

Alan C. Shapiro



Multinational Financial Management

**SEVENTH
EDITION**

SEVENTH EDITION

MULTINATIONAL FINANCIAL MANAGEMENT

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University of Southern California



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PREFACE

APPROACH

The basic thrust of this seventh edition of *Multinational Financial Management* is to provide a conceptual framework within which the key financial decisions of the multinational firm can be analyzed. The approach is to treat international financial management as a natural and logical extension of the principles learned in the foundations course in financial management. Thus, it builds on and extends the valuation framework provided by domestic corporate finance to account for dimensions unique to international finance.

MFM focuses on decision making in an international context. Analytical techniques help translate the often vague rules of thumb used by international financial executives into specific decision criteria. The book offers a variety of real-life examples, both numerical and institutional, that demonstrate the use of financial analysis and reasoning in solving international financial problems. These examples have been culled from the thousands of illustrations of corporate practice that I have collected over the years from business periodicals and my consulting practice. By scattering the best of these examples throughout the text, students can see the value of examining decision problems with the aid of a solid theoretical foundation. Seemingly disparate facts and events can then be interpreted as specific manifestations of more general financial principles.

All the traditional areas of corporate finance are explored, including working capital management, capital budgeting, cost of capital, and financial structure. However, this is done from the perspective of a multinational corporation, concentrating on those decision elements that are rarely, if ever, encountered by purely domestic firms. These elements include multiple currencies with frequent exchange rate changes and varying rates of inflation, differing tax systems, multiple money markets, exchange controls, segmented capital markets, and political risks such as nationalization or expropriation. Throughout the book, I have tried to demystify and simplify multinational financial management by showing that its basic principles rest on the same foundation as does corporate finance.

The emphasis throughout this book is on taking advantage of being multinational. Too often companies focus on the threats and risks inherent in venturing abroad rather than on the opportunities that are available to multinational firms. These opportunities include the ability to obtain a greater degree of international diversification than security purchases alone can provide as well as the ability to arbitrage between imperfect capital markets, thereby obtaining funds at a lower cost than could a purely domestic firm.

AUDIENCE

Multinational Financial Management is designed for use in masters-level courses. It is also suitable for use in bank management and other executive development programs.

FEATURES

Multinational Financial Management presumes a knowledge of basic corporate finance, economics, and algebra. However, it does not assume prior knowledge of international economics or international finance, and is therefore self-contained in that respect. For those who are not familiar with *Multinational Financial Management*, here are some of the distinctive features that have led to its widespread adoption:

- Extensive discussion of the basic concepts of absolute and comparative advantage as well as some insight into the gains and income redistributions associated with free trade and the consequences of barriers to trade (Appendix 1A: The Origins and Consequences of International Trade)
- Role of expectations in determining exchange rates (Chapter 2)
- Extensive discussion of the Mexican currency crisis in 1994–1995 (Chapter 2)
- Discussion of currency boards and the role of central bank credibility in the context of the dramatic changes made recently in Argentina and New Zealand (Chapter 2)
- Analysis of the September 1992 and August 1993 European currency crises (Chapter 3)
- Discussion of monetary union, optimum currency areas, and the causes and consequences of the introduction of the euro (Chapter 3)
- Integrated discussion of the five key parity relationships in international finance and how they can be used to forecast exchange rates (Chapter 4)
- Discussion of recent research on biases in the forward exchange rate and possible causes, including the peso problem (Chapter 4)
- Discussion on linking currency forecasts to specific decision rules (Chapter 4)
- Use of the balance-of-payments framework to assess the economic links among nations (Chapter 5)
- Demonstration of double-entry bookkeeping in balance-of-payments accounting (Chapter 5)
- Discussion of country risk analysis for both companies and banks, along with an analysis of the dramatic changes taking place throughout Latin America, Eastern Europe, and China and their implications for economic growth (Chapter 6)
- Comprehensive discussion of the foreign exchange market and its institutions and mechanisms, including electronic trading (Chapter 7)

