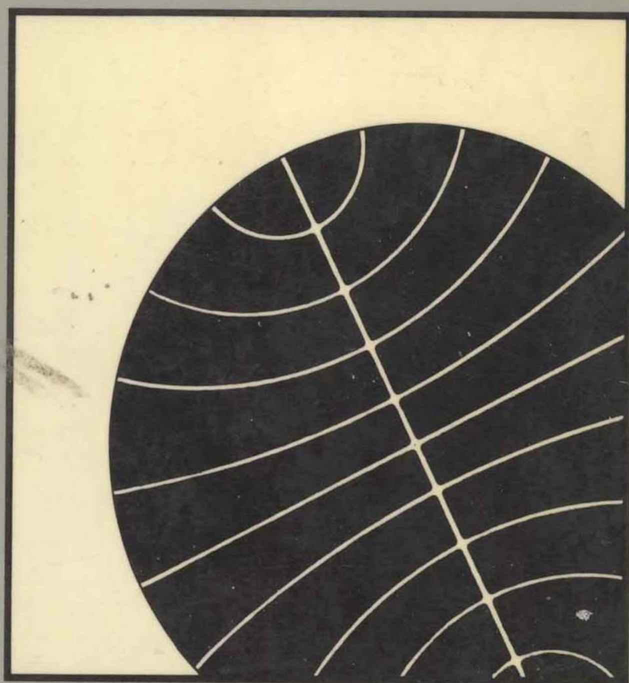
# INTERNATIONAL FINANCIAL MANAGEMENT



J. B. Holland

# INTERNATIONAL FINANCIAL MANAGEMENT

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# 1 THE INTERNATIONAL DIMENSIONS OF CORPORATE FINANCIAL MANAGEMENT

## 1. Introduction

The rapid growth of the multinational corporation since the Second World War has brought about a major change in the way in which international trade is conducted. The development of the MNC was not anticipated within the classical theory of international trade in which only goods and services were thought to be internationally mobile. Today, factors of production such as labour and capital are seen to move freely across national borders. The multinational corporation is the agent of this change and fully exploits its unique ability to move managerial teams, research and development knowledge and capital across borders.

This increased importance of the MNC has highlighted the significance of the finance function in the large industrial and commercial corporations. In particular, major challenges and opportunities have presented themselves to MNCs due to the emergence of international capital markets, the increased concern shown by managers with respect to exchange rate fluctuations and the growth of overseas corporate investment. The increased internationalization of the firm and its finance function has accentuated the need for a decision framework to help managers cope with the attendant increased complexity of their cash management, investment, financing and dividend decisions.

Of course, a basis for making such decisions already lies in the existing theory of corporate finance. This theory has been developed almost wholly within a single nation context. In practice the US academic community has provided and tested much of this theory (Weston, 1981). Some contributions to theory have occurred in the UK and other European countries.

A central question therefore arises: is the field of study of international financial management (IFM) significantly different to that of domestic financial management such that an additional theory of international corporate finance is required?

A related question is: can the existing domestic financial management theory be adapted to this new decision context?

These issues form a central concern of this book and their analysis is a necessary element in understanding IFM decision making. Chapters 1 to 8 examine these issues in the context of the key IFM decision areas.

In this chapter, the field of study of international financial management (IFM) will be examined to see how it differs or corresponds to that of domestic financial management. This analysis identifies criteria for segmenting the field of study of IFM in two major directions. The firm is classified on the basis of its degree of involvement in the international economic environment. This environment will be further analysed using three different but complementary sets of assumptions about markets and firms. The corporate classification scheme based on degree of international involvement is implied in much of the IFM literature, and the environmental assumptions reflect the central theoretical debates in IFM.

The segmentation of the field of study of IFM in this way therefore forms the basis from which this book approaches the questions about the significance of IFM, and the role of domestic financial management theory. In so doing, the central decision problems of IFM will be analysed in detail in chapters 2 to 8. As a result much of the literature on IFM will be summarized, and areas for further research identified.

