Case Problems in International Finance

W. CARL KESTER &
TIMOTHY A. LUEHRMAN

CASE PROBLEMS IN INTERNATIONAL FINANCE

This book was set in Times Roman by The Clarinda Company.
The editors were Kenneth A. MacLeod, Peitr Bohen, and Bernadette Boylan;
the production supervisor was Denise L. Puryear.
The cover was designed by Leon Bolognese.
R. R. Donnelley & Sons Company was printer and binder.

CASE PROBLEMS IN INTERNATIONAL FINANCE

Case material of the Harvard Graduate School of Business Administration is made possible by the cooperation of business firms and other organizations which may wish to remain anonymous by having names, quantities, and other identifying details disguised while maintaining basic relationships. Cases are prepared as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

1 2 3 4 5 6 7 8 9 0 DOH DOH 9 0 9 8 7 6 5 4 3 2*

ISBN 0-07-034263-6

Library of Congress Cataloging-in-Publication Data

Case problems in international finance / [edited by] W. Carl Kester,
Timothy A. Luehrman
p. cm. — (McGraw-Hill series in finance)
Includes index.
ISBN 0-07-034263-6
1. International finance—Case studies. I. Kester, W. Carl.
II. Luehrman, Timothy A. III. Series.
HG3881.C324 1993
658.15′99—dc20 92-27871

ABOUT THE AUTHORS

W. CARL KESTER is Professor of Business Administration at Harvard Business School where he teaches international finance in Harvard's MBA and Executive Education Programs. He became a member of the faculty at Harvard in 1981.

Professor Kester is the author or coauthor of more than thirty-five case studies and fifteen published articles on various finance topics. His articles have appeared in the *California Management Review, The Continental Journal of Applied Corporate Finance, Financial Management,* the *Harvard Business Review, Japan and the World Economy,* and the *Sloan Management Review,* among others. His research into Japanese mergers and acquisitions was supported by the 1987 O'Melveny & Myers Centennial Grant, and culminated in his recently published book, *Japanese Takeovers: The Global Contest for Corporate Control.* He is also co-editor of the tenth edition of *Case Problems in Finance.*

An economics graduate of Amherst College, Professor Kester also holds advanced degrees from Harvard Business School (MBA, 1977) and the London School of Economics and Political Science (M.Sc., 1974). He received his Ph.D. in Business-Economics in 1981 from Harvard University's Graduate School of Arts and Sciences.

TIMOTHY A. LUEHRMAN is Associate Professor of Business Administration at Harvard Business School where he teaches corporate finance in Harvard's MBA and Executive Education Programs. He became a member of the faculty at Harvard in 1986.

Professor Luehrman's research has focused on companies' operating exposure to real exchange rate changes, and international differences in the cost of capital. He is the author of more than twenty case studies and a dozen published articles. His articles have appeared in the *Harvard Business Review; Japan and the World Economy;* the *Journal of International Business Studies,* for which he serves as Associate Editor; and the *Sloan Management Review,* among others.

Professor Luehrman is a graduate of Amherst College where he studied economics and English literature. He received his MBA from Harvard Business School and his Ph.D. from Harvard University's Graduate School of Arts and Sciences in 1983 and 1986, respectively.

INTRODUCTION

Once considered the specialty of financial officers working at large multinational corporations, international finance today has become everyone's business. The ability to source funds quickly in different currencies and markets; the evolution of truly global product markets in industries such as automobiles, semiconductors, and pharmaceuticals, among many others; and the increasing availability and attractiveness of cross-border investment opportunities have thrust managers of all stripes and from all types of companies into the international financial area. Monitoring exchange rates and foreign capital costs has become as much a part of the general financial manager's routine as monitoring domestic interest rates and stock prices has always been. Indeed, even companies that source all their factors of production and sell all their output at home must now keep a watchful eye on shifting exchange rates and off-shore interest rates if they face substantial foreign competition in their home markets.

