# INTERNATIONAL FINANCIAL MANAGEMENT

THIRD EDITION

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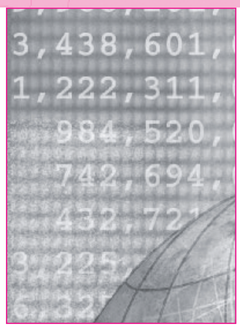
Robert Hodrick




# Preface

## Our Reason for Writing this Textbook

Both of us have been teaching international financial management to undergraduates and M.B.A. students at Georgia Institute of Technology, Wake Forest University, and at other universities we have visited for two decades. During this time period, we conducted many research studies, published in major finance and statistics journals, concerning the operation of international financial markets. As one might imagine, in doing this we put together an extensive set of teaching materials which we used successfully in the classroom. As the years went by, we individually relied more on our own teaching materials and notes and less on any one of the major existing textbooks in international finance (most of which we tried at some point).

As you may be aware, the scope and content of international finance have been fast evolving due to deregulation of financial markets, product innovations, and technological advancements. As capital markets of the world are becoming more integrated, a solid understanding of international finance has become essential for astute corporate decision making. Reflecting the growing importance of international finance as a discipline, we have seen a sharp increase in the demand for experts in the area in both the corporate and academic worlds.

In writing *International Financial Management,* Third Edition, our goal was to provide well-organized, comprehensive, and up-to-date coverage of the topics that take advantage of our many years of teaching and research in this area. We hope the text is challenging to students. This does not mean that it lacks readability. The text discussion is written so that a self-contained treatment of each subject is presented in a *user-friendly* fashion. The text is intended for use at both the advanced undergraduate and M.B.A. levels.

## The Underlying Philosophy

*International Financial Management,* Third Edition, like the first two editions, is written based on two tenets: emphasis on the basics, and emphasis on a managerial perspective.

### Emphasis on the Basics

We believe that any subject is better learned if one first is well grounded in the basics. Consequently, we initially devote several chapters to the fundamental concepts of international finance. After these are learned, the remaining material flows easily from them. We always bring the reader back, as the more advanced topics are developed, to their relationship to the fundamentals. By doing this, we believe students will be left with a framework for analysis that will serve them well when they need to apply this material in their careers in the years ahead.

## A Managerial Perspective

The text presentation never loses sight that it is teaching students how to make managerial decisions. *International Financial Management*, Third Edition, is founded in the belief that the fundamental job of the financial manager is to maximize shareholder wealth. This belief permeates the decision-making process we present from cover to cover. To reinforce the managerial perspective, we provide numerous "real-world" stories whenever appropriate.

## Changes in the Third Edition

Following are the specific key changes made to update this edition. For all chapters, examples and cases using former European Union national currencies have been revised to reflect the new common euro currency. Also, all chapter exhibits are updated with current data. There is a new chapter on corporate governance around the world.

Chapter 1: Updated review of new trends in the world economy.

Chapter 2: Extensive coverage of the Euro.

Chapter 3: Expanded coverage on the relationship between balance of payments accounting and national income accounting.

Chapter 4: Updated discussion of triangular arbitrage.

Chapter 5: More examples of international parity relationships and exchange rate forecasting.

Chapter 6: New section on the Japanese banking crisis.

Chapter 6: Updated section on bank capital adequacy reflecting the New Basle Accord.

Chapter 8: A new section on Global Registered Shares.

Chapter 8: A thorough revision of The European Stock Market section.

Chapter 10: Expanded coverage on interest rate and currency swap quotations.

Chapter 11: Updated analysis of risk-return of World Stock Markets. Revised and expanded appendices on international portfolio diversification and hedging exchange rate uncertainty.

Chapter 12: Updated real-world examples of exchange risk management practices.

Chapter 13: More discussion of exchange risk management and firm value.

Chapter 15: Updated coverage of foreign direct investment and cross-border M & As.

Chapter 16: More discussion of the effect of cross-border stock listings.

Chapter 21: New chapter on corporate governance. Comprehensive coverage of international corporate governance issues, with numerous real-world examples.

# Pedagogical Features

www.wto.org/

The World Trade Organization website covers news and data about international trade development.

**NEW! Annotated Web Resources**—New Annotated Web Resources have been added to the margins within each chapter to serve as a quick reference of pertinent chapter-related websites. Each URL listed also includes a short statement on what can be found at that specific site.

CFA® PROBLEMS

**NEW! CFA Questions**—Many chapters also include questions from prior CFA exams. These CFA problems, indicated with the CFA logo, show students the relevancy of what is expected of certified professional analysts.

INTERNET EXERCISES

**NEW! Web Exercises**—New Internet Exercises have been added at the end of each chapter to highlight specific topics, and prompt the student to search the Internet for specific data. The student is then able to analyze the data found to solve the exercise.

**Chapter Outline**—At the beginning of each chapter, a chapter outline and statement of purpose are presented, which detail the objectives of the chapter.

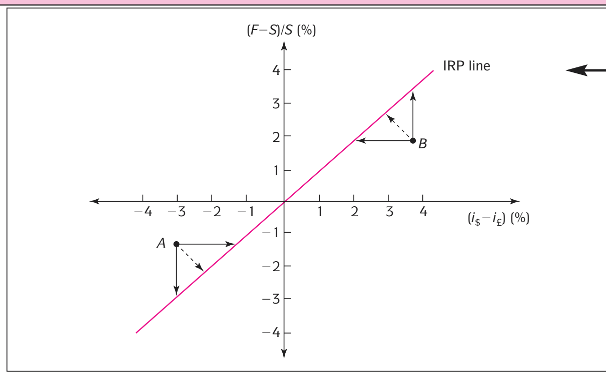
**EXAMPLE | 3.1** For example, suppose that Boeing Corporation exported a Boeing 747 aircraft to Japan Airlines for $50 million, and that Japan Airlines pays from its dollar bank account kept with Chase Manhattan Bank in New York City. Then, the receipt of $50 million by Boeing will be recorded as a credit (+), which will be matched by a debit (−) of the same amount representing a reduction of the U.S. bank's liabilities.

**EXAMPLE | 3.2** Suppose, for another example, that Boeing imports jet engines produced by Rolls-Royce for $30 million, and that Boeing makes payment by transferring the funds to a New York bank account kept by Rolls-Royce. In this case, payment by Boeing will be recorded as a debit (−), whereas the deposit of the funds by Rolls-Royce will be recorded as a credit (+).

**Examples**—These are integrated throughout the text, providing students with immediate application of the text concepts.

**EXHIBIT 5.3**

**The Interest Rate Parity Diagram**

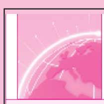



horizontal arrow) and, at the same time, lower the forward premium/discount (as indicated by the vertical arrow). Since the foreign exchange and money markets share the burden of adjustments, the actual path of adjustment to IRP can be depicted by the dotted arrow. When the initial market condition is located at point *B*, IRP will be restored partly by an increase in the forward premium, $(F - S)/S$, and partly by a decrease in the interest rate differential, $i_\$ - i_£$.

**EXAMPLE | 5.2** Before we move on, it would be useful to consider another CIA example. Suppose that the market condition is summarized as follows:

Three-month interest rate in the United States: 8.0% per annum.
Three-month interest rate in Germany: 5.0% per annum.
Current spot exchange rate: €1.0114/$.
Three-month forward exchange rate: €1.0101/$.

**Graphs and Numerical Examples**—Within each chapter extensive use is made of graphs to provide visual illustration of important concepts, which are followed by numerical examples.



INTERNATIONAL FINANCE IN PRACTICE

## The New World Order of Finance

Global financial panics erupt every decade or so. But even by historical standards, Mexico's currency collapse ranks among the scariest. With the crisis stretching into its seventh week, investors were stampeding. Worse yet, the panic was spreading from Buenos Aires to Budapest. Even the dollar was taking an unexpected shellacking. Some were bracing for another 1987 crash—not just in Mexico City, but in New York, London, and Tokyo.

It took forceful action to stop the runaway markets before they dragged the world economy down with them: $49.8 billion in loans and guarantees for Mexico from the U.S. and its allies. Some bankers say the total could reach $53 billion or more. Certainly, this will go down as the largest socialization of market risk in international history.

This time, it was mutual-, hedge-, and pension-fund gunslingers who provided the capital. Mexico attracted $45 billion in mutual-fund cash in the past three years. And when the peso dived, fund managers bolted. In this global market, all it takes is a phone call to Fidelity to send money hurtling toward Monterey—or zooming back. And world leaders should be able to act with similar speed.

Clinton's $40 billion in loan guarantees for Mexico got nowhere because Congress objected to bailing out Wall Street. Legislators also did not like the U.S. shouldering most of the cost. They were right. Emerging markets will stay volatile, and countries and investors shouldn't expect a handout every time an economy hits a rough patch. And when a rescue is necessary, it should be global.

**International Finance in Practice Boxes**—Selected chapters contain International Finance in Practice boxes. These real-world illustrations offer students a practical look at the major concepts presented in the chapter.

**SUMMARY**

This chapter presents an introduction to the market for foreign exchange. Broadly defined, the foreign exchange market encompasses the conversion of purchasing power from one currency into another, bank deposits of foreign currency, the extension of credit denominated in a foreign currency, foreign trade financing, and trading in foreign currency options and futures contracts. This chapter limits the discussion to the spot and forward market for foreign exchange. The other topics are covered in later chapters.

1. The FX market is the largest and most active financial market in the world. It is open somewhere in the world 24 hours a day, 365 days a year.
2. The FX market is divided into two tiers: the retail or client market and the wholesale or interbank market. The retail market is where international banks service their customers who need foreign exchange to conduct international commerce or trade in international financial assets. The great majority of FX trading takes place in the interbank market among international banks that are adjusting inventory positions or conducting speculative and arbitrage trades.
3. The FX market participants include international banks, bank customers, nonbank FX dealers, FX brokers, and central banks.
4. In the spot market for FX, nearly immediate purchase and sale of currencies takes place. In the chapter, notation for defining a spot rate quotation was developed. Additionally, the concept of a cross-exchange rate was developed. It was determined that nondollar currency transactions must satisfy the bid-ask spread determined from the cross-rate formula or a triangular arbitrage opportunity exists.
5. In the forward market, buyers and sellers can transact today at the forward price for the future purchase and sale of foreign exchange. Notation for forward exchange rate quotations was developed. The use of forward points as a shorthand method for expressing forward quotes from spot rate quotations was presented. Additionally, the concept of a forward premium was developed.

**Summary**—A short summary concludes each chapter, providing students with a handy overview of key concepts for review.

**KEY WORDS**

bimetallism, *27*
Bretton Woods system, *30*
currency board, *35*
euro, *26*
European Currency Unit (ECU), *38*
European Monetary System (EMS), *38*
European Monetary Union (EMU), *40*
Exchange Rate Mechanism (ERM), *40*
European System of Central Banks (ESCB), *41*
gold-exchange standard, *31*
gold standard, *27*
Gresham's law, *27*
international monetary system, *26*
Jamaica Agreement, *33*
Louvre Accord, *34*
Maastricht Treaty, *39*
managed-float system, *34*
optimum currency area, *43*
par value, *30*
Plaza Accord, *34*
price-specie-flow mechanism, *29*
Smithsonian Agreement, *32*
snake, *38*
special drawing rights (SDRs), *31*
sterilization of gold, *29*
"Tobin tax," *51*
Triffin paradox, *31*

**Key Words**—One of the most interesting aspects of studying international finance is learning new terminology. All key terms are presented in boldfaced type when they are first introduced, and they are defined thoroughly in the chapter. A list of key words is presented at the end of the chapter with convenient page references.