In chapter 2 we begin by describing the international financial system. Monetary arrangements between countries, the workings of the foreign exchange markets and Eurocurrency markets and other aspects of the institutional environment surrounding the MNC are discussed at this point. In addition, this forms the institutional background for outlining the neo-classical equilibrium theories linking interest rates changes, inflation and exchange rates changes. The parity relationships concerned are:

Interest rate (equity return) parity

International Fisher effect

The unbiased forward rate effect

The international capital asset pricing model

The purchasing parity theory

The parity relationships form a major extension to orthodox financial theory and are invaluable in gaining insights into the novel complexities of international financial phenomena. They are discussed in the context of the markets in which they are thought to prevail. Specifically, the Eurocurrency, Eurobond and national equity markets form the institutional background for discussing the parity relationships. This neo-classical framework is subsequently applied to three key decision areas in international financial management. These are foreign exchange risk management decisions, financing decisions and capital budgeting decisions. Under these conditions we will see that domestic financial management and IFM

problems are very similar and the domestic financial management framework, once extended is very useful in dealing with IFM decision problems. In particular, the basic concepts of finance such as market efficiency, are shown to have considerable power in interpreting pricing behaviour in foreign exchange and international capital markets.

In chapter 3 we outline four major classes of deviations from ideal parity conditions in foreign exchange and international capital markets and present the evidence for and against the equilibrium framework. The discussion in chapter 3 provides the basis, in chapters 4, 5 and 6, for analysing the limitations of the parity relationships and the implications of deviations from parity for exposure management, capital budgeting and financing decisions. Computer based models will be presented in these chapters and employed as decision aids for managers assessing potential opportunities arising from deviations.

The limitations of the 'market forces' perspective leads to an analysis in chapter 7 in which the financial manager is viewed as a member of an enterprise which is able to create and maintain market imperfections. However, corporate market power is shown to be constrained by political risk considerations. This view, in which the firm exercises considerable power, albeit constrained by political forces, is in sharp contrast to the 'market forces' perspective adopted in chapters 2 to 6. These possibilities have implications for the exposure, financing and capital budgeting decisions and these are examined in this chapter and chapter 8

The three decision frameworks outlined in chapters 2 to 7 are derived, respectively from neo classical views of the international economy, from views of imperfections or deviations from this ideal and from theories of MNC's economic behaviour. These views are complementary in many respects and can be of considerable value to the financial manager of the internationally involved enterprise. They will be used throughout these chapters to discuss in detail the 'state of the art' of international financial decision making. They are reconciled in chapter 8 when their merits and limitations are discussed in the development of an overall financial strategy for the internationally involved enterprise.

## 2. The Field of Study of International Financial Management

To begin to examine these issues we need to see how the field of study of IFM corresponds to or differs from that of domestic financial management. At its simplest the field of study of corporate finance consists both of firms making financial decisions over time and the economic environment in which they make these decisions. Conventionally, these decisions have been classified into the strategic investment,financing and dividend decisions and the tactical decisions such as cash management and working capital management (e.g Brealey and Myers, 1981). The economic en-

vironment has been seen mainly as the capital market, both as a source of funds and as a means to measure the discount rate for capital investments.

At first sight there is very little change in the class of decisions faced by either the domestic financial manager or his multinational counterpart. Both managers will be involved with capital budgeting, capital structure, financing and dividend decisions. They are generally assumed to be acting in the shareholders' interests and therefore should be making decisions to maximize shareholder wealth. Both types of manager will be concerned with problems concerning the interrelationships between these decisions over time and their effect on corporate value as manifest in the firm's share price. Finally, both managers will be operating in a financial environment in which sophisticated capital markets are constantly monitoring management decisions and evaluating current and prospective corporate performance. Hence both managers require a theory of financial management which links capital market and corporate decision behaviour via the shareholder wealth maximization goal.