The cases selected for inclusion in this volume reflect the current breadth and sophistication of skills employed by today's corporate financial managers. They are drawn from Harvard Business School's MBA course *International Managerial Finance*. Reflecting their use in that course, the cases are designed to stimulate critical thinking, active discussion, and the development of sound business judgment predicated on fundamental principles of financial economics. Accompanying the cases are technical notes designed to provide background and some fundamental skills for analyzing associated cases. They are not a substitute, however, for more comprehensive treatments provided in textbooks and other outside readings.

Although some cases have been disguised to protect confidential information, all but a handful describe actual administrative situations requiring analysis and a decision. As such, they replicate the multifaceted character of the problems faced by modern financial managers. The corporate finance slant of the cases is obvious enough, but this should not obscure the need to consider corporate strategy, organizational constraints, and many other exigencies in the course of recommending specific actions.

While the development of analytic skills and managerial judgment are the primary goals of these cases, the conveyance of general institutional knowledge about international finance is an important secondary one. Many of the cases and notes contain sections providing background about local markets, local financing techniques, local managerial practices, historical events preceding contemporary problems (e.g., the Latin American debt crisis), and so forth. Collectively, the administrative situations described in these cases span fifteen different countries, twenty-five different industries, and thirty-seven different companies ranging in size from $20 million to $16 billion.

As a group, this collection of cases develops several themes about international finance. First is the fundamental point that finance is an important determinant of corporate performance. By recognizing attractive international financing and investment opportunities, analyzing them correctly, and executing transactions prudently, corporate financial officers can add considerable value to the companies they manage.

Unbridled pursuit of any and all attractive deals available in today's complex markets will seldom be desirable, however. Financial execution must be governed by internally consistent financial policies, which are themselves part of a coherent financial strategy designed to support a corporate strategy. Thus, the interdependence of corporate and financial strategy, and the need to coordinate the two, constitutes a second major theme of these cases.

A third theme is that exchange rate changes matter, though often in ways that are subtle and indirect. Not all exchange rate shifts that critically influence a company's competitive position and value will show up in its financial accounts using generally accepted accounting principles. Likewise, not all of those that are reflected in financial reports affect value. The questions of which exchange rate exposures matter most and how they should be managed are addressed here within the traditional finance paradigm of value maximization.

Finally, through the analysis of international mergers, acquisitions, and corporate restructurings, fundamental differences in national systems of corporate governance are brought to light. As markets integrate and the volume of cross-border investment increases, these differences are being drawn in sharper relief. It is too common a mistake, however, to ascribe such differences solely to cultural factors. Thus, a final theme of these cases is that one must go beyond cultural norms and carefully analyze the economic purposes served by different governance institutions found in different parts of the world. What at first appears to be a peculiar idiosyncracy driven by cultural norms is often seen, upon closer inspection, to serve rational economic purposes. The sharp contrasts among German, Japanese, and Anglo-American systems of corporate governance, for example, and the relative success of corporations domiciled in those three countries, raise provocative questions about the most effective means of governing organizations competing in today's international markets.

A considerable debt of thanks is owed to the many people and organizations around the world who have contributed to the development of this collection of cases. Clearly, these cases could not have been written without the cooperation and generous sacrifices of time made by scores of managers interviewed at those companies providing the decision-making settings. Sheer numbers and the need to respect condfidentiality prohibits naming them all; but they know who they are and it is our sincere hope that they will realize the full extent of our gratitude and derive some satisfaction from having had an impact on the pedagogy of international financial management.

As we assembled the cases into a book, many helpful suggestions were provided to us by a number of scholarly reviewers. These include Esther Ancel, University of Wisconsin-Milwaukee; James N. Bodurtha, Jr., University of Michigan; Kirt C. Butler, Michigan State University; John M. Geppert, University of Nebraska-Lincoln; Luc A. Soenen, Cal Poly San Luis Obispo; and Anant K. Sundaram, Amos Tuck School of Business of Dartmouth College. Their thoughtful comments provided a rich resource for us to draw upon throughout the development of the manuscript.

