The scope and environment of international finance

Characteristics of main players

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- Source: Bekaert, G. J., and Hodrick, R. J. (2012). International Financial Management, 2nd edition. Chapter 1.

Why we study International Finance?

- We live in a highly globalized and integrated world economy.
- Continuous liberalization of international trade and investments and rapid advances in telecommunication and transportation technologies, the world is getting more integrated.
- Financial managers of MNCs should learn how to manage foreign exchange and political risk using proper tools and instruments, deal with market imperfections and benefit from the expanded investment and financing opportunities with the aim of contribution to share holder wealth maximization.

1.1 Introduction
“The world economy is becoming increasingly globalized“

- Globalization
  - Increasing connectivity and integration of countries and corporations and the people within them in terms of their economic, political, and social activities
  - Multinational corporations dominates the corporate landscape
    - Produce and sell goods or services in more than one nation (e.g. Coca-Cola, IBM, Nestle, ..)
    - BRIC countries (Brazil, Russia, India and China)/emerging markets offer a lot of opportunities for expansion (Why?)
- International scope creates opportunities but also challenges
  - Recent crisis (others?)

1.2 Globalization and two main trends: The Growth of International Trade and Capital Flows

1. The growth of international trade

- The **theory of comparative advantage** (advanced by David Ricardo) **says:**
- 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. It is not a "zero-sum game" in which one country benefits at the expense of another country. It is "increasing-sum" game at which all players are winners.
  - Assumptions:
    - Free trade
    - Perfect competition
    - No uncertainty
    - Costless information
    - No government interference
- Comparative advantage still explains why some countries are better for export

1.2 Globalization and two main trends: The Growth of International Trade and Capital Flows

- Trade liberalization so countries can specialize at production of goods for which they have a comparative advantage
- 1960s only 20% of countries were open
- Firms (1980s), the fall of the Iron Curtain in 1990 and subsequent trade liberalizations in many developing countries and privatization
- By 2000, over 70% of countries were open
- International Efforts to Promote Free Trade (Free trade agreements)
  - General Agreement on Tariffs and Trade GATT (1947)
  - World Trade Organization WTO (1986)
  - Regional Trade agreements (European Union, NAFTA, ASEAN)
- **More open economies, tend to grow faste**r (Frankel and Romer (1999), Sachs and Warner (1995), Alcal and Ciccone (2004), and Wacziarg and Welch (2008)).
- The examples of protectionist policies: tariffs on imports, subsidies to local producers, quotas on imported products, onerous regulations applying to imported products
- Advances in information technology supported **Outsourcing** of services
  - Shifting of non-strategic functions to specialist firms to reduce costs (IT, payrolls, logistics, maintenance facilities)
  - 21st century comparative advantage is based on services and supply chain outsourcing

1.2 Globalization and the Growth of International Trade and Capital Flows

- The evolution of trade openness dramatically increased trade flows between countries. One measure of trade openness is the sum of exports and imports in a given year divided by a measure of output (GDP)

- The growth in trade (patterns)
  - Germany is most open, United States is least open
  - China's trade jumped due to trade reforms
  - Countries that border oceans tend to trade more
  - Large countries tend to trade less than small (USA, China is exception)