**Supplementary Material**

## Capital Asset Pricing under Cross-Listings[10]

To fully understand the effects of international cross-listings, it is necessary to understand how assets will be priced under the alternative capital market regimes. In this section, we discuss an **International Asset Pricing Model (IAPM)** in a world in which some assets are internationally tradable while others are not. For ease of discussion, we will assume that cross-listed assets are **internationally tradable assets** while all other assets are **internationally nontradable assets.**

It is useful for our purpose to recalibrate the CAPM formula. Noting the definition of beta, the CAPM Equation 16.2 can be restated as:

$$\bar{R}_i = R_f + [(\bar{R}_M - R_f)/Var(R_M)]Cov(R_i, R_M) \quad \textbf{(16.3)}$$

For our purposes in this chapter, it is best to define $[(\bar{R}_M - R_f)/Var(R_M)]$ as equal to $A^M M$, where $A^M$ is a **measure of aggregate risk aversion** of all investors and $M$ is the aggregate market value of the market portfolio.[11] With these definitions, Equation 16.3 can be restated as:

**Supplementary Material**—Some topics are by nature more complex than others. The chapter sections that contain such material are indicated by the section heading "Supplementary Material"' and are in *blue type*. These sections may be skipped without loss of continuity, enabling the instructor to easily tailor the reading assignments to the students. End-of-chapter Questions and Problems relating to the Supplementary Material sections of the text are also indicated by *blue type*.

9. Use the quotations in Ex
of the 80½ September Ja
10. Assume the spot Swiss f
What is the minimum p
price of $0.6800 should
month Eurodollar rate is
11. Do problem 10 again as
12. Use the European optior
of problem 10 and the p

Excel

**Questions with Excel Software**—An icon indicates which end-of-chapter questions throughout the book are linked to the software program created by the authors. See the next section on Ancillary materials for more information on the software.

**QUESTIONS**

1. Suppose that your firm is operating in a segmented capital market. What actions would you recommend to mitigate the negative effects?
2. Explain why and how a firm's cost of capital may decrease when the firm's stock is cross-listed on foreign stock exchanges.
3. Explain the pricing *spillover effect.*
4. In what sense do firms with nontradable assets get a *free ride* from firms whose securities are internationally tradable?
5. Define and discuss *indirect world systematic risk.*
6. Discuss how the cost of capital is determined in segmented versus integrated capital markets.
7. Suppose there exists a nontradable asset with a perfect positive correlation with a portfolio *T* of tradable assets. How will the nontradable asset be priced?
8. Discuss what factors motivated Novo Industri to seek U.S. listing of its stock. What lessons can be derived from Novo's experiences?

**End-of-Chapter Questions and Problems**—A set of end-of-chapter questions and problems is provided for each chapter. This material can be used by students on their own to test their understanding of the material, or as homework exercises assigned by the instructor. Questions and Problems relating to the Supplementary Material sections of the text are indicated by *blue type*.

**REFERENCES & SUGGESTED READINGS**

Bank for International Settleme
ternational Settlements, M
Cheung, Yin-Wong, and Menzi
Survey of the US Market."
Coninx, Raymond G. F. *Foreign*
Irwin, 1986.
Copeland, Laurence S. *Exchan*
Addison-Wesley, 1994.
Dominguez, Kathryn M. "Cent
*ternational Money and Fir*
Federal Reserve Bank of New
*Survey: Turnover in the U*

**Reference and Suggested Readings**—At the end of each chapter a list of selected references and suggested readings is presented, allowing the student to easily locate references that provide additional information about specific topics.

**MINI CASE**

**Mexico's Balance-of-Payments Problem**

Recently, Mexico experienced large-scale trade deficits, depletion of foreign reserve holdings, and a major currency devaluation in December 1994, followed by the decision to freely float the peso. These events also brought about a severe recession and higher unemployment in Mexico. Since the devaluation, however, the trade balance has improved.

Investigate the Mexican experiences in detail and write a report on the subject. In the report, you may:

1. Document the trend in Mexico's key economic indicators, such as the balance of payments, the exchange rate, and foreign reserve holdings, during the period 1994.1 through 1995.12.
2. Investigate the causes of Mexico's balance-of-payments difficulties prior to the peso devaluation.
3. Discuss what policy actions might have prevented or mitigated the balance-of-payments problem and the subsequent collapse of the peso.
4. Derive lessons from the Mexican experience that may be useful for other developing countries.

In your report, you may identify and address any other relevant issues concerning Mexico's balance-of-payments problem. *International Financial Statistics* published by IMF provides basic macroeconomic data on Mexico.

**Mini Cases**—Almost every chapter includes a mini case for student analysis of multiple concepts covered throughout the chapter. These Mini Case problems are "real-world" in nature to show students how the theory and concepts in the textbook relate to the everyday world.

## Ancillary Materials

The third edition comes with the following materials:

*Instructor's Resource CD* (ISBN 0072825170)—Contains the following assets:

- **Instructor's Manual**—Includes detailed suggested answers and solutions to the problems and a software User's Manual and sample projects, all written by the authors
- **Test Bank**—Multiple-choice test questions for each chapter, written by the authors and Victor Abraham
- **Computerized Test Bank**—Includes the questions from the test bank (above) in a program that allows you to easily choose questions to create tests
- **PowerPoint Presentation System—PowerPoint** slides for each chapter to use in classroom lecture settings, created by John Stansfield, University of Missouri – Columbia

*Online Learning Center*—www.mhhe.com/er3e

This website contains the supplement assets for instructors and study tools, such as flashcards and quizzes, for students.

The site also includes the International Finance Software that can be used with this book. This Excel software has three main programs:

- A currency options pricing program allows students to price put and call options on foreign exchange.
- A hedging program allows the student to compare forward, money market instruments, futures, and options for hedging exchange risk.
- A portfolio optimization program based on the Markowitz model allows for examining the benefits of international portfolio diversification.

The three programs can be used to solve certain end-of-chapter problems (marked with an Excel icon) or assignments the instructor devises. A User's Manual and sample projects are included in the Instructor's Manual.

## Acknowledgments

We are indebted to the many colleagues who provided insight and guidance throughout the development process. Their careful work enabled us to create a text that is current, accurate, and modern in its approach. Among all who helped in this endeavor:

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We hope that you enjoy using *International Financial Management,* Third Edition. In addition, we welcome your comments for improvement. Please let us know either through McGraw-Hill/Irwin, c/o Editorial, or at our e-mail addresses provided below.

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## EXCHANGE RATES

Monday, August 19, 2002

The New York foreign exchange mid-range rates below apply to trading among banks in amounts of $1 million and more, as quoted at 4 p.m. Eastern time by Reuters and other sources. Retail transactions provide fewer units of foreign currency per dollar.

| | U.S. $ Equivalent | | Currency per U.S. $ | |
|---|---|---|---|---|
| **Country** | **Mon.** | **Fri.** | **Mon.** | **Fri.** |
| **Argentina** (Peso) -y | .2751 | .2751 | 3.6350 | 3.6350 |
| **Australia** (Dollar) | .5422 | .5459 | 1.8445 | 1.8317 |
| **Bahrain** (Dinar) | 2.6525 | 2.6525 | .3770 | .3770 |
| **Brazil** (Real) | .3221 | .3203 | 3.1045 | 3.1225 |
| **Britain** (Pound) | 1.5272 | 1.5387 | .6548 | .6499 |
| 1-month forward | 1.5242 | 1.5359 | .6561 | .6511 |
| 3-months forward | 1.5188 | 1.5303 | .6584 | .6535 |
| 6-months forward | 1.5104 | 1.5218 | .6621 | .6571 |
| **Canada** (Dollar) | .6356 | .6407 | 1.5734 | 1.5607 |
| 1-month forward | .6350 | .6402 | 1.5748 | 1.5621 |
| 3-months forward | .6337 | .6389 | 1.5780 | 1.5653 |
| 6-months forward | .6315 | .6367 | 1.5836 | 1.5707 |
| **Chile** (Peso) | .001431 | .001429 | 698.75 | 699.75 |
| **China** (Renminbi) | .1208 | .1208 | 8.2767 | 8.2768 |
| **Colombia** (Peso) | .0003782 | .003789 | 2643.95 | 2639.05 |
| **Czech. Rep.** (Koruna) | | | | |
| Commercial rate | .03155 | .03151 | 31.697 | 31.731 |
| **Denmark** (Krone) | .1315 | .1325 | 7.6069 | 7.5450 |
| **Ecuador** (U.S. Dollar) | 1.0000 | 1.0000 | 1.0000 | 1.0000 |
| **Hong Kong** (Dollar) | .1282 | .1282 | 7.8000 | 7.8000 |
| **Hungary** (Forint) | .003962 | .003996 | 252.41 | 250.28 |
| **India** (Rupee) | .02059 | .02060 | 48.560 | 48.550 |
| **Indonesia** (Rupiah) | .0001130 | .0001134 | 8848 | 8815 |
| **Israel** (Shekel) | .2162 | .2144 | 4.6250 | 4.6650 |
| **Japan** (Yen) | .008433 | .008493 | 118.58 | 117.75 |
| 1-month forward | .008448 | .008506 | 118.37 | 117.57 |
| 3-months forward | .008471 | .008531 | 118.05 | 117.23 |
| 6-months forward | .008508 | .008568 | 117.53 | 116.72 |
| **Jordan** (Dinar) | 1.4184 | 1.4184 | .7050 | .7050 |
| **Kuwait** (Dinar) | 3.3113 | 3.3156 | .3020 | .3016 |
| **Lebanon** (Pound) | .0006612 | .0006612 | 1512.50 | 1512.50 |
| **Malaysia** (Ringgit) -b | .2632 | .2632 | 3.8000 | 3.8000 |
| **Malta** (Lira) | 2.3613 | 2.3747 | .4235 | .4211 |
| **Mexico** (Peso) | | | | |
| Floating rate | .1028 | .1019 | 9.7235 | 9.8130 |
| **New Zealand** (Dollar) | .4667 | .4684 | 2.1427 | 2.1349 |
| **Norway** (Krone) | .1324 | .1333 | 7.5533 | 7.4992 |
| **Pakistan** (Rupee) | .01683 | .01683 | 59.425 | 59.425 |
| **Peru** (new Sol) | .2805 | .2807 | 3.5650 | 3.5628 |
| **Philippines** (Peso) | .01926 | .01931 | 51.925 | 51.795 |
| **Poland** (Zloty) | .2397 | .2393 | 4.1725 | 4.1795 |
| **Russia** (Ruble) -a | .03167 | .03167 | 31.575 | 31.575 |
| **Saudi Arabia** (Riyal) | .2666 | .2666 | 3.7505 | 3.7505 |
| **Singapore** (Dollar) | .5710 | .5724 | 1.7513 | 1.7470 |
| **Slovak Rep.** (Koruna) | .02241 | .02256 | 44.629 | 44.328 |
| **South Africa** (Rand) | .0941 | .0947 | 10.6315 | 10.5600 |
| **South Korea** (Won) | .0008409 | .0008447 | 1189.20 | 1183.90 |
| **Sweden** (Krona) | .1058 | .1067 | 9.4486 | 9.3703 |
| **Switzerland** (Franc) | .6653 | .6714 | 1.5030 | 1.4895 |
| 1-month forward | .6660 | .6720 | 1.5016 | 1.4881 |
| 3-months forward | .6670 | .6730 | 1.4993 | 1.4858 |
| 6-months forward | .6684 | .6744 | 1.4961 | 1.4828 |
| **Taiwan** (Dollar) | .02959 | .02968 | 33.790 | 33.690 |
| **Thailand** (Baht) | .02378 | .02393 | 42.055 | 41.780 |
| **Turkey** (Lira) | .00000061 | .00000061 | 1640000 | 1640000 |
| **United Arab** (Dirham) | .2723 | .2723 | 3.6729 | 3.6729 |
| **Uruguay** (Peso) | | | | |
| Financial | .03738 | .03738 | 26.750 | 26.750 |
| **Venezuela** (Bolivar) | .000726 | .000726 | 1376.50 | 1376.50 |
| **SDR** | 1.3247 | 1.3228 | .7549 | .7560 |
| **Euro** | .9764 | .9847 | 1.0242 | 1.0155 |

Special Drawing Rights (SDR) are based on exchange rates for the U.S., British, and Japanese currencies. Source: International Monetary Fund. a-Russian Central Bank rate. b-Government rate. y-Floating rate.