Domestic financial management theory attempts to satisfy these decision needs by using the following associated constructs:

a theory of asset pricing in domestic capital markets;

an identification of the financial managers problems and decision needs;

logical links between shareholder requirements (as manifest in capital markets) and the financial managers' decision problems. These links usually involve a set of normative decision rules designed to guide managerial actions and choices towards the shareholder goal.

Orthodox domestic financial management theory places considerable emphasis on an asset pricing theory for capital markets (and the associated concept of market efficiency) as the major means to explain the economic environment surrounding corporate financial decision making. Capital market theory, allied with fundamental definitions of the firms' financial management decision problems, is used to develop normative decision rules for the strategic and tactical financial decisions, and to critically examine managerial practices with respect to these decisions. Since the 1950s considerable progress has been made in these areas of scholarly activity and financial management theory now provides domestic financial managers with a formidable array of financial advice and policy implications.

Given these similarities in both domestic financial management and IFM fields of study, a theory for international financial management decision making would clearly have to cope with a similar class of financial decisions as domestic theory. It would therefore employ many of the central concepts of orthodox theory such as capital asset pricing, market efficiency and the net present value rule.

However, there may be problems in directly applying domestic financial management theory to the following situations:

(1) A firm operating wholly within a domestic economy which is quite different to that of the US. For example, one common situation is where the government actively interferes in corporate decision making by actively directing investment decision making and controlling sources of finance.
(2) A firm operating in the international economy, which may also differ to that of the US. An example here would be a MNC operating in several capital markets in which assets of similar risk are priced on a different basis.

In the first case, domestic financial management orthodoxy demonstrates its mainly US origins (Weston 1966,1981), in that it lays little stress on describing corporate financial practices, financial institutions and the variety of financial instruments available to firms. Thus little theory development has occurred in areas such as the process of financial decision making and the role of governments and financial institutions in influencing or directing corporate financial decision making.

These alternative areas of study are not considered significant in the US and UK where capital markets are very sophisticated and where autonomous corporate financial decision making is the norm. This situation is less common in those Western countries where the government and financial institutions play a significant role in corporate financial decision making. Furthermore, domestic financial management theory may be less applicable to developing countries where capital markets and financial institutions are relatively unsophisticated.

These possible national differences in the field of study of domestic financial management would,if significant, create the need on the part of *domestic firms for extensions or modifications to the existing domestic* financial management theory. Under these conditions the decision problems of domestic financial management will exist at the boundary between the domestic firm and its economic and perhaps political environment. Thus investment decisions involve joint firm and market (product, factor and capital) analyses. Financing decisions involve joint firm and capital market analyses. Both decisions may also involve negotiations with governments and financial institutions. If the domestic economic environments differ significantly say in the level of corporate autonomy, then the range of domestic financial management problems will vary from country to country, and contain unique local elements. For example West German and Japanese firms have very close links with their local banking community and investment and financing decisions may involve a high degree of consultation between banks and firms. A knowledge of such local aspects

of financial decision making will be essential for indigenous financial managers.

In the case of the international trading firm the field of study of IFM may become very complex. This is because such a firm may be involved within many different economies and therefore may experience the above problems many times over. It also operates across these economies and may therefore experience 'boundary' problems. These may range from transacting in many currencies to trading with mutually antagonistic states. These latter possibilities highlight the international dimension to IFM. As such we can see that the field of study of IFM is distinguishable from that of domestic financial management by the added complexity and increased variety of the environment of the international trading firm. In particular this is brought about because such firms

(1) operate across and within different political, legal, taxation and cultural systems;
(2) operate across and within a wider range of product and factor markets, each with differing levels of competition, and efficiency;
(3) trade in a wide range of currencies, and have frequent resort to foreign exchange markets;
(4) have access to a wide range of domestic capital markets, and to unregulated international capital markets. These markets may also exhibit differing degrees of efficiency and integration with each other.