We also thank the hundreds of executive and MBA students who analyzed and discussed these cases in classes at Harvard Business School. Their many insights and comments helped us ''season'' the cases appearing here. We are also most grateful for editorial support provided by Jane Manilych, and the production and proofreading of the manuscript by Dale Abramson, Brenda L. Fucillo, and the Word Processing Center of Harvard Business School.

Finally, special thanks and recognition go to Professors Dwight B. Crane; Steven R. Fenster; William E. Fruhan, Jr.; Samuel L. Hayes, III; Scott P. Mason; Thomas R. Piper; Henry B. Reiling; and G. Peter Wilson, each of whom graciously extended permission to include cases or notes developed by them in this collection. Glyn Ferguson Aepple; William B. Allen, Jr.; Rajiv A. Ghatalia; Robert W. Lightfoot; Richard P. Melnick; Julia Morley; William T. Schiano; and James J. Student are also warmly thanked for their invaluable assistance in the preparation of our cases and notes during the last several years. We are grateful for generous financial support provided by Harvard Business School's Division of Research in the course of developing these cases, and to Harvard Business School's Publishing Division for its cooperation in granting permission to include them in this volume.

W. Carl Kester

Timothy A. Luehrman

CONTENTS

PART ONE

FOREIGN EXCHANGE MARKETS AND EXCHANGE-RATE DETERMINATION

MANAGING THE U.S. DOLLAR IN THE 1980s

80-85 dollar Rose to Record levels

Starting in 1980, the value of the U.S. dollar increased steadily against other currencies and reached record levels by early 1985. An index of the trade-weighted nominal value of the U.S. dollar rose from 100 in 1980 to nearly 170 by late 1984 (see **Exhibit 1**). The same general pattern could be observed in the bilateral exchange rates of the dollar with the four currencies of the other major industrial countries, France, Germany, the United Kingdom, and Japan (see **Exhibit 2**).

The strong dollar, coupled with the booming U.S. economy, fueled growth in sales and profitability for many industrial companies around the world. For 4 years, export sales to the United States increased with widening margins. The effect of the strong dollar on U.S. companies, however, was quite different. It made U.S. exports less competitive in foreign markets, allowed less expensive foreign-made goods to flood U.S. markets, and cost an estimated three million U.S. jobs. The adverse effects were so pronounced that the U.S. Congress gave serious consideration to various trade protection measures proposed by business and labor leaders. Complicating the public debate on this issue was the fact that a wide variety of theories had emerged to explain the dollar's strength.

THE 1985 DOLLAR DEBATE

The debate on causes of the dollar's rising value, although far from resolved, focused primarily on the impact of relative inflation rates and interest rates on the dollar.

This case was prepared by Professor W. Carl Kester and Research Associate Richard P. Melnick. Harvard Business School case 292-001.

Closely linked to these determinants were discussions concerning the balance of trade, the federal government's deficit, monetary growth, real economic growth, and international capital flows.

Briefly, the United States ran an increasingly negative trade balance, current account, and federal government budget deficit beginning in 1980. The U.S. gross national product, however, grew at a slow but healthy rate in 1983 and 1984. Inflation slowed after reaching a peak of 13 percent in 1980, and interest rates generally declined after peaking in 1980 and 1981. **Exhibit 3** provides statistics on several key economic variables for the United States, France, Germany, Japan, and the United Kingdom.

Traditionally, nations with continuing balance-of-trade, current-account, and budget deficits experienced depreciations in the international value of their currencies. It seemed a paradox, therefore, that the United States enjoyed a strong dollar while suffering from expanding deficits of these very same types.

Some economists explained the paradox by noting that in the 1980s a happy side effect of the U.S. trade deficit was a substantial capital surplus. Although the federal budget deficit stimulated aggregate demand in the United States, thus increasing demand for imports, it was also the primary stimulant behind the capital inflows needed to finance the trade deficit.