## MONEY RATES

Monday, August 19, 2002

The key U.S. and foreign annual interest rates below are a guide to general levels but don't always represent actual transactions.

**Prime Rate:** 4.75% (effective 12/12/01).

**Discount Rate:** 1.25% (effective 12/11/01).

**Federal Funds:** 1.750% high, 1.625% low, 1.625% near closing bid, 1.688% offered. Effective rate: 1.73%. Source: Prebon Yamane (USA) Inc. Federal-funds target rate: 1.750% (effective 12/11/01).

**Call Money:** 3.50% (effective 12/12/01).

**Commercial Paper:** Placed directly by General Electric Capital Corp.: 1.72% 30 to 64 days; 1.70% 65 to 270 days.

**Euro Commercial Paper:** Placed directly by General Electric Capital Corp.: 3.30% 30 days; 3.31% two months; 3.32% three months; 3.34% four months; 3.34% five months; 3.35% six months.

**Dealer Commercial Paper:** High-grade unsecured notes sold through dealers by major corporations: 1.73% 30 days; 1.69% 60 days; 1.68% 90 days.

**Certificates of Deposit:** 1.75% one month; 1.70% three months; 1.70% six months.

**Bankers Acceptances:** 1.74% 30 days; 1.72% 60 days; 1.71% 90 days; 1.70% 120 days; 1.70% 150 days; 1.70% 180 days. Source: Prebon Yamane (USA) Inc.

**Eurodollars:** 1.76%–1.74% one month; 1.74%–1.70% two months; 1.73%–1.70% three months; 1.72%–1.68% four months; 1.72%–1.68% five months; 1.74%–1.70% six months. Source: Prebon Yamane (USA) Inc.

**London Interbank Offered Rates (Libor):** 1.8050% one month; 1.7700% three months; 1.76594% six months; 1.93875% one year. Effective rate for contracts entered into two days from date appearing at top of this column.

**Euro Libor:** 3.32900% one month; 3.35625% three months; 3.40113% six months; 3.49713% one year. Effective rate for contracts entered into two days from date appearing at top of this column.

**Euro Interbank Offered Rates (Euribor):** 3.327% one month; 3.360% three months; 3.404% six months; 3.497% one year. Source: Reuters.

**Foreign Prime Rates:** Canada 4.50%, Germany 3.25%, Japan 1.375%, Switzerland 2.625%, Britain 4.00%.

**Treasury Bills:** Results of the Monday, August 19, 2002, auction of short-term U.S. government bills, sold at a discount from face value in units of $1,000 to $1 million: 1.630% 13 weeks; 1.630% 26 weeks. Tuesday, August 13, 2002 auction: 1.670% 4 weeks.

**Overnight Repurchase Rate:** 1.74%. Source: Garban Intercapital.

**Freddie Mac:** Posted yields on 30-year mortgage commitments. Delivery within 30 days 6.00%, 60 days 6.09%, standard conventional fixed-rate mortgages: 3.375%, 2% rate capped one-year adjustable rate mortgages.

**Fannie Mae:** Posted yields on 30 year mortgage commitments (priced at par) for delivery within 30 days 6.10%, 60 days 6.19%, standard conventional fixed-rate mortgages; 3.75%, 6/2 rate capped one-year adjustable rate mortgages. Constant Maturity Debt Index: 1.688% three months; 1.683% six months; 1.865% one year.

**Merrill Lynch Ready Assets Trust:** 1.36%.

**Consumer Price Index:** July, 180.1, up 1.5% from a year ago. Bureau of Labor Statistics.

## CURRENCY FUTURES

Monday, August 19, 2002

**Japanese Yen** (CME) −12.5 million yen; $ per yen (.00)

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sept | .8518 | .8526 | .8434 | .8448 | −.0069 | .8685 | .7495 | 71,162 |
| Dec | .8510 | .8510 | .8473 | .8484 | −.0069 | .8885 | .7569 | 1,925 |

Est vol 2,731; vol Fri 5,050; open int 73,683, +274.

**Canadian Dollar** (CME) −100,000 dlrs; $ per Can $

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sept | .6403 | .6415 | .6345 | .6355 | −.0050 | .6640 | .6175 | 51,278 |
| Dec | .6370 | .6396 | .6327 | .6336 | −.0051 | .6620 | .6190 | 8,472 |
| Mr03 | .6370 | .6370 | .6318 | .6317 | −.0053 | .6590 | .6198 | 2,051 |
| June | .6315 | .6325 | .6290 | .6299 | −.0055 | .6565 | .6197 | 742 |

Est vol 5,493; vol Fri 4,232; open int 62,946, −315.

**British Pound** (CME) −62,500 pds; $ per pound

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sept | 1.5364 | 1.5420 | 1.5222 | 1.5238 | −.0104 | 1.5900 | 1.3990 | 28,828 |
| Dec | 1.5176 | 1.5218 | 1.5130 | 1.5150 | −.0104 | 1.5720 | 1.4070 | 738 |

Est vol 1,991; vol Fri 2,449; open int 29,626, +38.

**Swiss Franc** (CME) −125,000 francs; $ per franc

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sept | .6716 | .6735 | .6648 | .6659 | −.0056 | .6975 | .5860 | 36,600 |
| Dec | .6724 | .6724 | .6668 | .6674 | −.0056 | .6986 | .5875 | 984 |

Est vol 3,208; vol Fri 5,979; open int 37,663, +391.

**Australian Dollar** (CME) −100,000 dlrs; $ per A$

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sept | .5450 | .5458 | .5398 | .5409 | −.0030 | .5752 | .4790 | 20,790 |
| Dec | .5304 | .5396 | .5365 | .5366 | −.0030 | .5702 | .4980 | 855 |

Est vol 708; vol Fri 1,551; open int 22,446, −396.

**Mexican Peso** (CME) − 500,000 new Mex. peso, $ per MP

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sept | .10145 | .10243 | .10135 | .10238 | 00072 | .10830 | .09710 | 14,102 |
| Dec | .09995 | .10060 | .09995 | .10063 | 00070 | .10673 | .09540 | 2,104 |

Est vol 5,938; vol Fri 9,023; open int 16,650, −565.

**Euro FX** (CME) - Euro 125,000; $ per Euro

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sept | .9832 | .9860 | .9738 | .9756 | −.0069 | 1.0185 | .8375 | 94,786 |
| Dec | .9795 | .9818 | .9700 | .9716 | −.0069 | 1.0129 | .8390 | 4,713 |

Est vol 7,504; vol Fri 15,217; open int 100,009, −1,001.

## CURRENCY OPTIONS

Tuesday, July 6, 1999

### PHILADELPHIA EXCHANGE

| | | Calls | | Puts | |
|---|---|---|---|---|---|
| | | **Vol.** | **Last** | **Vol.** | **Last** |
| **British Pound** | | | | | **156.13** |
| **31,250 Brit. Pounds-European Style.** | | | | | |
| 158 | Jul | 16 | 0.23 | . . . | . . . |
| **31,250 Brit. Pounds-cents per unit.** | | | | | |
| 163 | Jul | 4 | 0.01 | . . . | 0.01 |
| **Euro** | | | | | **102.46** |
| **62,500 Euro-cents per unit.** | | | | | |
| 98 | Sep | . . . | 0.01 | 89 | 0.35 |
| 100 | Sep | . . . | . . . | 22 | 0.67 |
| 102 | Sep | . . . | 0.01 | 4 | 1.38 |
| 104 | Sep | . . . | . . . | 24 | 2.47 |
| 106 | Sep | 2 | 0.53 | . . . | 0.01 |
| 110 | Sep | 3 | 0.10 | . . . | 0.01 |
| **Japanese Yen 82.64** | | | | | |
| **6,250,000 J. Yen-100ths of a cent per unit.** | | | | | |
| 80 ½ | Sep | . . . | 0.01 | 25 | 0.60 |
| **6,250,000 J. Yen-EuropeanStyle.** | | | | | |
| 80 ½ | Sep | . . . | 0.01 | 20 | 0.53 |
| **Swiss Franc** | | | | | **63.80** |
| **62,500 Swiss Francs-cents per unit.** | | | | | |
| 67 | Sep | 10 | 0.30 | . . . | . . . |
| 68 | Sep | 2 | 0.15 | . . . | . . . |
| **Call Vol . . . . . . . . . . . .** | | **986** | **Open Int . . . . . . . . . . . .** | | **39,510** |
| **Put Vol . . . . . . . . . . . . .** | | **3,569** | **Open Int . . . . . . . . . . . .** | | **30,445** |

**Category 1**
Antigua & Barbuda
Aruba
Bahamas
Bahrain
Barbados
Belize
China, PR
Djibouti
Dominica
Ecuador
El Salvador
Grenada
Hong Kong, PRC
Kiribati
Lebanon
Malaysia
Maldives
Marshall Islands
Micronesia
Oman
Palau
Qatar
Saudi Arabia
St. Kitts & Nervis
St. Lucia
St. Vincent & the Grenadines
Syria
Turkmenistan
United Arab Emirates
Zimbabwe

**Category 2**
Benin
Bosnia & Herzegovina
Bulgaria
Burkina Faso
Cameron
C. African Rep.
Chad
Comoros
Congo
Côte d'Ivoire
Equatorial Guinea
Estonia
Gabon
Guinea-Bissau
Lithuania
Mali
Niger
Senegal
Togo

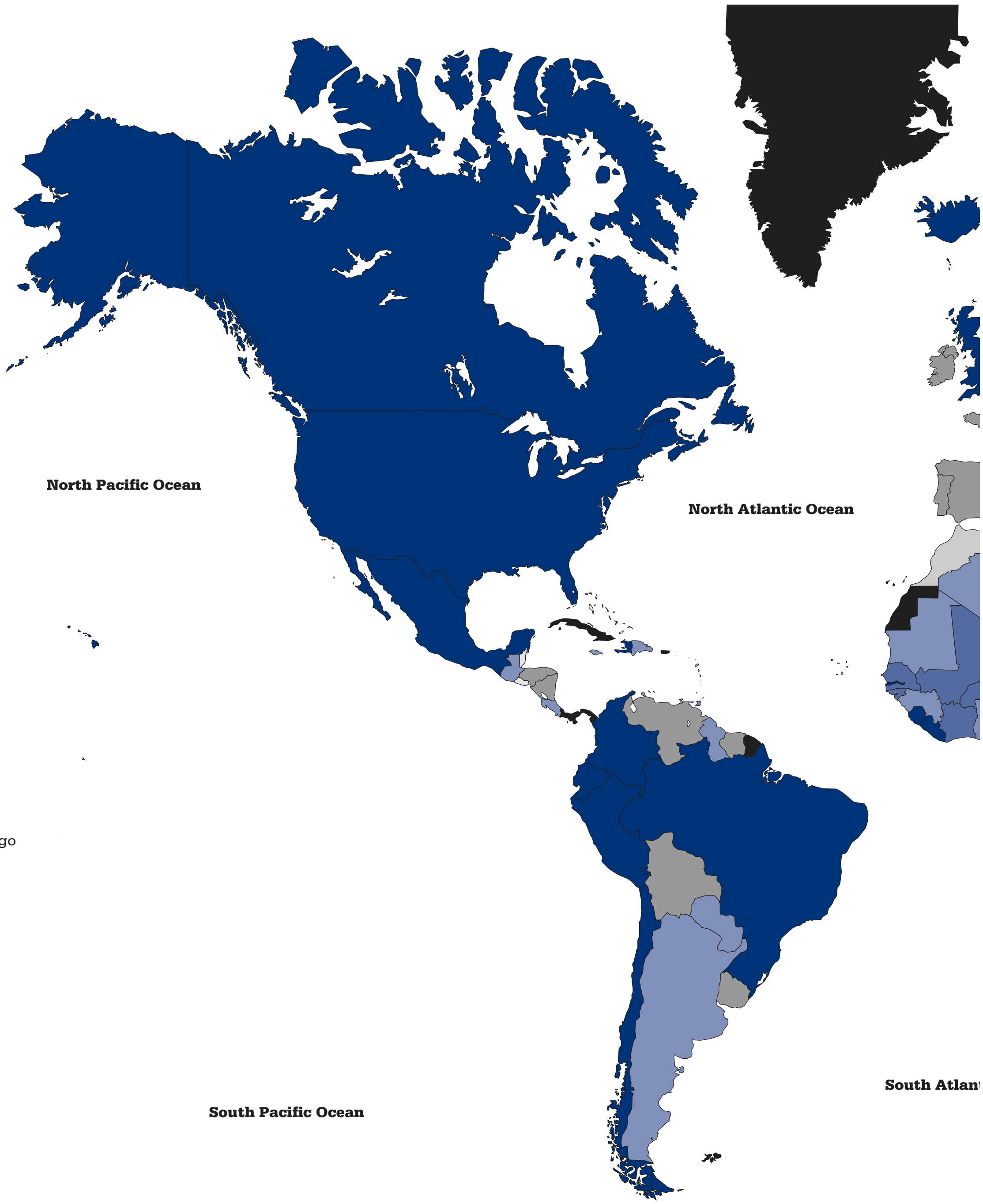
**Category 3**
Bangladesh
Bhutan
Botswana
Burunei
Cape Verde
Fiji
Jordan
Kuwait
Latvia
Lesotho
Libyn AJ
Malta
Morocco
Namibia
Nepal
Samoa
Swaziland
Vanuatu