Whether corporate IFM decision problems resulting from this additional complexity are significantly different from those of domestic financial management depend upon the following related criteria:

(1) the degree of involvement of the firm in the international economic environment;
(2) the extent to which the international economic environment differs from that of its domestic counterpart.

Criteria similiar to 1 are used throughout the literature on IFM to help resolve the issue of significance. For example one simple classification scheme which assumes different levels of international involvement is,

the occasional exporter/importer

the frequent exporter/importer

the firm with overseas subsidiaries

The second criterion reflects much of the theoretical debate in the field. An analysis of the economic environment and the major corporate IFM decisions will therefore form the major focus and content of this book. In

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particular the book will concentrate on the effect, if any, of differences in economic environments (and degree of involvement) on the type and nature of corporate financial decisions.

In the following pages the significance (or otherwise) of IFM phenomena and problems will be considered in greater detail. To facilitate this analysis the above criteria are used to segment the field of study of IFM. In section 3 the firm will be classified on the basis of its degree of involvement in the international economic environment, and in section 4 the international environment will be analysed using competing sets of assumptions. Section 5 will use sections 3 and 4 to tentatively identify novel issues and decision problems of IFM. Section 6 will briefly outline how the remaining chapters in the book will explore these issues and analyse the major decision problems of IFM.

## 3. Classes of Firm

In order to begin to answer these questions about IFM phenomena and relevant theory constructs, we begin with a simple framework for classifying firms. This categorizes companies according to their degree of involvement in international product, factor and capital markets. The classification is further broken down by separating equity and debt sources and by having ownership of foreign subsidiaries as an extra category. The former extension is designed to highlight shareholder issues and the latter indicates a key extra dimension to the firm's involvement in international product and factor markets. Given such a framework, firms can be classified as in table 1.1 according to their degree of involvement in international product, factor and capital markets.

TABLE 1.1

| | *Product Markets* | *Factor Markets* | *Foreign Subsidiaries* | *Debt Capital* | *Equity Capital* |
|---|---|---|---|---|---|
| Domestic I | D | D | - | D | D |
| Domestic II | I | I | – | D | D |
| Multinational corporation I | I | I | I | D | D |
| Multinational corporation II | I | I | I | I | D |
| Multinational corporation III | I | I | I | I | I |

D = high involvement domestically, I = high involvement internationally

The first point to make about this classification scheme is that it does not imply a model of MNC evolution. Certainly a plausible case can be made that as a firm increases its involvement in international product and factor markets, then the tendency to establish foreign subsidiaries becomes strong. This in turn is likely to encourage the firm to consider international sources of capital. However, many alternative paths to full multinational status, i.e. MNC III, are possible and these will be discussed in chapters 5 and 7. Given the range of theories about the development of MNCs, it is clear that this classification scheme does not cover all possibilities. It does however provide a useful basis for managers to identify the degree of international involvement of their firm .

It also demonstrates clearly how the significance of IFM issues can vary between companies, especially if their international economic environment can be shown to be significantly different to that of their domestic environment. Clearly if there is no difference in these environments, then this classification scheme explains very little. The classification scheme inevitably omits some interesting features useful in differentiating firms on the basis of their international involvement. For example,

(1) A firm may have several subsidiaries in many countries. Intercountry transfers of products , cash, etc between subsidiaries are therefore be ignored by this taxonomy.
(2) Joint ventures, licencing and management contract may be seen as an alternative forms of overseas involvement compared with 100 per cent ownership of Direct Foreign Investment by an MNC.
(3) Distinguishing between overseas sources of capital for the parent or the subsidiaries may be of value.
(4) The frequency of exporting and importing by the firm may be valuable in distinguishing between different classes of domestic firms. Also the specialization of a firm in either imports or exports may be of interest.

The taxonomy can be extended considerably, if so desired. However, the present simple scheme is thought to capture the major differences in types of firm. It will be used throughout this book to address the issue of the significance of IFM and to identify those firms likely to have specific IFM problems.