Exhibit 1.1 (Panel A) International Trade as a Percentage of GDP

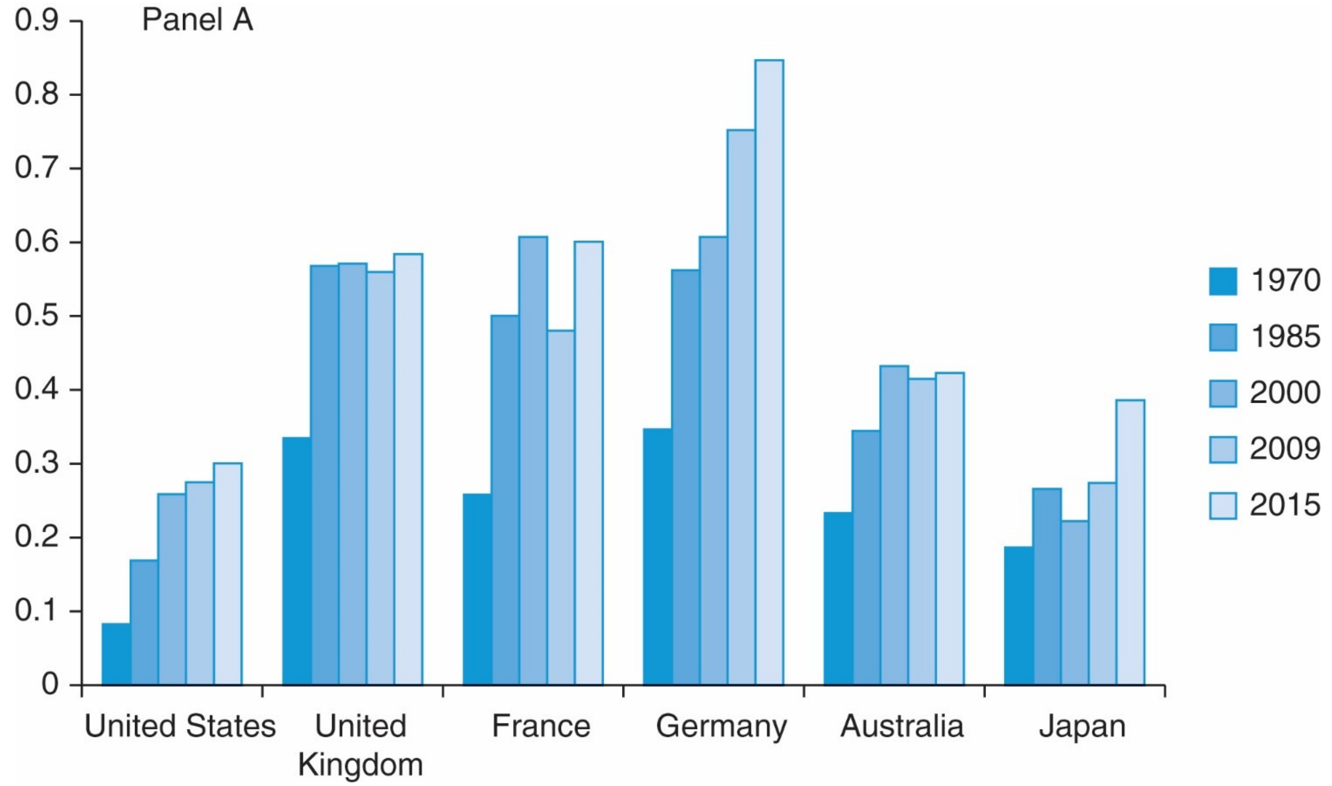
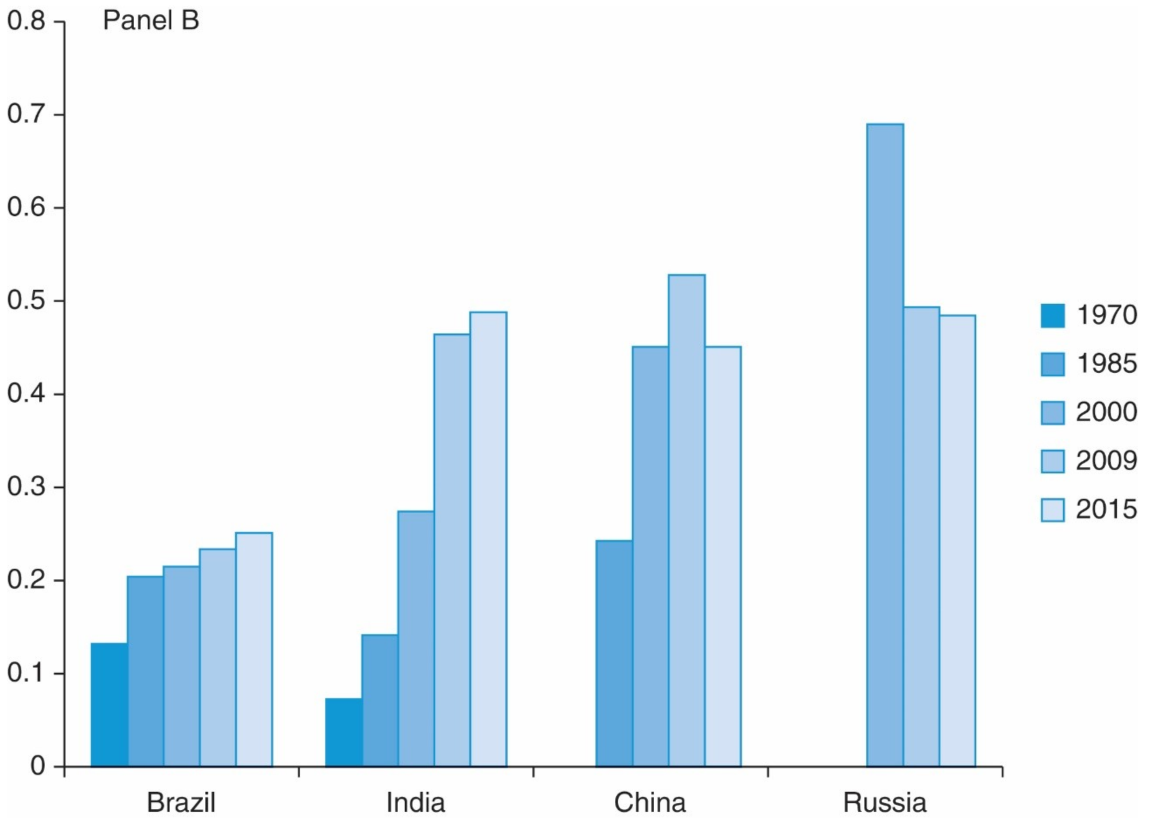