**Category 4**
Austria
Belgium
Finland
France
Germany
Greece
Ireland
Italy
Luxembourg
Netherlands
Portugal
Spain

**Category 5**
Belarus
Bolivia
Costa Rica
Cyprus
Denmark
Egypt
Honduras
Hungary
Israel
Nicaragua
Romania
Solomon Islands
Suriname
Tonga
Uruguay
Venezuela

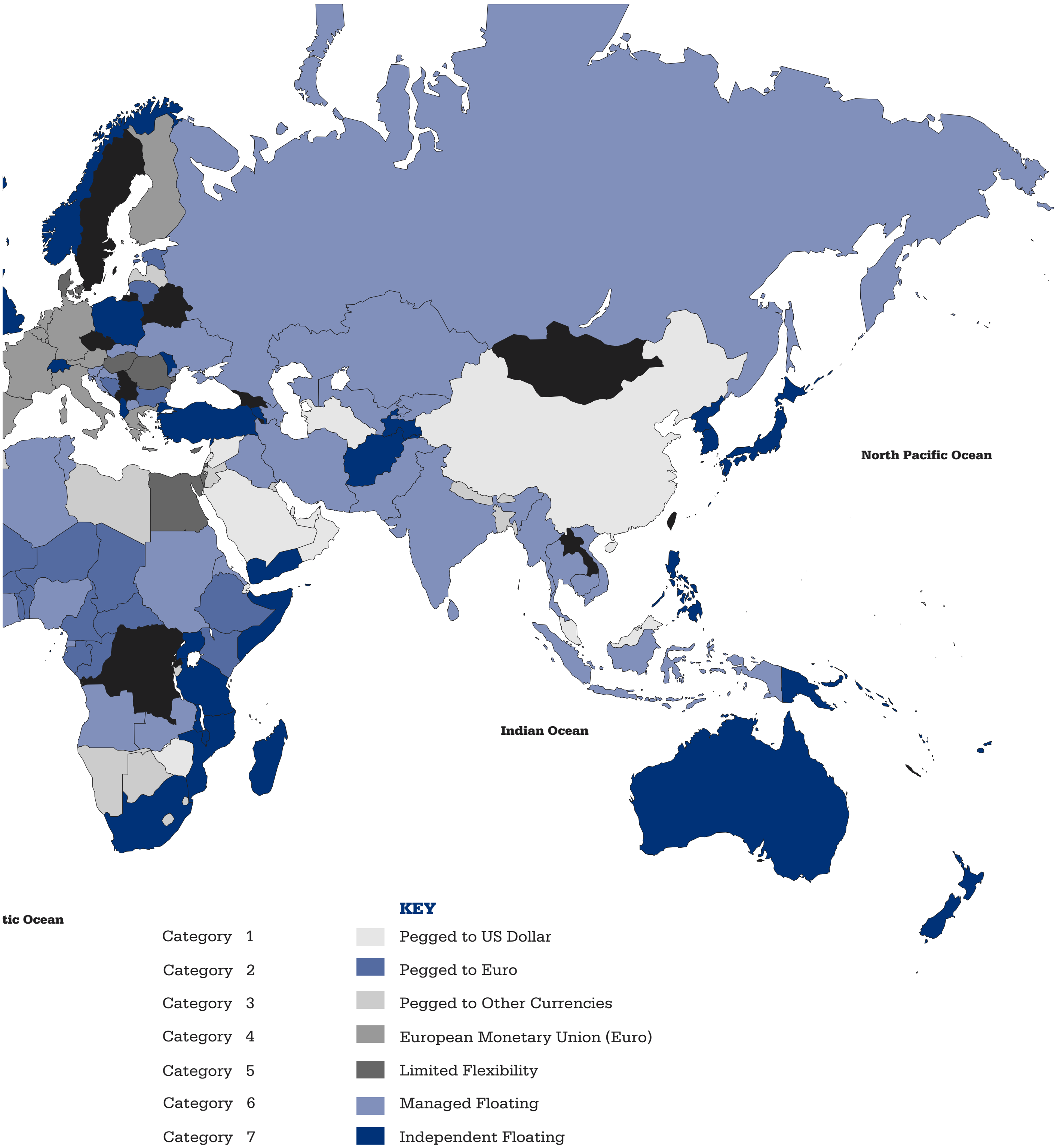
**Category 6**
Algeria
Angola
Argentina
Azerbaijan
Burundi
Cambodia
Croatia
Dominican Rep.
Eritrea
Ethiopia
Ghana
Guatemala
Guinea
Guyana
India
Indonesia
Iran
Iraq
Jamaica
Kazakhstan
Kenya
Kyrgyz Rep.
Macedonia
Mauritania
Mauritius
Myanmar
Nigeria
Pakistan
Paraguay
Russia
São Tomé & Principe
Singapore
Slovak Rep.
Slovenia
Sudan
Thailand
Trinidad & Tobago
Tunisia
Ukraine
Uzbekistan
Vietnam
Yugoslavia
Zambia

**Category 7**
Afghanistan
Albania
Armenia
Australia
Brazil
Canada
Chile
Colombia
Congo, DR
Gambia
Haiti
Iceland
Japan
Korea, Rep.
Liberia
Madagascar
Malawi
Mexico
Moldova
Mozambique
New Zealand
Norway
Papua New Guinea
Peru
Philippines
Poland
Sierra Leone
Somalia
South Africa
Switzerland
Tajikistan
Tanzania
Turkey
Uganda
United Kingdom
United States
Yemen



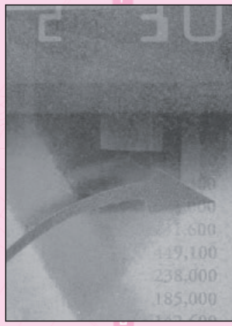

# Exchange Rate A

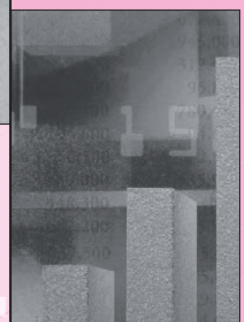
**SOURCE:** *International Financial Statistics*, January 200




# Arrangements

This map is not to scale





# PART ONE

OUTLINE

# Foundations of International Financial Management

PART ONE lays the macroeconomic foundation for all the topics to follow. A thorough understanding of this material is essential for understanding the advanced topics covered in the remaining sections.

CHAPTER 1 provides an introduction to *International Financial Management.* The chapter discusses why it is important to study international finance and distinguishes international finance from domestic finance.

CHAPTER 2 introduces the various types of international monetary systems under which the world economy can function and has functioned at various times. The chapter traces the historical development of the world's international monetary systems from the early 1800s to the present. Additionally, a detailed discussion of the European Monetary System of the European Union is presented.

CHAPTER 3 presents balance-of-payment concepts and accounting. The chapter shows that even a country must keep its "economic house in order" or else it will experience current account deficits that will undermine the value of its currency.

CHAPTER 4 provides an introduction to the organization and operation of the spot and forward foreign exchange market. This chapter describes institutional arrangements of the foreign exchange market and details of how foreign exchange is quoted and traded worldwide.

CHAPTER 5 presents the fundamental international parity relationships among exchange rates, interest rates, and inflation rates. An understanding of these parity relationships is essential for practicing financial management in a global setting.

CHAPTER 1

# Globalization and the Multinational Firm

CHAPTER OUTLINE



AS THE TITLE *International Financial Management* indicates, in this book we are concerned with financial management in an international setting. Financial management is mainly concerned with how to *optimally* make various corporate financial decisions, such as those pertaining to investment, capital structure, dividend policy, and working capital management, with a view to achieving a set of given corporate objectives. In Anglo-American countries as well as in many advanced countries with well-developed capital markets, maximizing shareholder wealth is generally considered the most important corporate objective.

Why do we need to study "international" financial management? The answer to this question is straightforward: We are now living in a highly **globalized and integrated world economy.** American consumers, for example, routinely purchase oil imported from Saudi Arabia and Nigeria, TV sets and camcorders from Japan, automobiles from Germany, garments from China, shoes from Indonesia, pasta from Italy, and wine from France. Foreigners, in turn, purchase American-made aircraft, software, movies, jeans, wheat, and other products. Continued liberalization of international trade is certain to further internationalize consumption patterns around the world.

Like consumption, production of goods and services has become highly globalized. To a large extent, this has happened as a result of multinational corporations' (MNCs) relentless efforts to source inputs and locate production anywhere in the world where costs are lower and profits are higher. For example, IBM personal computers sold in the world market might have been assembled in Malaysia with Taiwanese-made monitors, Korean-made keyboards, U.S.-made chips, and preinstalled software packages that were jointly developed by U.S. and Indian engineers. It has often become difficult to clearly associate a product with a single country of origin.

Recently, financial markets have also become highly integrated. This development allows investors to diversify their investment portfolios internationally. In the words of a *Wall Street Journal* article, "Over the past decade, U.S. investors have poured buckets of money into overseas markets, in the form of international mutual funds. In April 1996, the total assets in these funds reached a whopping $148.14 billion, far beyond the measly $2.49 billion reported in 1985."[1] At the same time, Japanese investors are investing heavily in U.S. and other foreign financial markets in efforts to recycle their enormous trade surpluses. In addition, many major corporations of the world, such as IBM, Daimler-Benz (now, DaimlerChrysler), and Sony, have their shares cross-listed on foreign stock exchanges, thereby rendering their shares internationally tradable and gaining access to foreign capital as well. Consequently, Daimler-Benz's venture, say,

[1] Sara Calian, "Decision, Decision," *The Wall Street Journal,* June 27, 1996, p. R6.

in China can be financed partly by American investors who purchase Daimler-Benz shares traded on the New York Stock Exchange.

Undoubtedly, we are now living in a world where all the major economic functions—consumption, production, and investment—are highly globalized. It is thus essential for financial managers to fully understand vital international dimensions of financial management. This *global shift* is in marked contrast to a few decades ago, when the authors of this book were learning finance. At that time, most professors customarily (and safely, to some extent) ignored international aspects of finance. This attitude has become untenable since then.

## What's Special about International Finance?

Although we may be convinced of the importance of studying international finance, we still have to ask ourselves, what's special about international finance? Put another way, how is international finance different from purely domestic finance (if such a thing exists)? Three major dimensions set international finance apart from domestic finance. They are:

1. Foreign exchange and political risks.
2. Market imperfections.
3. Expanded opportunity set.

As we will see, these major dimensions of international finance largely stem from the fact that sovereign nations have the right and power to issue currencies, formulate their own economic policies, impose taxes, and regulate movements of people, goods, and capital across their borders. Before we move on, let us briefly describe each of the key dimensions of international financial management.