## 4. Assumptions about the International Economic Environment

Two major classes of assumptions concerning the international economic environment are generally employed in the IFM literature. These 'market forces' views are based on the following:

(1) Neo-classical assumptions about international trade and about inflation, interest rate and exchange rate relationships. These assumptions have provided the basis from which to develop equilibrium theories about international trade and about links between international capital, foreign exchange, product and factor markets;
(2) Assumptions about deviations from the ideal conditions described by the neo-classical view of the international economic environment. These normally take the form of assumptions about imperfections in the capital, foreign exchange, product and factor markets. Such imperfections are deemed to create profit opportunities for firms, especially those with a high involvement in these markets. Deviations from parity conditions will be discussed in detail in chapter 3 and the range of profit opportunities open to the firm identified.

Calvet (1981) has proposed a taxonomy of market imperfections. He distinguished between four major classes of imperfections. These were,

Market disequilibrium hypotheses

Government imposed distortions

Market structure imperfections

Market failure imperfections

Calvet used this taxonomy to analyse the direct foreign investment decision. It will be used later in this book (chapter 3) to structure the discussion concerning imperfections in the international financial markets in which domestic firms and MNCs are likely to be involved.

These two major sets of assumptions (neo-classical and imperfections) concerning the international economic environment provide the conventional framework for identifying the central problems of, and decision techniques of, IFM. They both share the common view that the major explanations for IFM problems lie in a market framework, perfect or otherwise. Thus in these two sets of assumptions the firm is seen as either passively accepting market forces or, alternatively, reacting to market imperfections.

However a significant part of the IFM literature now emphasizes the active role of the firm in fashioning the economic environment to its own requirements. This development is particularly strong in the general area of theorizing about the role of MNCs and in the specific areas dealing with political risk and direct foreign investment by MNCs. From this perspective assumptions are made about the nature of the MNC and its impact on the economic environment. The joint firm–market view of economic phenomena developed by Williamson (1975) and others provides a novel

alternative framework from which to assess the significance (or otherwise) of IFM issues. Calvet (1981) has already employed this approach in analysing the direct foreign investment issue and the intention of this book is to extend this view across a wider range of IFM issues.

In conclusion, the three sets of assumptions about the economic environment to be employed in this text are,

neo-classical assumptions – perfect markets

deviations from neo-classical ideal conditions – imperfect markets

joint market–firm behaviour – MNCs as active economic agents

The 'market forces' perspective (including deviations) dominates the analyses of IFM decision making in chapters 2 to 6 and is therefore a major theme of the book. Chapters 7 and 8 employ the alternative view of the MNC as active economic agent and draw further implications for IFM decision making, especially in the areas of integrated financial planning and strategic analysis.

## 5. Novel Issues in IFM

At this stage, the classification schemes for types of firms and environmental assumptions can be used to tentatively identify some of the novel issues created by the additional complexity of IFM phenomena.

The first category of firm i.e. Domestic I, appears to have no international involvement at all, and it apparently corresponds to the conventional scope of domestic financial management. However, if capital markets are assumed to be fully integrated with one world pricing mechanism for risky financial securities, then even Domestic I must take a global perspective. If its owners hold diversified portfolios in a world capital market in which a world risk/return trade off exists, then its managers should employ the worldwide opportunity cost of funds when measuring discount rates for investment projects. Domestic I faces further internationally based problems if MNCs are competing in its home market. The presence of MNCs may affect the cash flows expected on existing investments and on new proposals. This may occur directly via worldwide competition or indirectly through exchange rate changes affecting the competitive position. Thus even Domestic I type companies may face IFM issues, especially with respect to the the appropriate capital budgeting discount rate, levels of expected cash flows and sources of finance.

If we turn to Domestic II, then the firm is now actively engaged in international factor and product markets as major importers and exporters or possibly both. This may involve receipts and payments in foreign currencies and therefore the possibility of exposure to transaction risk, ie

the risk that these receipts and payments will be adversely effected by relative changes in currency values. Various strategies for minimizing transactions exposure are employed by practitioners. These include the purchase and sale of currencies in foreign exchange markets at some future transaction date (forward hedges), or the use of the money markets to 'hedge' or avoid the perceived foreign exchange rate risk.