Exhibit 1.1 (Panel B) International Trade as a Percentage of GDP (BRIC countries)



1.2 Globalization and the Growth of International Trade and Capital Flows

- Incredible growth in MNCs after WWII boosted international trade
  - 37,000 MNCs in 1990
  - 82,053 in 2010
  - More than 50% of international trade occurs within MNCs
- Globalization of financial markets improved MNCs access to foreign capital, and enhanced their ability to reduce financing costs
  - Trends in financial openness
    - Countries open financially and allow foreigners to invest in their markets (1980s) and vice versa (= free flow of capital across borders)
    - Creation of new asset class – emerging markets
  - New financial landscape – derivatives (← deregulation, advance in technology)
    - An investment whose payoff over time is derived from the performance of underlying assets (futures, forwards, …)
    - Securitization – repackaging of "pools" of loans or other receivables to create a new financial instrument
- Derivatives and securitization improved the ability of banks and corporations to manage financial risk

1.2 Globalization and the Growth of International Trade and Capital Flows

- Globalization of financial markets
  - Pros and cons of development
    - Pro – banks (and companies) could hedge against risk
    - Cons – smart financiers exploit differences in country-specific regulations and complexity of instruments created opaqueness in the financial system
      - Global Financial Crisis – 2008 – 2010
        - Started in U.S.
        - Longest and deepest in the postwar era
        - Scale and depth of crisis raises deep issues about the functioning of the global financial system

1.3 Multinational Corporations

- A parent company in the firm’s originating country and operating subsidiaries, branches, and affiliates abroad
  - UN calls these “transnational corporations”
- How they enter foreign markets
  - Exporting / Importing
  - Licensing – gives local firms right to manufacture their products in exchange for a fee (royalties) (difficult to maintain quality standards)
  - Franchising – the firm provides sales or service strategies in exchange for fees
  - Joint venture – two or more firms form a new legal entity, jointly owned by all of the firms
  - Buying foreign company
  - Greenfield investments – starting company from scratch (part of FDI)