Martin Feldstein, former chairman of the Council of Economic Advisors, and his wife, Kathleen, an economist, also blamed the budget deficit for the strong dollar. However, they viewed the trade deficit primarily as a consequence of that strength:

> The current huge trade deficit is not due to any fundamental weakness of American industry or to increases in unfair trade practices of other nations . . . the real trade problem [is] the overvalued dollar.
>
> The major and fundamental change that has occurred during the Reagan years is, of course, the unprecedented increase in the federal budget deficit. The government borrowing to finance this deficit has absorbed more than half of all net savings generated in the United States and has kept real interest rates much higher than abroad. These high interest rates attract investment from abroad and push up demand for the dollar.[1]

Allan Meltzer, a professor of political economy and public policy at Carnegie-Mellon University, had a very different view of the role budget deficits played in the dollar's strength:

> The effect of large budget deficits is to weaken currencies, not strengthen them. A country with continually large budget deficits eventually will have to pay the bill by raising taxes or printing money and creating more inflation. Both taxes and inflation chase away foreign investors, so either course is poison for the value of the country's currency. The exchange markets recognize this immediately, and the dollar weakens. The dollar is strong despite the budget deficit, not because of it.[2]

It was Professor Meltzer's opinion that the dollar was strong because of growth in the U.S. economy, particularly in the area of investment spending. This growth, he

[1]Martin and Kathleen Feldstein, "Time to Raise Taxes," *Boston Globe,* October 1, 1985, p. 42.
[2]Allan H. Meltzer, "How to Cut the Trade Deficit," *Fortune,* November 25, 1985, p. 177.

believed, was stimulated by the lowering of effective tax rates on capital spending and the lowering of inflation, which raised the real value of depreciation write-offs.

Analysts at Morgan Guaranty Trust Company emphasized yet another view on this issue. They believed that "While the large federal deficit may have contributed to a strong dollar in the past, insofar as it has increased real interest rates, continued failure to come to grips with the deficit is likely to erode confidence in the dollar."[3]

So-called "monetarist" economists tended to discount the importance of budget deficits and focused instead on monetary policy to find an explanation for the dollar's strength. They attributed this strong dollar to the U.S. Federal Reserve's low-inflation monetary policy adopted in the early 1980s. Indeed, some monetarists argued that the dollar would stay high so long as the Fed held monetary growth within reasonable bounds, no matter what happened to the budget deficit.[4] As *The Wall Street Journal* claimed, "With a given set of outside influences, the value of the dollar in marks depends on how many dollars are created by the Fed and how many marks are created by the Bundesbank, period."[5]

The Group of Five (G-5) Agreement

In the midst of this confusion, the Reagan administration initiated a meeting of the finance ministers and central bankers from five major industrial countries (the "Group of Five," or "G-5"): France, Germany, Japan, the United Kingdom, and the United States. The participants met at the Plaza Hotel in New York and announced a three-point program on September 22, 1985, consisting of the following elements:

- A new U.S. commitment to join other nations in lowering the U.S. dollar's value. Although an explicit plan of intervention was only hinted at, it was clear that such a commitment would require coordinated bank sales of dollars in foreign exchange markets in return for British pounds, German marks, Japanese yen, and French francs.

- Tax cuts and other measures to spur growth in Europe and Japan, and to increase the value of the foreign currencies against the dollar.

- Continued Reagan administration efforts to reduce U.S. budget deficits and resist protectionist pressures in Congress.

As a rationale for the program, it was stated in the communiqué that "recent shifts in fundamental economic conditions . . . together with policy commitments for the future . . . [had] not been reflected fully in the exchange markets." Nevertheless, it was clear that any attempt to engineer a devaluation of the dollar through market intervention would face serious risks and skepticism.

One such risk was that if this program were too successful it might result in a free-fall of the dollar. This could rekindle inflation and raise interest rates. At the other end of the spectrum was the risk that the dollar would not depreciate much at all. This was

[3]Morgan Guaranty Trust Company, *World Financial Markets,* August 1985, p. 2.
[4]"The 'Cambridge Mafia' and the Friedmanites Debate the Dollar," *Business Week,* September 9, 1985, pp. 22–23.
[5]"Only Schizoid Intervention," *The Wall Street Journal,* September 23, 1985, p. 30.

especially likely if the markets interpreted the program as being merely lip service, or if the Group of Five did not fulfill their commitments to improve investment and growth prospects in their own countries.

