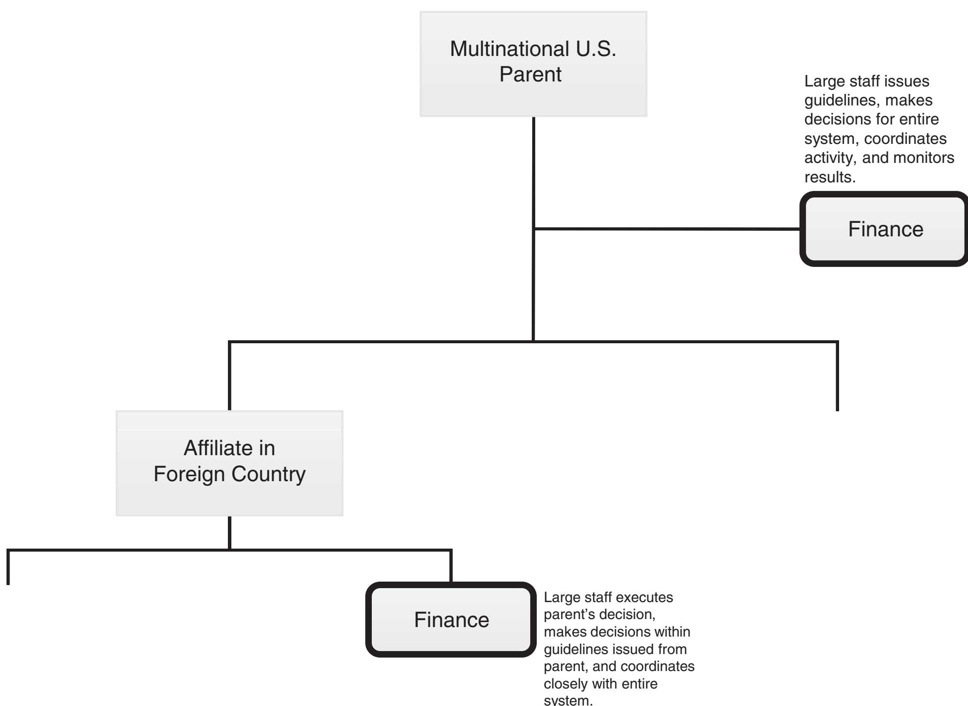
EXHIBIT 1.2 *(Continued)*

Panel B: Stage II of Financial Development of a Multinational Enterprise



Panel C: Stage III of Financial Development of a Multinational Enterprise



center of gravity of financial decision making will be equally distributed between parent and foreign subsidiaries, with close coordination between them and tight integration of all funding and investment decisions to best exploit the firm's multinational system potential.

The organizational dynamics of the global finance function is best understood in the strategic context adopted by the firm. As long as the multinational enterprise follows a *multidomestic* strategy, each foreign subsidiary will develop as a reasonably independent entity primarily responsive to the idiosyncrasies of its host market. Financial decision making will be nested in the foreign subsidiary with relatively minor interference from the parent company, which at most will get involved in dividends repatriation decisions. However, should the multinational enterprise adopt a more *global* strategy with strong production rationalization among its various subsidiaries, it will coordinate its financial decision making more closely between the parent's finance function and its many foreign subsidiaries. Exploiting the multinational enterprise's potential (see next section) through skillful transfer prices[6] of cross-border intracorporate shipments of parts, subassemblies, or finished products requires strong financial decision-making capabilities both at the parent's and at the foreign subsidiaries' level, often reinforced by the establishment of reinvoicing centers that channel intracorporate financial flows through low-tax jurisdictions. The danger, though, is that a skillful exploitation of the financial system may undermine the autonomy of each operating unit and disincentivize its management as performance measurement becomes murky. General Motors, for example, kept its currency risk management policies relatively decentralized at national operating levels even though that meant having redundant hedging policies that are clearly suboptimal from a system optimization perspective.

THE INTERNATIONAL CONTROL CONUNDRUM

At the core of a successful strategy are effective planning, budgeting, and control systems. For multinationals the challenge is to translate pro forma financials, budgets, and performance measures first compiled in the currency of each foreign subsidiary into a common currency (numéraire) to allow for meaningful comparison and efficient resource allocation. The design of an effective management control system for multinational corporations is compounded by exchange rate fluctuations between the foreign subsidiary's local currency and the parent company's reference currency.[7] To be reliable, management control systems for multinational corporations must somehow incorporate a multiplicity of complicating factors such as exchange rates, differential rates of inflation, and byzantine national price and exchange controls.

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[6] By charging more (over-invoicing) for shipping parts or subassemblies to sister-affiliates domiciled in high-tax jurisdictions, the multinational corporations can shift income toward subsidiaries operating in low-tax countries while reducing taxable income in high-tax countries.

[7] The traditional dichotomy is made between the reporting subsidiary's foreign/local currency and the parent firm's reference currency, in which consolidated financial statements are prepared.