### Foreign Exchange and Political Risks

Suppose Mexico is a major export market for your company and the Mexican peso depreciates drastically against the U.S. dollar, as it did in December 1994. This means that your company's products can be priced out of the Mexican market, as the peso price of American imports will rise following the peso's fall. If such countries as Indonesia, Thailand, and Korea are major export markets, your company would have faced the same difficult situation in the wake of the Asian currency crisis of 1997. The preceding examples suggest that when firms and individuals are engaged in cross-border transactions, they are potentially exposed to **foreign exchange risk** that they would not normally encounter in purely domestic transactions.

Currently, the exchange rates among such major currencies as the U.S. dollar, Japanese yen, British pound, and euro fluctuate continuously in an unpredictable manner. This has been the case since the early 1970s, when fixed exchange rates were abandoned. As can be seen from Exhibit 1.1, exchange rate volatility has exploded since 1973. Exchange rate uncertainty will have a pervasive influence on all the major economic functions, that is, consumption, production, and investment.

**www.cia.gov/cia/publications/factbook/**

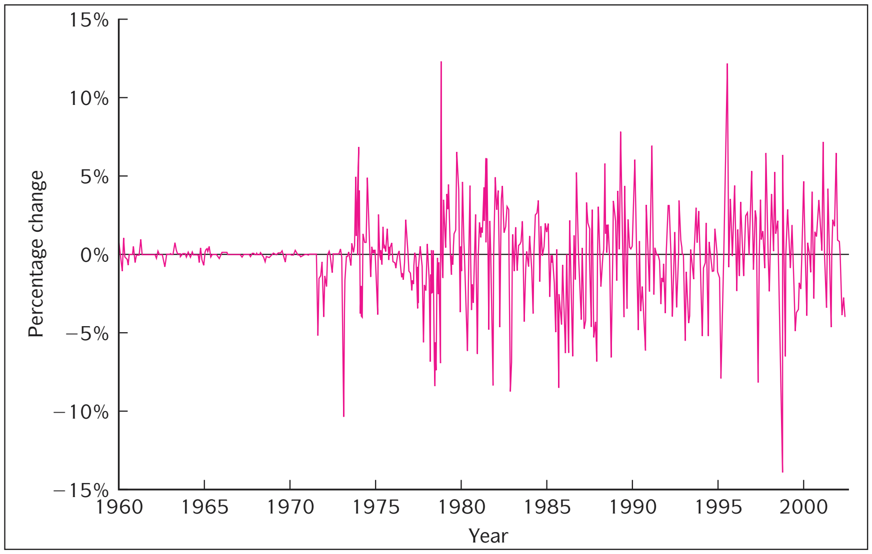
Website of *The World Factbook* published by the CIA provides background information, such as geography, government, and economy, of countries around the world.

Another risk that firms and individuals may encounter in an international setting is political risk. **Political risk** ranges from unexpected changes in tax rules to outright expropriation of assets held by foreigners. 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. In 1992, for example, the Enron Development Corporation, a subsidiary of a Houston-based energy company, signed a contract to build India's largest power plant. After Enron had spent nearly $300 million, the project was canceled in 1995 by nationalist politicians in the Maharashtra state who argued India didn't need the power plant. The Enron episode illustrates the difficulty of enforcing contracts in foreign countries.[2]

[2]Since then, Enron has renegotiated the deal with the Maharashtra state.

**EXHIBIT 1.1**

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




**Source:** International Monetary Fund, *International Financial Statistics,* various issues.

## Market Imperfections

Although the world economy is much more integrated today than was the case 10 or 20 years ago, a variety of barriers still hamper free movements of people, goods, services, and capital across national boundaries. These barriers include legal restrictions, excessive transaction and transportation costs, and discriminatory taxation. The world markets are thus highly imperfect. As we will discuss later in this book, **market imperfections,** which represent various frictions and impediments preventing markets from functioning perfectly, play an important role in motivating MNCs to locate production overseas. Honda, a Japanese automobile company, for instance, decided to establish production facilities in Ohio, mainly to circumvent trade barriers. One might even say that MNCs are a gift of market imperfections.

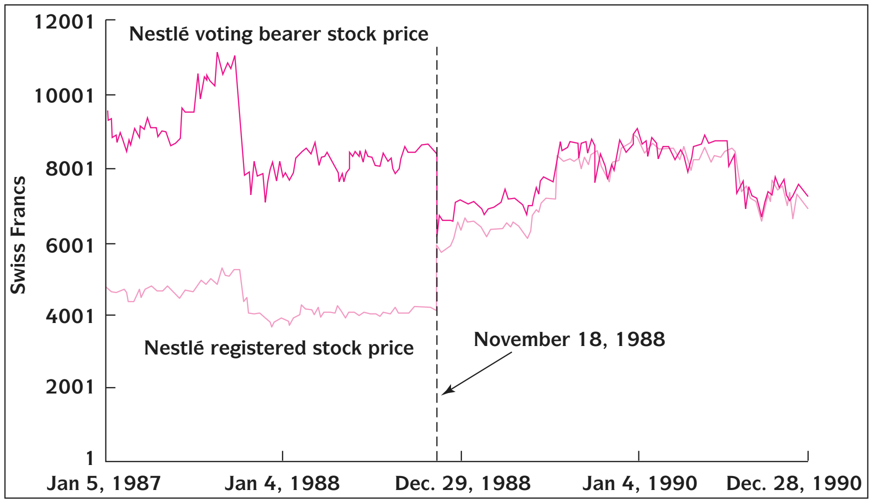
Imperfections in the world financial markets tend to restrict the extent to which investors can diversify their portfolios. An interesting example is provided by the Nestlé Corporation, a well-known Swiss MNC. Nestlé used to issue two different classes of common stock, bearer shares and registered shares, and foreigners were allowed to hold only bearer shares. As Exhibit 1.2 shows, bearer shares used to trade for about twice the price of registered shares, which were exclusively reserved for Swiss residents.[3] This kind of price disparity is a uniquely international phenomenon that is attributable to market imperfections.

On November 18, 1988, however, Nestlé lifted restrictions imposed on foreigners, allowing them to hold registered as well as bearer shares. After this announcement, the price spread between the two types of Nestlé shares narrowed drastically. As Exhibit 1.2 shows, the price of bearer shares declined sharply, whereas that of registered shares rose sharply. This implies that there was a major transfer of wealth from foreign shareholders to domestic shareholders. Foreigners holding Nestlé bearer shares were exposed to political risk in a country that is widely viewed as a haven from such risk. The Nestlé episode illustrates both the importance of considering market imperfections in international finance and the peril of political risk.

[3]It is noted that bearer and registered shares of Nestlé had the same claims on dividends but differential voting rights. Chapter 16 provides a detailed discussion of the Nestlé case.

**EXHIBIT 1.2**

**Daily Prices of Nestlé's Bearer and Registered Shares**




**Source:** Reprinted from *Journal of Financial Economics,* Volume 37, Issue 3, Claudio Loderer and Andreas Jacobs, "The Nestlé Crash," pp. 315–339, 1995, with kind permission from Elsevier Science S.A., P.O. Box 564, 1001 Lausanne, Switzerland.

### Expanded Opportunity Set

When firms venture into the arena of global markets, they can benefit from an **expanded opportunity set.** As previously mentioned, firms can locate production in any country or region of the world to maximize their performance and raise funds in any capital market where the cost of capital is the lowest. In addition, firms can gain from greater economies of scale when their tangible and intangible assets are deployed on a global basis. A real-world example showing the gains from a global approach to financial management is provided by the following excerpt from *The Wall Street Journal* (April 9, 1996):

> Another factor binding bond markets ever closer is large companies' flexibility to issue bonds around the world at will, thanks to the global swap market. At the vanguard are companies such as General Electric of the U.S. Mark VanderGriend, who runs the financing desk at Banque Paribas, says it took "about 15 minutes" to put together a four billion franc ($791.6 million) deal for GE. By raising the money in francs and swapping into dollars instantly, GE will save five hundredths of a percentage point—or about $400,000 annually on the nine-year deal. "They have such a huge requirement for capital that they are constantly looking for arbitrages," adds Mr. VanderGriend. "And they don't care much how they get there."

Individual investors can also benefit greatly if they invest internationally rather than domestically. Suppose you have a given amount of money to invest in stocks. You may invest the entire amount in U.S. (domestic) stocks. Alternatively, you may allocate the funds across domestic and foreign stocks. If you diversify internationally, the resulting international portfolio may have a lower risk or a higher return (or both) than a purely domestic portfolio. This can happen mainly because stock returns tend to covary much less across countries than within a given country. Once you are aware of overseas investment opportunities and are willing to diversify internationally, you face a much expanded opportunity set and you can benefit from it. It just doesn't make sense to play in only one corner of the sandbox.

## Goals for International Financial Management

The foregoing discussion implies that understanding and managing foreign exchange and political risks and coping with market imperfections have become important parts of the financial manager's job. *International Financial Management* is designed to provide today's financial managers with an understanding of the fundamental concepts and the tools necessary to be effective global managers. Throughout, the text emphasizes how to deal with exchange risk and market imperfections, using the various instruments and tools that are available, while at the same time maximizing the benefits from an expanded global opportunity set.

Effective financial management, however, is more than the application of the newest business techniques or operating more efficiently. There must be an underlying goal. *International Financial Management* is written from the perspective that the fundamental goal of sound financial management is shareholder wealth maximization. **Shareholder wealth maximization** means that the firm makes all business decisions and investments with an eye toward making the owners of the firm—the shareholders—better off financially, or more wealthy, than they were before.

Whereas shareholder wealth maximization is generally accepted as the ultimate goal of financial management in "Anglo-Saxon" countries, such as Australia, Canada, the United Kingdom, and especially the United States, it is not as widely embraced a goal in other parts of the world. In countries like France and Germany, for example, shareholders are generally viewed as one of the "stakeholders" of the firm, others being employees, customers, suppliers, banks, and so forth. European managers tend to consider the promotion of the firm's stakeholders' overall welfare as the most important corporate goal. In Japan, on the other hand, many companies form a small number of interlocking business groups called *keiretsu,* such as Mitsubishi, Mitsui, and Sumitomo, which arose from consolidation of family-owned business empires. Japanese managers tend to regard the prosperity and growth of their *keiretsu* as the critical goal; for instance, they tend to strive to maximize market share, rather than shareholder wealth.

It is pointed out, however, that as capital markets are becoming more liberalized and internationally integrated in recent years, even managers in France, Germany, Japan and other non-Anglo-Saxon countries are beginning to pay serious attention to shareholder wealth maximization. In Germany, for example, companies are now allowed to repurchase stocks, if necessary, for the benefit of shareholders. In accepting an unprecedented $183 billion takeover offer by Vodafone AirTouch, a leading British wireless phone company, Klaus Esser, CEO of Mannesmann of Germany cited shareholder interests: "The shareholders clearly think that this company, Mannesmann, a great company, would be better together with Vodafone AirTouch. . . . The final decision belongs to shareholders."[4]

Obviously, the firm could pursue other goals. This does not mean, however, that the goal of shareholder wealth maximization is merely an alternative, or that the firm should enter into a debate as to its appropriate fundamental goal. Quite the contrary. If the firm seeks to maximize shareholder wealth, it will most likely simultaneously be accomplishing other legitimate goals that are perceived as worthwhile. Shareholder wealth maximization is a long-run goal. A firm cannot stay in business to maximize shareholder wealth if it treats employees poorly, produces shoddy merchandise, wastes raw materials and natural resources, operates inefficiently, or fails to satisfy customers. Only a well-managed business firm that profitably produces what is demanded in an efficient manner can expect to stay in business in the long run and thereby provide employment opportunities.