The general skepticism with which the G-5 announcement met was summarized by Ronald Holzer, a vice president and chief foreign-exchange dealer of Harris Trust & Savings Bank, Chicago, who stated:

> The past has shown us that whenever the finance ministers from the Big Five get together there's a lot of rhetoric and little action. Any time there's talk of intervention and outside forces in the market, it creates volatility and uncertainty. But in the long term it doesn't have any lasting impact.[6]

THE 1987 DOLLAR DEBATE

late 85, &
Early 86
dollar dropped
30% (mark & yen)

Following the G-5 agreement in September 1985, the dollar depreciated rapidly (see **Exhibits 1** and **2**). By February 20, 1986, the dollar had dropped 30 percent against the deutsche mark and the yen, exceeding most expectations and prompting Federal Reserve Chairman Paul Volcker to say the dollar had fallen enough. In an October 1986 meeting, Treasury Secretary James Baker and Japanese Finance Minister Kiichi Miyazawa agreed that the dollar should not fall much below ¥155. However, the Reagan administration, under pressure to decrease the trade deficit, leaked word in January 1987 that it wanted the dollar to fall further. As the dollar continued to drop, public officials and economists debated what, if anything, could or should be done about the dollar, interest rates, and the trade deficit.

The Administration's Strategy

Nearly everyone in Washington had an opinion about the trade deficit and the dollar's fall. One argument held that the dollar's January 1987 plunge centered around the Reagan administration's effort to avoid protectionist legislation in Congress in the spring. Secretary Baker had masterminded a comprehensive exchange-rate, interest rate, and global growth strategy because "We feel that we are engaged in a life-or-death struggle to preserve the world economy."[7] His strategy appeared to center on using the weak dollar as leverage to encourage Germany and Japan to stimulate their economies with tax and interest rate cuts. These actions, it was hoped, would support the dollar by creating demand for American exports and making it relatively attractive to invest in the United States. However, Secretary Baker denied that the administration had "talked the dollar down" in January, and noted, "There's a limit to what you can do. The fact of the matter is, the market will determine what the appropriate level for the dollar is."[8]

[6]"Central Banks' Intervention to Influence Currency Prices Is a Game of Skill and Timing Played amid Uncertainty," *The Wall Street Journal,* September 23, 1985, p. 26.
[7]*The New York Times,* February 1, 1987, Business section, p. 1.
[8]*The Wall Street Journal,* January 27, 1987, p. 3.

Paul Volcker expressed deep concerns about a continued dollar devaluation. He feared that too much downward pressure on the dollar could send it into a free-fall like the decline of 1976 to 1980. "The danger of movements from the present level is that you get a more complete pass-through, I think, into import prices,"[9] he told the Congressional Joint Economic Committee. This outcome might yield increased domestic inflation, capital flight, higher interest rates, and eventually a recession. Chairman Volcker added a further problem: "Declining currencies do not provide for extra flexibility in the conduct of monetary policy."[10] Instead of driving the dollar down, he recommended that the administration attack the more fundamental cause of the trade deficit. Specifically, he thought the United States must decrease its federal budget deficit while increasing private investment in new equipment and technology.

Was the Dollar Correctly Valued?

Arguing that the dollar was in fact still *overvalued,* Martin Feldstein wrote, "The only thing that can achieve a sustained reduction of the U.S. trade deficit is a continued substantial decline of the dollar. And that decline is coming."[11] Professor Feldstein added that small differences between U.S. interest rates and Japanese and German interest rates could not prevent the fall of the dollar because investors realized that the dollar's current level was unsustainable.