Multinational corporations tend simply to extend their domestic control systems to foreign operations. Indeed, performance relative to the operating budget continues to be the major evaluation and control system used. Simply put, budgetary *variance analysis* is based on the comparison of actual performance, whether it be measured by sales, operating expenses, accounting income, or free cash flows as recorded *ex post*, and the corresponding budgeted amount as forecast *ex ante* (at the outset of the budgetary cycle). Differences between actual and budgeted amounts are then explained in terms of *price and/or volume variance*, which can in turn be traced to *environmental variables* that are generally noncontrollable by the reporting subsidiary's managers. Clearly, operating managers should be held responsible only for budgetary variances that are deemed to have resulted from variables over which they do have control.

Unique to international control systems is the choice of exchange rates used for translating local currency budgets into reference currency terms. Technically, exchange rates enter the budgeting control process at two levels: in *drafting* the operating budget and in measuring or *tracking* results. Should the initial spot exchange rate be used in setting up the operating budget and the performance be tracked and gauged at the ending exchange rate? Under such circumstances, local managers will bear the full responsibility for exchange rate changes during the period and, as a consequence, may be expected to behave in an overly risk-averse manner. A potentially harmful consequence of such a system may be the padding of budgets as well as decentralized hedging by local managers eager to reduce their perceived exposure to exchange risk (which is generally suboptimal from the parent's point of view).

Conversely, one may take the view that because foreign subsidiaries' operations are carried out in a foreign environment and are effected in the foreign currency, then a local currency perspective ought to prevail. However, when performance evaluation is based strictly on local currency, foreign currency translation gains and losses resulting from fluctuating exchange rates are generally dissociated from the subsidiary's performance, thereby transferring the responsibility of foreign exchange risk management to the treasury at headquarters. Specifically, initial spot exchange rates are used both to set budgets and to track performance, thus removing incentives for local managers to incorporate anticipated exchange rates into operating decisions or to react swiftly to unanticipated exchange rate changes during the life of the budget.

Alternatively, projected exchange rates could be incorporated in both the budgeting process and the tracking process. This approach allows the subsidiary to negotiate with its parent an *internal forward rate* that best reflects its anticipation of exchange rate changes. Such internal forward rates are deemed to foster goal congruence between home-country parent and foreign subsidiaries as well as fairness for operating managers, since they would receive neither blame nor credit for variance in performance attributed to exchange rate surprises. Local management is de facto shielded from unforeseen exchange rate changes, since the parent company acts as a banker, literally buying its foreign subsidiary's budget at a forward rate.

EXPLOITING THE MULTINATIONAL ENTERPRISE SYSTEM

Unique to the web of international business activities that firms weave around the globe is the making of a complex multinational enterprise system that gives the firm unique opportunities to move capital across borders from one subsidiary to

the parent or to another subsidiary. For example, in the aftermath of the 1997 Asian financial crisis, countries such as Thailand and Indonesia imposed tight credit policies in the form of punishing interest rates. Foreign subsidiaries of many multinationals operating in these countries were able to bypass such restrictive policies by tapping into the internal financial market of their parent, in effect procuring low-interest-rate financing from other parts of the multinational financial system. This provided them with a significant competitive advantage over local firms and allowed them to capture market share. Let's consider first the architecture of the multinational enterprise's financial system before showing how its skillful optimization will create value in its own right (see Exhibit 1.3).

The architecture of the multinational financial system is anchored in the *equity and debt linkages* that tie foreign affiliates to their parent. Such linkages, typically established when the subsidiary is first set up, are likely to be upgraded over time as the parent provides additional capital to its subsidiary. They result in periodic *financial flows* such as dividends (on equity ownership) and interest payments on outstanding debt (see lower part of Exhibit 1.3).

Similarly, the parent company establishes *operational linkages* in the form of licensing contracts or management service agreements with its foreign subsidiaries, which also give rise to periodic royalty payments (on licensing agreements) and