While managers are hired to run the company for the interests of shareholders, there is no guarantee that they will actually do so. As shown by a series of recent corporate scandals at companies like Enron, WorldCom, and Global Crossing, managers may pursue their own private interests at the expense of shareholders when they are not closely monitored. Extensive corporate malfeasance and accounting manipulations at

[4]The source for this information is *The New York Times,* February 4, 2000, p. C9.

these companies eventually drove them into financial distress and bankruptcy, devastating shareholders and employees alike. Lamentably, some senior managers enriched themselves enormously in the process. Clearly, the boards of directors, the ultimate guardians of the interests of shareholders, failed to perform their duties at these companies. In the wake of these corporate calamities that have undermined the credibility of the free market system, the society has painfully learned the importance of **corporate governance,** that is, the financial and legal framework for regulating the relationship between a company's management and its shareholders. Needless to say, the corporate governance problem is not confined to the United States. In fact, it can be a much more serious problem in many other parts of the world, especially emerging and transition economies, such as Indonesia, Korea, China, and Russia, where legal protection of shareholders is weak or virtually nonexistent.

Shareholders are the owners of the business; it is their capital that is at risk. It is only equitable that they receive a fair return on their investment. Private capital may not have been forthcoming for the business firm if it had intended to accomplish any other objective. As we will discuss shortly, the massive privatization that is currently taking place in developing and formerly socialist countries, which will eventually enhance the standard of living of these countries' citizens, depends on private investment. It is thus vitally important to strengthen corporate governance so that shareholders receive fair returns on their investments. In what follows, we are going to discuss in detail: (1) the globalization of the world economy, (2) the growing role of MNCs in the world economy, and (3) the organization of the text.

## Globalization of the World Economy: Recent Trends

The term "globalization" became a popular buzzword for describing business practices in the last few decades, and it appears as if it will continue to be a key word for describing business management throughout the new century. In this section, we review a few key trends of the world economy: (i) the emergence of globalized financial markets, (ii) advent of the euro (iii) continued trade liberalization and economic integration, and (iv) large-scale privatization of state-owned enterprises.

### Emergence of Globalized Financial Markets

The 1980s and 90s saw a rapid integration of international capital and financial markets. The impetus for globalized financial markets initially came from the governments of major countries that had begun to deregulate their foreign exchange and capital markets. For example, in 1980 Japan deregulated its foreign exchange market, and in 1985 the Tokyo Stock Exchange admitted as members a limited number of foreign brokerage firms. Additionally, the London Stock Exchange (LSE) began admitting foreign firms as full members in February 1986.

Perhaps the most celebrated deregulation, however, occurred in London on October 27, 1986, and is known as the "Big Bang." On that date, as on "May Day" in 1975 in the United States, the London Stock Exchange eliminated fixed brokerage commissions. Additionally, the regulation separating the order-taking function from the market-making function was eliminated. In Europe, financial institutions are allowed to perform both investment-banking and commercial-banking functions. Hence, the London affiliates of foreign commercial banks were eligible for membership on the LSE. These changes were designed to give London the most open and competitive capital markets in the world. It has worked, and today the competition in London is especially fierce among the world's major financial centers. The United States recently repealed the Glass-Steagall Act, which restricted commercial banks from investment banking activities (such as underwriting corporate securities), further promoting competition among financial institutions. Even developing countries such as Chile, Mexico, and Korea began to liberalize by allowing foreigners to directly invest in their financial markets.

www.imf.org/external/np/exr/ib/

Offers an overview of globalization and ways in which countries may gain from the process.

Deregulated financial markets and heightened competition in financial services provided a natural environment for financial innovations that resulted in the introduction of various instruments. Examples of these innovative instruments include currency futures and options, multicurrency bonds, international mutual funds, country funds, and foreign stock index futures and options. Corporations also played an active role in integrating the world financial markets by listing their shares across borders. Such well-known non-U.S. companies as Seagram, Sony, Toyota Motor, Fiat, Telefonos de Mexico, KLM, British Petroleum, Glaxo, and Daimler are directly listed and traded on the New York Stock Exchange. At the same time, U.S. firms such as IBM and GM are listed on the Brussels, Frankfurt, London, and Paris stock exchanges. Such cross-border listings of stocks allow investors to buy and sell foreign shares as if they were domestic shares, facilitating international investments.[5]

Last but not least, advances in computer and telecommunications technology contributed in no small measure to the emergence of global financial markets. These technological advancements, especially Internet-based information technologies, gave investors around the world immediate access to the most recent news and information affecting their investments, sharply reducing information costs. Also, computerized order-processing and settlement procedures have reduced the costs of international transactions. Based on the U.S. Department of Commerce computer price deflator, the relative cost index of computing power declined from a level of 100 in 1960 to 15.6 in 1970, 2.9 in 1980, and only 0.5 in 1999. As a result of these technological developments and the liberalization of financial markets, cross-border financial transactions have exploded in recent years.

## Advent of the Euro

The advent of the euro at the start of 1999 represents a momentous event in the history of world financial system that has profound ramifications for the world economy. Currently, more than 300 million Europeans in 12 countries (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain) are using the common currency on a daily basis. No single currency has circulated so widely in Europe since the days of the Roman Empire. Considering that up to 10 countries, including the Czech Republic, Hungary, and Poland, may join the European Union (EU) by the year 2004, and that many of them would like to adopt the euro relatively soon thereafter, the **transaction domain** of the euro may become larger than that of the U.S. dollar in the near future.

Once a country adopts the common currency, it obviously cannot have its own monetary policy. The common monetary policy for the euro zone is now formulated by the **European Central Bank** (ECB) that is located in Frankfurt and partly modeled after the Bundesbank, the German central bank. ECB is legally mandated to achieve price stability for the euro zone. Considering the sheer size of the euro zone in terms of population, economic output, and world trade share and the prospect of monetary stability in Europe, the euro has a strong potential for becoming another global currency rivaling the U.S. dollar for dominance in international trade and finance. Reflecting the significance of the euro's introduction, Professor Robert Mundell, who is often referred to as the intellectual father of the euro, recently stated: "The creation of the euro area will eventually, but inevitably, lead to competition with the dollar area, both from the standpoint of excellence in monetary policy, and in the enlistment of other currencies."[6] The world thus faces a prospect of bipolar international monetary system.

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[5]Various studies indicate that the liberalization of capital markets tends to lower the cost of capital. See, for example, Peter Henry, "Stock Market Liberalization, Economic Reform, and Emerging Market Equity Prices," *Journal Finance* (2000), pp. 529–64.

[6]Source: Robert Mundell, 2000, "Currency Area, Volatility and Intervention," *Journal of Policy Modeling 22* (3), 281–99

Since its inception in 1999, the euro has already brought about revolutionary changes in European finance. For instance, by redenominating corporate and government bonds and stocks from 12 different currencies into the common currency, the euro has precipitated the emergence of continentwide capital markets in Europe that are comparable to U.S. markets in its depth and liquidity. Companies all over the world can benefit from this development as they can raise capital more easily on favorable terms in Europe. In addition, the recent surge in European M&A activities, cross-border alliances among financial exchanges, and lessening dependence on the banking sectors for capital raising are all manifestations of the profound effects of the euro. The International Finance in Practice box, "Why We Believe in the Euro," presents an upbeat view of the euro expressed by Jürgen Schrempp, CEO of DaimlerChrysler.

Since the end of World War I, the U.S. dollar has played the role of the dominant global currency, displacing the British pound. As a result, foreign exchange rates of currencies are quoted against the dollar and the lion's share of currency trading involves the dollar on either the buy or sell side. Similarly, international trade in primary commodities, such as petroleum, coffee, wheat, and gold, is conducted using the U.S. dollar as the invoice currency. Reflecting the dominant position of the dollar in the world economy, central banks of the world hold a major portion of their external reserves in dollars. The ascendance of the dollar reflects several key factors such as the dominant size of the U.S. economy, mature and open capital markets, price stability, and the political and military power of the United States. It is noted that the dominant global currency status of the dollar confers upon the United States many special privileges such as the ability to run trade deficits without having to hold much foreign exchange reserves, that is, "deficits without tears," and conduct a large portion of international transactions in dollars, without bearing exchange risks. However, once economic agents start to use the euro in earnest as an invoice, vehicle, and reserve currency, the dollar may have to share the aforementioned privileges with the euro.[7]

## Trade Liberalization and Economic Integration

International trade, which has been the traditional link between national economies, continued to expand. As Exhibit 1.3 shows, the ratio of merchandise exports to GDP for the world has increased from 7.0 percent in 1950 to 19.7 percent in 2001. This implies that, over the same time period, international trade increased nearly three times as fast as world GDP. For some countries, international trade grew much faster; for Germany, the ratio rose from 6.2 percent to 31.1 percent, while for Taiwan it grew from 2.5 percent to 45.2 percent over the same time period. Latin American countries such as Argentina and Brazil have relatively low export-to-GDP ratios. This reflects the inward-looking, protectionist economic policies these countries pursued in the past. Even these once-protectionist countries are now increasingly pursuing free-market and open-economy policies because of the gains from international trade.

The principal argument for international trade is based on the **theory of comparative advantage,** which was advanced by David Ricardo in his seminal book, *Principles of Political Economy* (1817). According to Ricardo, it is mutually beneficial for countries if they specialize in the production of those goods they can produce most efficiently and trade those goods among them. Suppose England produces textiles most efficiently, whereas France produces wine most efficiently. It then makes sense if England specializes in the production of textiles and France in the production of wine, and the two countries then trade their products. By doing so, the two countries can increase their combined production of textiles and wine, which, in turn, allows both countries

[7]A recent study by Eun and Lai, 2002, "The Power Contest in FX Markets: The Euro vs. the Dollar," indicates that within three years since its inception, the euro has succeeded in establishing its own currency bloc in Europe, comprising the currencies of Croatia, Czech Republic, Hungary, Norway, Slovakia, Slovenia, Sweden, and Switzerland. The study, however, shows that the U.S. dollar remains as the dominant global currency. In contrast, the Japanese yen does not have its own currency bloc in Asia.

INTERNATIONAL FINANCE IN PRACTICE

# Why We Believe in the Euro

*By Jürgen Schrempp, CEO of DaimlerChrysler*

In our company, we don't mean to waste even a day in putting the euro to work. On Jan. 1, 1999—day one for the new currency—our company will switch over completely to the euro as the internal and external unit of account. We expect to be one of the first German-based companies—perhaps *the* first—to make such a complete change. We'll also encourage our suppliers within Euroland to invoice us in euros from the very beginning. Our Euroland customers, of course, will have the option of paying in either euros or their domestic currency until 2001.

Nearly all major European companies are in favor of the single currency. But having recently agreed on a historic, transatlantic merger with Chrysler Corp. of the United States, we feel especially attuned to the forces of global competition that make the euro so essential. For our new company, DaimlerChrysler AG, and for Germany and Europe as a whole, economic and monetary union will bring substantial and lasting benefits as we take our place in the interdependent world of the 21st century.

Those benefits will take shape—indeed, are already occurring—in several realms at once. First and most fundamental is the political. The single currency will push the countries of Europe into cooperating more and more in seeking solutions to common economic problems. As they do so, they'll grow increasingly intertwined politically.

At the same time, the euro will unleash powerful market forces certain to transform the way Europeans live and work. The years ahead will bring increased efficiency, greater productivity, higher overall living standards and lower unemployment. For businesses, a common currency will reduce transaction costs—eliminating, among other things, the unnecessary waste of resources involved in dealing with several European currencies. At present, doing business across borders means having to buy and sell foreign currencies—and taking the risk that sudden changes in their relative value could upend an otherwise sound business strategy. The risks can be hedged, of course, but only at a cost that must ultimately be borne by customers.

The market forces unleashed by the euro will be felt not just by corporate managers but also by political leaders. Business executives are already working to rationalize their companies, enhancing productivity and improving labor flexibility. Elected officials, facing competition as they try to attract the investments that create jobs, will eventually lower corporate tax rates and streamline regulation. In so doing, governments will give corporations a boost, like the reduction in the cost of capital that came about as countries tightened their fiscal and monetary policies in preparation for EMU.