1.3 Multinational Corporations

- Goals of an MNC
  - Maximize shareholder wealth
    - Australia, Canada, U.K. and U.S.
    - Appropriate time horizon is long
  - Maximize stakeholder wealth
    - Europe and Asia
    - Agency Theory – stockholders hire managers who make decisions about production and marketing. *How can the ultimate owners of the assets motivate the managers to act in the owners' interest?*
    - The studies problems that arise from the separation of ownership and control
      - Corporate governance – legal/financial structure controlling relationship the relationship between a company's shareholders and its management. Establish the framework within which the managers operate and to mitigate the principal–agent problem.
      - Corporate fraud
        - Enron, WorldCom, Tyco, Parmalat

Exhibit 1.4 Methods of Overcoming Agency Problems Due to the Separation of Ownership and Control

Exhibit 1.4 Methods of overcoming agency problems due to the separation of ownership and control

Method	Pros	Cons
1. Independent board of directors.	Protection of minority shareholders' interests. Increased risk sharing.	Often not sufficiently independent of management and therefore ineffective.
2. Partial concentration of ownership and control in the hands of a large shareholder.	A large shareholder has the self-interest to monitor management's activities to prevent abuses.	Possible collusion between management and large shareholder against smaller shareholders. Reduced liquidity in the stock.
3. Executive compensation with options or bonuses related to performance.	Provides a direct incentive to maximize stock price.	Rewards management for good luck. Subject to manipulation and possible short-term focus to all management to get rich.
4. Clearly defined fiduciary duties for CEOs with class-action lawsuits.	Provides a complementary disciplining device.	Increases legal costs and enriches lawyers at the expense of stockholders.
5. Hostile takeovers and proxy contests.	Directly disciplines bad management.	Provides an incentive for raiders to expropriate wealth from creditors and employees.

1.3 Multinational Corporations

- Foreign Direct Investment (FDI)
  - When a company from one country buys at least 10% of a company in another country
  - Has grown from $7.5 trillion in 2000 to $25.0 trillion in 2015
  - Mergers and acquisitions (M&A) play a huge role in this trend

Exhibit 1.6 Cross-Border Mergers and Acquisitions, 2000–2015
(in millions of dollars)

Exhibit 1.6 Cross-border mergers and acquisitions, 2000–2015 (in millions of dollars)

	By purchaser			By seller		
Region/Economy	2000	2010	2015	2000	2010	2015
World	959,681	347,094	721,455	959,681	347,094	721,455
Developed economies	894,982	224,759	585,860	870,099	259,926	630,853
Europe	724,478	44,262	318,047	507,745	127,458	295,090
France	154,785	6,180	23,506	33,579	3,573	44,104
Germany	9,737	7,025	46,669	232,578	10,515	14,604
Ireland	5,985	5,124	97,480	3,665	2,127	48,049
Italy	18,439	(5,190)	3,101	11,300	6,329	14,269
Luxembourg	492	1,558	17,352	26	2,138	13,558
Netherlands	33,604	16,418	20,275	28,779	4,162	15,540
Spain	36,495	2,898	16,715	20,095	10,348	9,665
Switzerland	59,786	12,928	39,971	5,765	1,321	17,416
United Kingdom	339,546	(3,851)	34,955	112,160	60,826	71,047
North America	150,430	120,717	207,851	332,885	97,616	313,368
Canada	39,032	35,614	87,826	79,944	13,272	14,629
United States	111,398	85,104	120,024	252,941	84,344	298,739
Other developed economies	20,074	59,779	59,963	29,469	34,853	22,396
Australia	3,441	15,629	11,527	8,861	27,172	9,091
Japan	3,107	31,271	50,381	11,439	7,114	3,203
Developing economies	60,810	100,378	119,057	88,971	83,072	81,181
Africa	2,938	3,792	3,358	2,387	7,493	20,414
South Africa	2,934	1,619	549	352	3,653	20,969
Asia	53,181	79,865	110,342	52,771	37,723	46,398
China	(398)	29,828	43,653	37,875	6,758	9,660
Hong Kong, China	39,865	13,318	17,916	1,472	12,684	23,832
Korea, Republic of	1,286	9,952	563	6,345	(2,063)	(3,649)
Kuwait	(480)	(10,793)	731	0	460	868
Qatar	2	626	8,838	0	12	0
Singapore	7,504	8,963	21,130	1,397	3,859	4,977
Latin America and the Caribbean	4,323	16,725	5,340	33,811	29,013	12,134
Brazil	239	9,030	(1,654)	12,981	10,115	2,719
Mexico	4,031	2,896	2,393	4,528	7,989	4,765
Russian Federation	294	3,875	4,338	411	2,882	6,677