However, when one turns to MNC I, a major change has occurred in the decision problems facing the company. The decision to make a corporate investment overseas in a new subsidiary marks a dramatic change for many companies. The complexity of this decision is witnessed by the vast and burgeoning literature on the theory of direct foreign investment.

The firm now faces different legal, political and cultural systems impinging on its day to day operational decision making. This added complexity introduces a new dimension to the risk of managing subsidiaries, i.e. political risk. This is the risk that host governments may, periodically, interfere in the subsidiaries operations, and that this interference will have an adverse effect on the returns on direct foreign investment as received by the parent. The analysis of direct foreign investment and political risk are wholly new issues raised in IFM, and domestic financial management offers little in this respect. Further potential problems associated with the direct foreign investment decision include the effect of exchange rate changes on future overseas cash flows (economic exposure) and on accounting measurements of events prior to, and up to the exchange rate changes (Accounting or translation exposure). The large MNC with many overseas subsidiaries can partially avoid some foreign exchange risk by the internal transfer of funds within the firm. The ability to combat foreign exchange risks in this way is a unique feature of MNCs and of the field of IFM and this will be explored in chapters 5 and 7.

MNC II and MNC III complete the full internationalization of the firm as the firm first enters a range of domestic debt markets and unregulated 'offshore' debt markets and also seeks equity funds in several domestic stock exchanges. The firm may now face exchange rate risk on its sources of capital as well as its uses of capital. This also raises further questions about capital structure and the cost of financing of such sophisticated MNCs. The expanded choice of external financing sources also enhances the ability of the MNC to use its internal financial transfer system to exploit these choices.

These questions are uniquely thrown up by the MNC and the existence of international capital markets. However, their strong similarities to the equivalent domestic financial management questions suggest that domestic financial management theory can provide a useful starting point. In particular it will be shown in chapters 4, 5 and 6 that international capital budgeting and financing decisions have many similarities with the equivalent domestic decisions. However, the issues of exchange rate risk, political interference and the wide variety of international capital markets,

do create unique problems in understanding issues in the international capital budgeting, financing, liqidity management and working capital decision areas. The differences between the domestic decision and its international counterpart will therefore be the focus of attention in these chapters. Dividend decisions in MNCs can be separated into subsidiary dividends paid to the parent and MNC dividends paid to shareholders of the parent. The former decision will involve the cross border transfer of funds and has many novel IFM implications. The latter decision involving the home country dividend decision of the MNC is assumed to be little influenced by the multinationality of the firm and is considered to be comparable to the dividend decision of the domestic company. The subsidiary dividend question is therefore considered in this text as part of the analysis of the intra firm transfer of funds. The overall MNC dividend decision is assumed to be adequately covered in the domestic financial management literature and a detailed discussion is therefore omitted from this text. As a result the novel issues in IFM appear to include,

Foreign currency exchange behaviour

The determinants of direct foreign investment decisions

Political risk analysis

International capital markets-integration and efficiency

Differences between various domestic capital markets

The extension to the class of decisions to be found in domestic financial management appear to include,

Foreign exchange exposure management

Capital budgeting discount rates in international capital markets

Capital structure and financing decisions in international capital markets

Cash and working capital management in many currencies, including intra firm transfers of funds and the subsidiary dividend decision.

The extent to which these issues and the associated decision needs arise in the firm are clearly dependent on the degree of international involvement of the firm and the nature of the international economy. These issues will be shown to impinge upon domestic companies to some degree, and will be shown to be central to firms such as the MNC I to MNC III. In the following chapters an attempt will be made to identify the conditions under which they become significant to the various types of firm. The emphasis will be on the internationally involved firm ranging from Domestic II to MNC III and the three strategic decision areas identified above, i.e. capital budgeting,

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