These changes are mutually reinforcing. And as they take hold, Euroland companies will grow more confident

**EXHIBIT 1.3**

**Long-Term Openness in Perspective** (Merchandise Exports/GDP at 1990 Prices, in Percent)

| Country | 1870 | 1913 | 1929 | 1950 | 1973 | 2001 |
|---|---|---|---|---|---|---|
| United States | 2.5 | 3.7 | 3.6 | 3.0 | 5.0 | 7.2 |
| Canada | 12.0 | 12.2 | 15.8 | 13.0 | 19.9 | 41.1 |
| Australia | 7.4 | 12.8 | 11.2 | 9.1 | 11.2 | 17.6 |
| United Kingdom | 12.0 | 17.7 | 13.3 | 11.4 | 14.0 | 19.0 |
| Germany | 9.5 | 15.6 | 12.8 | 6.2 | 23.8 | 31.1 |
| France | 4.9 | 8.2 | 8.6 | 7.7 | 15.4 | 24.7 |
| Spain | 3.8 | 8.1 | 5.0 | 1.6 | 5.0 | 19.0 |
| Japan | 0.2 | 2.4 | 3.5 | 2.3 | 7.9 | 10.7 |
| Korea | 0.0 | 1.0 | 4.5 | 1.0 | 8.2 | 36.0 |
| Taiwan | 0.0 | 2.5 | 5.2 | 2.5 | 10.2 | 45.2 |
| Thailand | 2.1 | 6.7 | 6.6 | 7.0 | 4.5 | 59.4 |
| Argentina | 9.4 | 6.8 | 6.1 | 2.4 | 2.1 | 9.9 |
| Brazil | 11.8 | 9.5 | 7.1 | 4.0 | 2.6 | 10.3 |
| Mexico | 3.7 | 10.8 | 14.8 | 3.5 | 2.2 | 28.7 |
| World | 5.0 | 8.7 | 9.0 | 7.0 | 11.2 | 19.7 |

**Source:** Various issues of *World Financial Markets,* JP Morgan, and *International Financial Statistics,* IMF.

about committing resources to long-term projects. A look at the level of corporate mergers in recent years shows that managers have already stepped up their strategic decision making. Europe saw 237 such deals last year, worth $250 billion, of which 25 percent were European cross-border transactions. In 1995, by contrast, there were just 100 deals, worth $168 billion—and only 17 percent were European cross-border transactions.

Euroland will be a strong base for companies striving to compete globally. In 1997 its combined population numbered 290 million, compared with 268 million for the United States and 126 million for Japan. Its combined GDP was $6.3 trillion, versus $7.8 trillion for the United States and $4.2 trillion for Japan. Euroland already trades with the rest of the world as much as the United States does, and the picture will change in favor of Europe as soon as the United Kingdom, and others who have stayed out of the first wave, join the currency union. Such a development—the sooner the better—is something we would very much welcome.

Launching the new euro is one thing; successfully managing the EMU process in the years ahead is quite another. Implementation poses major challenges. Some will be technical; others will have to do with maintaining a unity of purpose among a diverse group of nations, regions, peoples and cultures. I believe, however, that Europe possesses the unshakable political will and financial expertise needed to keep this endeavor on track.

It will help that—as we as DaimlerChrysler well know—some of the payoffs are immediate and obvious. Currently, one third of our group's revenues are earned in Deutsche marks, but nearly three quarters of our costs are incurred in that currency. That makes planning harder and running the company more complex. But with the coming of the euro, the disparity between our DM costs and DM revenues will diminish. As of January, 50 percent of our revenues will be in euros, with 80 percent of our costs incurred in the same currency.

How will the euro affect our ability to compete in the United States, our main export market outside the EU? In a word, positively. Higher productivity and a stable "home" currency will allow us to maintain a competitive pricing structure. Such long-term consistency in our business practices is something our U.S. customers have come to appreciate.

One final point. Thanks to the single market and the pending introduction of a single currency, Europe has matured both politically and economically. As a major transatlantic player, DaimlerChrysler is now in a position to communicate an important message to its business partners in that other great single-currency market, the United States. Working through the World Trade Organization and other groups, the globe has made great progress toward free and fair trade over the years. Now let us together examine opportunities for removing some of the remaining obstacles to trade between Europe and the United States. The beneficiaries will be consumers on both sides of the Atlantic.

**Source:** *Newsweek*, Special Issue. Winter 1998, p. 38. Reprinted with permission.

to consume more of both goods. This argument remains valid even if one country can produce both goods more efficiently than the other country.[8] Ricardo's theory has a clear policy implication: *Liberalization of international trade will enhance the welfare of the world's citizens.* In other words, international trade is not a "zero-sum" game in which one country benefits at the expense of another country—the view held by the "mercantilists." Rather, international trade could be an "increasing-sum" game at which all players become winners.

Although the theory of comparative advantage is not completely immune to valid criticism, it nevertheless provides a powerful intellectual rationale for promoting free trade among nations. Currently, international trade is becoming further liberalized at both the global and regional levels. At the global level, the **General Agreement on Tariffs and Trade (GATT),** which is a multilateral agreement among member countries, has played a key role in dismantling barriers to international trade. Since it was founded in 1947, GATT has been successful in gradually eliminating and reducing tariffs, subsidies, quotas, and other barriers to trade. The latest round of talks, the Uruguay Round launched in 1986, aims to (1) reduce the import tariffs worldwide by an average of 38 percent, (2) increase the proportion of duty-free products from 20 percent to 44 percent for industrialized countries, and (3) extend the rules of world trade to cover agriculture, services such as banking and insurance, and intellectual property rights. It also created a permanent **World Trade Organization (WTO)** to replace GATT. The WTO

www.wto.org/

The World Trade Organization website covers news and data about international trade development.

[8]Readers are referred to Appendix 1A for a detailed discussion of the theory of comparative advantage.

has more power to enforce the rules of international trade. China recently joined WTO. China's WTO membership will further legitimize the idea of free trade.

**www.lib.berkeley.edu/GSSI/eu.html**

The University of California at Berkeley library provides a web guide to resources related to the European Union.

On the regional level, formal arrangements among countries have been instituted to promote economic integration. The **European Union (EU)** is a prime example. The European Union is the direct descendent of the European Community (formerly the European Economic Community), which was established to foster economic integration among the countries of Western Europe. Today the EU includes 15 member states that have eliminated barriers to the free flow of goods, capital, and people. The member states of the EU hope this move will strengthen its economic position relative to the United States and Japan. In January 1999, 11 member countries of EU successfully adopted a single common currency, the euro, which may rival the U.S. dollar as a dominant currency for international trade and investment. The launch of the euro has spurred a rush by European companies into seeking pan-European and global alliances. Merger and acquisition (M&A) deals in Europe totaled $1.2 trillion in 1999, exceeding the figure for U.S. deals for the first time. The EU may expand in the near future to include such formerly socialist countries as Poland, Hungary, and the Czech Republic.

Whereas the economic and monetary union planned by the EU is one of the most advanced forms of economic integration, a free trade area is the most basic. In 1994, Canada, the United States, and Mexico entered into the **North American Free Trade Agreement (NAFTA).** Canada is the United States' largest trading partner and Mexico is the third-largest. In a free trade area, all impediments to trade, such as tariffs and import quotas, are eliminated among members. The terms of NAFTA call for phasing out tariffs over a 15-year period. Many observers believe that NAFTA will foster increased trade among its members, resulting in an increase in the number of jobs and the standard of living in all member countries. It is interesting to note from Exhibit 1.3 that for Mexico, the ratio of export to GDP has increased dramatically from 2.2 percent in 1973 to 28.7 percent in 2001.

## Privatization

The economic integration and globalization that began in the 1980s picked up speed in the 1990s via privatization. Through **privatization,** a country divests itself of the ownership and operation of a business venture by turning it over to the free market system. Privatization did not begin with the fall of the Berlin Wall; nevertheless, its pace has quickly accelerated since the collapse of communism in the Eastern Bloc countries. It is ironic that the very political and economic system that only a short while ago extolled the virtues of state ownership should so dramatically be shifting toward capitalism by shedding state-operated businesses. President Calvin Coolidge once said that the business of America is business. One might now say that business is the business of the world.[9]

Privatization can be viewed in many ways. In one sense it is a denationalization process. When a national government divests itself of a state-run business, it gives up part of its national identity. Moreover, if the new owners are foreign, the country may simultaneously be importing a cultural influence that did not previously exist. Privatization is frequently viewed as a means to an end. One benefit of privatization for many less-developed countries is that the sale of state-owned businesses brings to the national treasury hard-currency foreign reserves. The sale proceeds are often used to pay down sovereign debt that has weighed heavily on the economy. Additionally, privatization is often seen as a cure for bureaucratic inefficiency and waste; some economists estimate that privatization improves efficiency and reduces operating costs by as much as 20 percent.

[9]Our discussion in this subsection draws heavily from the article in the special "World Business" section of *The Wall Street Journal,* October 2, 1995, entitled "Sale of the Century."

There is no one single way to privatize state-owned operations. The objectives of the country seem to be the prevailing guide. For the Czech Republic, speed was the overriding factor. To accomplish privatization en masse, the Czech government essentially gave away its businesses to the Czech people. For a nominal fee, vouchers were sold that allowed Czech citizens to bid on businesses as they went on the auction block. From 1991 to 1995, more than 1,700 companies were turned over to private hands. Moreover, three-quarters of the Czech citizens became stockholders in these newly privatized firms.

In Russia, there has been an "irreversible" shift to private ownership, according to the World Bank. More than 80 percent of the country's nonfarm workers are now employed in the private sector. Eleven million apartment units have been privatized, as have half of the country's 240,000 other business firms. Additionally, via a Czech-style voucher system, 40 million Russians now own stock in over 15,000 medium- to large-size corporations that recently became privatized through mass auctions of state-owned enterprises.

For some countries, privatization has meant globalization. For example, to achieve fiscal stability, New Zealand had to open its once-socialist economy to foreign capital. Australian investors now control its commercial banks, and U.S. firms purchased the national telephone company and timber operations. While workers' rights have changed under foreign ownership and a capitalist economy, New Zealand now ranks high among the most competitive market environments. Fiscal stability has also been realized. In 1994, New Zealand's economy grew at a rate of 6 percent and inflation was under control. As can be seen from the experiences of New Zealand, privatization has spurred a tremendous increase in cross-border investment. The Bank for International Settlements reports that foreign direct investment has soared to $240 billion in 1994 from an annual level of $100 billion in the early 1990s and only $10 billion a decade earlier.

## Multinational Corporations

In addition to international trade, foreign direct investment by MNCs is a major force driving globalization of the world economy. According to a UN report, there are about 60,000 MNCs in the world with over 500,000 foreign affiliates.[10] Throughout the 1990s, foreign direct investment by MNCs grew at the annual rate of about 10 percent. In comparison, international trade grew at the rate of 3.5 percent during the same period. MNCs' worldwide sales reached $11 trillion in 1998, compared to about $7 trillion of world exports in the same year.[11] As indicated in the International Finance in Practice box on page 17, MNCs are reshaping the structure of the world economy.

A **multinational corporation (MNC)** is a business firm incorporated in one country that has production and sales operations in several other countries. The term suggests a firm obtaining raw materials from one national market and financial capital from another, producing goods with labor and capital equipment in a third country, and selling the finished product in yet other national markets. Indeed, some MNCs have operations in dozens of different countries. MNCs obtain financing from major money centers around the world in many different currencies to finance their operations. Global operations force the treasurer's office to establish international banking relationships, place short-term funds in several currency denominations, and effectively manage foreign exchange risk.

www.unctad.org/wir/

This UNCTAD website provides a broad coverage of cross-border investment activities by multinational corporations.

Exhibit 1.4 lists the top 40 of the largest 100 MNCs ranked by the size of foreign assets. The list was compiled by the United Nations Conference on Trade and Development (UNCTAD). Many of the firms on the list are well-known MNCs with household

[10]The source for this information is the United Nations' *World Investment Report 1999.*

[11]The source of this information is *World Investment Report 1999,* the United Nations.