Ronald I. McKinnon, professor of economics at Stanford University, in contrast, felt the dollar was highly *undervalued*. He explained:

> At 200 yen and 2.3 marks by the end of 1985, the dollar was more or less correctly aligned with the currencies of our Japanese and European trading partners in two closely related aspects. First, there was approximate purchasing power parity. . . . Second, rates of price inflation (as measured by changes in their respective wholesale-price indexes in three areas) were virtually the same, and close to zero.[12]

Professor McKinnon said the reason the dollar was undervalued was that the United States followed the "false academic doctrine" that says a devaluation of a currency can by itself reduce that country's trade deficit. Since real interest rates were still too high, he believed, the U.S. government should reduce its budget deficit instead of pressuring other governments to expand their economies. Once the trade deficit was no longer a problem, Professor McKinnon wrote, the G-7 (the G-5 plus Canada and Italy) should meet to realign exchange rates at purchasing power parity and to coordinate their monetary and fiscal policies.

Martin Feldstein believed that intervention in the markets, as Professor McKinnon proposed, was futile. He wrote:

[9] *The Wall Street Journal,* February 3, 1987, p. 2.
[10] *The Wall Street Journal,* January 23, 1987, p. 3.
[11] *The Wall Street Journal,* November 25, 1986, p. 28.
[12] *The Wall Street Journal,* February 2, 1987, p. 22.

The decline of the dollar began in March 1985, six months before the Plaza G-5 meeting. Moreover, the dollar's value (relative to a weighted average of other industrial currencies) declined as fast between March and September of 1985 as it has since the meeting. The evidence indicates that the dollar's decline has been caused by private investors responding to economic fundamentals rather than government pronouncements or exchange-market interventions.[13]

The Continuing Trade Deficit

trade deficit continued despite dollar's decline

Surrounding the debate about the weak dollar were those who tried to explain why the trade situation had not improved despite the dollar's decline (see **Exhibit 3**). Deborah Allen Olivier, president of the Claremont Economic Institute, said, "The dollar's two year plunge is benefitting American industry very little and very unevenly."[14] A lot of the problem arose because the currencies of several major trading partners such as Canada, Brazil, and South Korea had either been stable or had even fallen against the dollar (see **Exhibit 4**).

Ms. Olivier emphasized the importance of using a broad trade-weighted measure of the dollar when gauging its value. While the Federal Reserve Board said the dollar had depreciated 39 percent against our 10 major trading partners since early 1985, the Federal Reserve Bank of Dallas said the dollar had decreased only 5 percent relative to the 131 countries with which the United States traded. Ms. Olivier argued that there were "very few U.S. industries . . . more competitive today than they were 2 years ago." Furthermore, there was "tremendous variation in the amount by which various goods are influenced by currency changes."[15]

Others offered different reasons to explain why our trade deficits with Germany and Japan had not decreased. Deputy Secretary of the Treasury Richard Darman accused America's big corporations of being "bloated, risk-averse, inefficient and unimaginative."[16] The Japanese, it was said, were defending their U.S. market shares by holding dollar prices constant despite the yen's appreciation. Burk Kalweit, senior economist for the National Association of Machine Tool Builders, noted: "The Germans aren't selling on price; they're selling on engineering and features."[17]

A more basic question was asked by Vermont Royster, editor emeritus of *The Wall Street Journal,* who wrote, "One of the things that's always puzzled me is how those who manage our economic affairs think they know what is the 'right' price for a dollar in terms of francs, pounds, yen or whatever. And if they do, why do they keep changing their minds?"[18]

Part of the problem, as the *Financial Times* pointed out, was that "There is no scientific way of calculating a 'correct' value for the dollar."[19] Aside from pegging

[13] *The Wall Street Journal,* November 25, 1986, p. 28.
[14] *The Wall Street Journal,* January 30, 1987, p. 22.
[15] Ibid.
[16] *The Wall Street Journal,* January 7, 1987, p. 1.
[17] Ibid., p. 18.
[18] *The Wall Street Journal,* January 27, 1987, p. 34.
[19] *Financial Times,* January 23, 1987, p. 16.