1.4 Other Important International Players

- International banks (CitiBank, HSBC, Global Asset management firms for M&As)
- International institutions
  - International Monetary Funds (IMF)
    - Member organization whose goal is to ensure the stability of the international monetary and financial system through surveillance and technical assistance. IMF helps to resolve crises when they occur, and to promote growth and alleviate poverty.
  - The World Bank
    - The World Bank also provides advisory services to developing countries and is actively involved with efforts to reduce and cancel the international debt of the poorest countries

1.4 Other Important International Players

- Multilateral development banks
  - Provide financial support and professional advice for economic and social development activities in developing countries
  - Regional development banks (including World Bank and regional banks in Africa, Asia and Europe) who provide financing and grants
- World Trade organization (WTO)
  - Mediates trade disputes
- Organization for Economic Cooperation and Development (OECD)
  - Examines, devises and coordinates policies across 34 relatively wealthy nations to foster sustainable economic growth and employment, rising standards of living and financial stability
- Bank for International Settlements (BIS)
  - Fosters international monetary and financial cooperation – central banks’ central bank

1.4 Other Important International Players

- European Union (EU)
  - Cooperation among countries in this region and (in most cases) the adoption of the same currency to promote international business
  - Economic and monetary union (EMU)
- Governments
- Individual investors
- Institutional investors
- Sovereign wealth funds
  - Government-run investment pools
- Hedge funds
- Private equity funds

1.5 Globalization and the MNC: Benefactor or Menace?

- Countries who had opened their markets to foreigners subsequently fell into crisis
- Benefits of openness
  - Channels savings to most productive uses
  - Sharing of risk beyond what is possible domestically
  - Domestic recessions can be buffered through borrowing
  - Cost of capital decreases, leading firms to invest more, which increases growth
- Costs of openness
  - Sometimes capital is not used wisely (price boom)
  - Foreign capital can leave quickly causing financial volatility
  - Difficulty in taxing profits – MNCs shift to avoid
  - Capital control effectiveness decreases

1.5 Globalization and the MNC: Benefactor or Menace?

- Anti-globalist movement and MNCs
  - Movement opposing globalization
  - Identifies MNCs as a main "villain" of globalization
  - Criticize global financial institutions such as the World Bank, IMF and WTO
  - They fear that MNC activities will harm the environment
  - They argue that globalization is seen as a threat to employment in their own country

1.5 Globalization and the MNC: Benefactor or Menace?

- Final thoughts on globalization
  - Can be valuable
  - Some evidence that workers in developed countries have not benefited
    - Globalization destroys some jobs and creates others
  - Some believe that government must intervene to better spread the newly created wealth by helping those that have been displaced by globalization
    - Retraining
  - Benefits of openness should be fairly shared among countries.

Questions

1. What is agency theory? How does corporate governance the issues raised by agency theory?
2. Why is ownership more concentrated in developing countries than in developed countries?
3. Go to the Web site of your favorite multinational firm and determine where it operates thoughout the world. How many employees does it have worldwide? Has it done any interesting cross-border mergers and acquisitions during the last year?
4. Go to UNCTADstat at http://unctadstat.unctad.org. Update the data in Exhibit 1.6 on cross-border mergers and acquisitions for the most recent years.

(country profile for the Czech Rep. http://unctadstat.unctad.org/CountryProfile/GeneralProfile/en-GB/203/index.html).