**EXHIBIT 1.4** The World's Top 40 MNCs Ranked by Foreign Assets, 1999 (Billions of Dollars)

| Ranking by Foreign Assets | Corporation | Country | | Assets Foreign | Assets Total | Sales Foreign | Sales Total |
|---|---|---|---|---|---|---|---|
| 1 | General Electric | United States | Electronics | 141.1 | 405.2 | 32.7 | 111.6 |
| 2 | ExxonMobil Corporation | United States | Petroleum expl./ref./distr. | 99.4 | 144.5 | 115.5 | 160.9 |
| 3 | Royal Dutch/Shell Group | The Netherlands/ United Kingdom | Petroleum expl./ref./distr. | 68.7 | 113.9 | 53.5 | 105.4 |
| 4 | General Motors | United States | Motor vehicles | 68.5 | 274.7 | 46.5 | 176.6 |
| 5 | Ford Motor Company | United States | Motor vehicles | .. | 273.4 | 50.1 | 162.6 |
| 6 | Toyota Motor Corporation | Japan | Motor vehicles | 56.3 | 154.9 | 60.0 | 119.7 |
| 7 | DaimlerChrysler AG | Germany | Motor vehicles | 55.7 | 175.9 | 122.4 | 151.0 |
| 8 | TotalFina SA | France | Petroleum expl./ref./distr. | .. | 77.6 | 31.6 | 39.6 |
| 9 | IBM | United States | Computers | 44.7 | 87.5 | 50.4 | 87.6 |
| 10 | BP | United Kingdom | Petroleum expl./ref./distr. | 39.3 | 52.6 | 57.7 | 83.5 |
| 11 | Nestlé SA | Switzerland | Food/beverages | 33.1 | 36.8 | 45.9 | 46.7 |
| 12 | Volkswagen Group | Germany | Motor vehicles | .. | 64.3 | 47.8 | 70.6 |
| 13 | Nippon Mitsubishi Oil Corporation (Nippon Oil Co. Ltd.) | Japan | Petroleum expl./ref./distr. | 31.5 | 35.5 | 28.4 | 33.9 |
| 14 | Siemens AG | Germany | Electronics | .. | 76.6 | 53.2 | 72.2 |
| 15 | Wal-Mart Stores | United States | Retailing | 30.2 | 50.0 | 19.4 | 137.6 |
| 16 | Repsol-YPF SA | Spain | Petroleum expl./ref./distr. | 29.6 | 42.1 | 9.1 | 26.3 |
| 17 | Diageo Plc | United Kingdom | Beverages | 28.0 | 40.4 | 16.4 | 19.0 |
| 18 | Mannesmann AG | Germany | Telecommunications/ engineering | .. | 57.7 | 11.8 | 21.8 |
| 19 | Suez Lyonnaise des Eaux | France | Diversified/utility | .. | 71.6 | 9.7 | 23.5 |
| 20 | BMW AG | Germany | Motor vehicles | 27.1 | 39.2 | 26.8 | 36.7 |
| 21 | ABB | Switzerland | Electrical equipment | 27.0 | 30.6 | 23.8 | 24.4 |
| 22 | Sony Corporation | Japan | Electronics | .. | 64.2 | 43.1 | 63.1 |
| 23 | Seagram Company | Canada | Beverages/media | 25.6 | 35.0 | 12.3 | 11.8 |
| 24 | Unilever | United Kingdom/ The Netherlands | Food/beverages | 25.3 | 28.0 | 38.4 | 44.0 |
| 25 | Aventis | France | Pharmaceuticals/ chemicals | .. | 39.0 | 4.7 | 19.2 |
| 26 | Mitsubishi Corporation | Japan | Diversified | 24.6 | 78.6 | 15.8 | 127.3 |
| 27 | Roche Group | Switzerland | Pharmaceuticals | 24.5 | 27.1 | 18.1 | 18.4 |
| 28 | Renault SA | France | Motor vehicles | .. | 46.4 | 23.9 | 37.6 |
| 29 | Honda Motor Co Ltd. | Japan | Motor vehicles | 24.4 | 41.8 | 38.7 | 51.7 |
| 30 | Telefónica SA | Spain | Telecommunications | 24.2 | 64.1 | 9.5 | 23.0 |
| 31 | News Corporation | Australia | Media/publishing | 23.5 | 38.4 | 12.9 | 14.3 |
| 32 | Motorola Inc | United States | Electronics | 23.5 | 40.5 | 18.3 | 33.1 |
| 33 | Philips Electronics | The Netherlands | Electronics | 22.7 | 29.8 | 31.8 | 33.5 |
| 34 | Nissan Motor Co. Ltd. | Japan | Motor vehicles | .. | 59.7 | .. | 58.1 |
| 35 | British American Tobacco Plc | United Kingdom | Food/tobacco | 22.0 | 26.2 | 16.5 | 18.1 |
| 36 | ENI Group | Italy | Petroleum expl./ref./distr. | 20.9 | 44.3 | 11.4 | 29.1 |
| 37 | Chevron Corporation | United States | Petroleum expl./ref./distr. | 20.1 | 40.7 | 9.7 | 35.4 |
| 38 | Johnson & Johnson | United States | Pharmaceuticals | 19.8 | 29.2 | 12.1 | 27.5 |
| 39 | Hewlett-Packard | United States | Electronics/computers | .. | 35.3 | 23.4 | 42.4 |
| 40 | Elf Aquitaine SA | France | Petroleum expl./ref./distr. | 18.8 | 43.2 | 25.7 | 35.8 |

**Source:** *World Investment Report 2001*, United Nations.

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## Mulutinationals More Efficient

Foreign-owned manufacturing companies in the world's most highly developed countries are generally more productive and pay their workers more than comparable locally-owned businesses, according to the Organisation for Economic Co-operation and Development.

The Paris-based organisation also says that the proportion of manufacturing under foreign ownership in European Union countries rose substantially during the 1990s, a sign of increasing economic integration.

In a report on the global role of multinationals, the OECD points out that for some countries, the level of production abroad by foreign subsidiaries of national businesses was comparable to total exports from these countries.

The finding underlines the increasing importance in the world economy of large companies with bases scattered across the globe.

Gross output per employee, a measure of productivity, in most OECD nations tends to be greater in multinationals than in locally-owned companies, the report says.

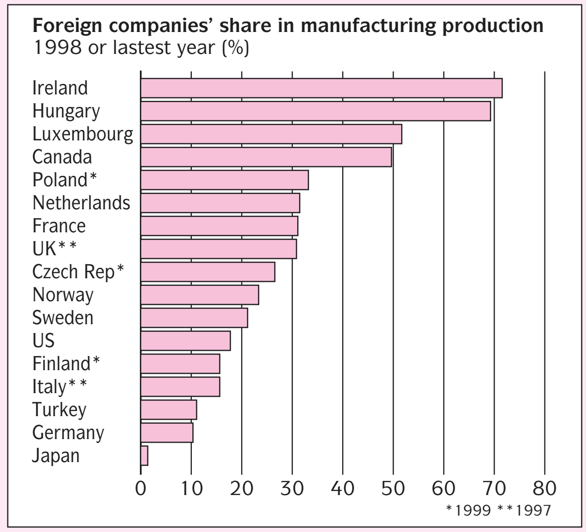
This is partly a factor of the multinationals being bigger and more geared to operating according to world-class levels of efficiency. But it also reflects their ability to transfer new thinking in production technologies through an international factory network.

Reflecting the greater efficiencies, workers in foreign-owned plants tend to earn more money than those in locally-owned ones.

In Turkey, employees of multinationals earn double the wages of their counterparts. The equivalent figure in the UK is 23 per cent and in the US it is 9 per cent.

In the EU in 1998, a quarter of total manufacturing production was controlled by a foreign subsidiary of a bigger company compared to 17 per cent in 1990. The figure has probably increased since then, and is expected to climb further as the impact of the euro tightens the link between member countries' economies.

*Measuring Globalisation: The Role of Multinationals in OECD Economies. For details see* www.oecd.org




**Source:** OECD, Activities of Foreign Affiliates database

**Source:** Peter Marsh, *Financial Times,* March 20, 2002, p. 6. Reprinted with permission.

names because of their presence in consumer product markets. For example, General Motors, Royal/Dutch Shell, Toyota, Daimler-Benz, IBM, Philip Morris, British Petroleum, Unilever, Nestlé, Sony, and Siemens are names recognized by most people. By country of origin, U.S. MNCs, with 26 out of the total of 100, constitute the largest group. Japan ranks second with 18 MNCs in the top 100, followed by France with 13, Germany with 12, and the U.K. with 8. It is interesting to note that some Swiss firms are extremely multinational. Nestlé, for instance, derived about 98 percent of its sales from overseas markets.

MNCs may gain from their global presence in a variety of ways. First of all, MNCs can benefit from the economy of scale by (1) spreading R&D expenditures and advertising costs over their global sales, (2) pooling global purchasing power over suppliers, (3) utilizing their technological and managerial know-how globally with minimum additional costs, and so forth. Furthermore, MNCs can use their global presence to take advantage of underpriced labor services available in certain developing countries, and gain access to special R&D capabilities residing in advanced foreign countries. MNCs can indeed leverage their global presence to boost their profit margins and create shareholder value.

## Organization of the Text

*International Financial Management* contains 21 chapters divided into four parts. Part One, Foundations of International Financial Management, contains five chapters on the fundamentals of international finance. This section lays the macroeconomic foundation for all the topics to follow. A thorough understanding of this material is essential for understanding the advanced topics covered in the remaining sections.

Chapter 2 introduces the student to the various types of international monetary systems under which the world economy can function and has functioned at various times. Extensive treatment is given to the differences between a fixed and a flexible exchange rate regime. The chapter traces the historical development of the world's international monetary systems from the early 1800s to the present. Additionally, a detailed discussion of the European Monetary System of the European Union is presented. Chapter 3 presents balance-of-payment concepts and accounting. The chapter is designed to show that even a national government must keep its "economic house in order" or else it will experience current account deficits that will undermine the value of its currency. This chapter also shows how the balance of payments reveals the sources of demand and supply of a country's currency. It concludes by surveying the balance-of-payments trends in major countries.

Chapter 4 provides an introduction to the organization and operation of the spot and forward foreign exchange market. It describes institutional arrangements of the foreign exchange markets and details of how foreign exchange is quoted and traded worldwide. Chapter 5, in turn, presents some of the fundamental international parity relationships among exchange rates, interest rates, and inflation rates. An understanding of these parity relationships, which are manifestations of market equilibrium, is essential for astute financial management in a global setting. Chapter 5 begins with the derivation of *interest rate parity,* showing the interrelationship between the interest rates of two countries and the spot and forward exchange rates between the same two countries. Similarly, the theory of *purchasing power parity (PPP)* is developed, showing the relationship between a change in exchange rate between two countries and the relative values of their inflation rates. The limitations of PPP are clearly detailed. The chapter concludes with a discussion of forecasting exchange rates using parity relationships and other fundamental and technical forecasting techniques.

The chapters in Part One lay the macroeconomic foundation for *International Financial Management.* Exhibit 1.5 provides a diagram that shows the text layout. The diagram shows that the discussion moves from a study of macroeconomic foundations to a study of the financial environment in which the firm and the financial manager must function. Financial strategy and decision making can be discussed intelligently only after one has an appreciation of the financial environment.

Part Two, World Financial Markets and Institutions, provides a thorough discussion of international financial institutions, financial assets, and marketplaces, and develops the tools necessary to manage exchange rate uncertainty. Chapter 6, International Banking and the Money Market, begins the section. The chapter differentiates between international and domestic bank operations and examines the institutional differences between various types of international banking offices. International banks and their clients make up the Eurocurrency market and form the core of the international money market. The chapter includes a discussion of the features and characteristics of the major international money market instruments: forward rate agreements, Euronotes, Euro-medium-term notes, and Eurocommercial paper. The chapter concludes with an examination of the international debt crisis that severely jeopardized the economic viability of many of the world's largest banks during the past decade.

Chapter 7 distinguishes between foreign bonds and Eurobonds, which together make up the international bond market. It discusses the advantages to the issuer of sourcing funds from the international bond market as opposed to raising funds domestically. It describes both the underwriting procedure for issuing new Eurobonds and the