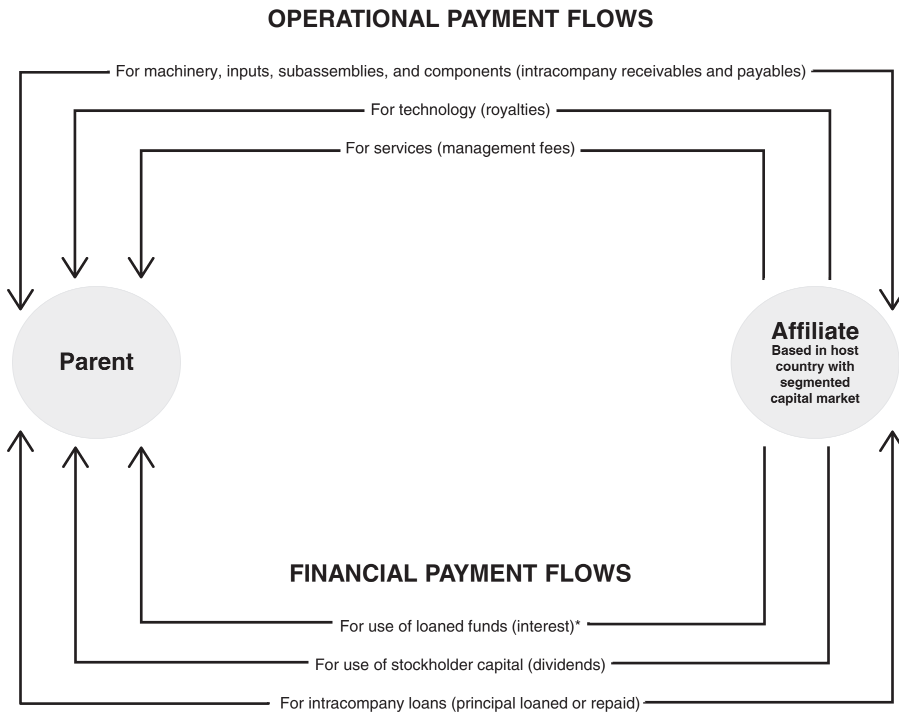

EXHIBIT 1.3 Exploiting the Multinational Financial System

*MNCs have discretion to manipulate maturity structure of accounts and interest payables or receivables (leading or lagging) and adjust the magnitude of payment flow (overinvoicing or underinvoicing).

management know-how fees. Depending on the international division of labor that the multinational corporation is implementing, intracorporate trade in parts, subassemblies, and finished products among different national subsidiaries and its parent may be important and may generate a different kind of financial flows, namely payments for goods (see upper part of Exhibit 1.3).

Constrained Optimization

In order to shift income out of high-tax-rate countries, the multinational enterprise has several levers at its disposal: *transfer pricing*[8] in the form of *overinvoicing* of shipment to a foreign subsidiary domiciled in a high-tax country to reduce its taxable income or *leading payments/dividend remittances* ahead of a currency devaluation or *underinvoicing* in order to pay lower tariff duties on key imported subassemblies to allow for skillful global tax minimization and therefore enhanced value creation.

SUMMARY

1. Globalization is about the increasing integration of national economies as cross-border movements of labor, goods, and services, as well as money, continue at an unabated pace. It is fueled primarily by (1) technological breakthroughs aided by the marriage of computers with telecommunications, (2) the dismantling of tariff barriers and exchange controls that has returned many currencies to full convertibility, and (3) deregulation that has reasserted the rule of the "invisible hand."
2. Globalization is minimal in the international market for labor because of barriers to migration. It is significant in the market for goods and services, as multilateral rounds of negotiations have progressively lowered tariff and nontariff barriers. As more developed and emerging market countries return to full currency convertibility, financial globalization is almost—but not quite—a reality.
3. The scope of decisions confronting the global finance function is far broader than in the case of strictly domestic corporate finance: (1) How should foreign subsidiaries be financed? (2) When and how should earnings be repatriated from foreign subsidiaries? (3) How should similar investment opportunities in different countries be analyzed and compared? (4) Where should financial decision making be located between parent and its many far-flung foreign subsidiaries? and (5) How should managerial incentives and control systems be designed congruent with the firm's overall strategy that can account for the idiosyncrasies of individual foreign countries?
4. International financial management is complicated by factors such as currency risk, country risk, and less than fully integrated national capital markets.

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[8] Transfer pricing refers to the price at which the sales of goods or services is carried out between two independent parties such as nonaffiliated firms. When the transaction is carried out between the subsidiaries of the same parent multinational there is discretion for manipulating the actual price up (overinvoicing) or down (underinvoicing) and therefore shifting income out of high-tax countries.

5. The challenge of designing an effective management control system for multinational corporations is compounded by exchange rate fluctuations between the foreign subsidiary's local currency and the parent company's reference currency.
6. By exploiting its system potential, the multinational enterprise has several levers at its disposal to shift income out of high-tax-rate countries toward lower-tax jurisdictions, thereby minimizing its global tax liabilities: *transfer pricing* in the form of *overinvoicing* of shipments to a foreign subsidiary domiciled in a high-tax country to reduce its taxable income, or *leading payments/dividend remittances* ahead of a currency devaluation, or *underinvoicing* in order to pay lower tariff duties on key imported subassemblies to allow for skillful global tax minimization and therefore enhanced value creation.

QUESTIONS FOR DISCUSSION

1. Define in your own words what is meant by globalization.
2. Discuss the key drivers of globalization.
3. What is meant by "the world is flat"? (Was Galileo wrong?)
4. What are the key motivations for firms to expand abroad?
5. Is international financial management different from domestic corporate finance?
6. What is corporate governance, and how does it vary across countries?
7. What are the unique risks faced by multinationals?
8. Explain the international control conundrum faced by multinational corporations.
9. What are the organizational challenges of managing the finance function in a multinational corporation? Where should the locus of financial decision making be housed?
10. How can multinationals exploit their global financial systems to create value?

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