- Understanding of currency futures and options contracts (Chapter 8), and their use in exchange risk management (Chapter 10)
- Presentation on how to compute gains, losses, and maintenance margins on a futures contract (Chapter 8)
- Discussion of currency spreads and knockout (or barrier) options (Chapter 8)
- Introduction of a modified Black-Scholes option pricing model to the pricing of currency options and discussion of its shortcomings (Chapter 8)
- Use of interest rate and currency swaps to manage foreign exchange and interest rate risk (Chapter 9)
- Discussion of fixed-for-fixed and fixed-for-floating currency interest rate swaps (Chapter 9)
- Discussion of interest-rate risk management techniques, including forward rate agreements, forward forwards, and Eurodollar futures (Chapter 9)
- Discussion and comparison of the three basic types of exposure—accounting exposure, transaction exposure, and operating exposure (Chapter 10)
- Extended discussion on the design of a hedging strategy (Chapter 10)
- Discussion of managing the risk management function, including lessons learned from some highly publicized cases of derivatives-related losses (Chapter 10)
- Use of currency risk sharing in international contracts (Chapter 10)
- Comparison of hedging alternatives when there are transaction costs (Chapter 10)
- Discussion of cross-hedging using a simple regression analysis (Chapter 10)
- Discussion of how to structure and use currency collars (or range forwards) and currency cylinders to hedge exchange risk (Chapter 10)
- Identification of the economic, as opposed to accounting, aspects of foreign exchange risk (Chapter 11)
- Development of marketing and production strategies to cope with exchange risk (Chapter 11)
- Analysis of how Japanese firms have coped with the appreciation of the yen (Chapter 11)
- Discussion of the functions, consequences, and globalization of financial markets and the links between national and international capital markets (Chapter 12)
- Discussion of the external medium- and long-term financing options available to the multinational corporation (Chapter 12)
- Discussion of international differences in corporate governance and the economic consequences of those differences (Chapter 12)
- Discussion of the Eurocurrency and Eurobond markets (Chapter 13)
- Discussion of how to calculate the effective costs of Eurocurrency loans and Eurocommercial paper and all-in costs of Eurobonds (Chapter 13)

- Evaluation of foreign currency-denominated debt (Chapter 14)
- Extended discussion of calculating the cost of capital for multinational companies (Chapter 14)
- Design of a global financing strategy (Chapter 14)
- Discussion of alternative approaches to estimating the cost of capital for foreign operations (Chapter 14)
- Understanding of the nature and consequences of international portfolio investment (Chapter 15)
- Discussion of the home bias in international portfolio investing and the effects of hedging on the efficient frontier for internationally diversified portfolios (Chapter 15)
- Analysis of exchange risk associated with foreign portfolio investments (Chapter 15)
- Development of global strategies of MNCs (Chapter 16)
- Assessment of the true profitability of a foreign operation (Chapter 17)
- Valuation of the growth options often associated with foreign investments (Chapter 17)
- Role of countertrade in financing international trade (Chapter 18)
- Calculation of the cost of acceptance financing and factoring (Chapter 18)
- Costs and benefits of managing interaffiliate fund flows on a global basis (Chapter 20)
- Discussion of new transfer pricing issues and “earnings-stripping” charges involving foreign company operations in the United States (Chapter 20)
- Integration of tax management with financial management based on recent tax law changes (Chapter 20)

CHANGES TO THE SEVENTH EDITION

Overall, the book has been updated and shortened. It now contains 20 chapters instead of the previous 22. Specific changes that have been made to the seventh edition of *Multinational Financial Management* include the following:

- Part I remains as before, Environment of International Financial Management. The other sections of the book have been rearranged. A new Part II, titled Foreign Exchange and Derivative Markets, has been added. Foreign Exchange Risk Management, which was previously Part II, is now Part III. The organization of the remaining parts has been changed as well. Previously, the sequence was Part III (Working Capital Management), Part IV (Financing Foreign Operations), and Part V (Foreign Investment Analysis); it is now Part IV (Financing Foreign Operations), Part V (Foreign Investment Analysis), and Part VI (Working Capital Management). The aim is to deal with the financing subject matter, including the cost of capital, prior to discussing the investment decision.

- Part I now includes two new chapters. One addition is Chapter 4, which was previously Chapter 7, Parity Conditions in International Finance and Currency Forecasting. The aim is to bring this key chapter up front, right after the discussion of exchange rate determination and the international monetary system in Chapters 2 and 3, respectively. The other addition to Part I is Chapter 6, Country Risk Analysis, which sheds light on key economic and political factors affecting the economic health of nations.

- Part I also contains a new case, “Will Argentina Devalue Its Peso?,” that deals with the factors that would enter into a forecast of peso devaluation.

- The section on interest-rate parity theory has been transferred from Chapter 7 (The Foreign Exchange Market) to Chapter 4 (Parity Conditions in International Finance), where it provides the link between the spot and forward exchange markets and money markets.

- The old Chapter 16, on currency and interest rate swaps, has now been updated and shifted to Part II, where it is now titled **Swaps and Interest Rate Derivatives**.

- Old Chapters 8 and 9 have been combined into a new Chapter 10, Measuring and Managing Translation and Transaction Exposure.

- Old Chapters 10 and 11 have been combined into a new Chapter 11, Measuring and Managing Economic Exposure.

- Former Chapter 22 (Measurement and Management of Political Risk) has been split into Chapter 6 (Country Risk Analysis) and Appendix 17A (Managing Political Risk).

- Former Chapter 17 (International Banking Trends and Strategies) has been eliminated, and the section on Country Risk Analysis in International Banking has been moved into Chapter 6.

- Former Chapter 15 (International Financing and International Financial Markets) has been split into two separate chapters, Chapter 12 (International Financing and National Financial Markets) and Chapter 13 (The Euromarkets).

- Part VI has a new case, “Xerox Miscopies Foreign Interest Rate Data,” that explores the problems xerox has had in recording revenues from foreign affiliates and valuing their lease receivables.

At the same time that the book has been updated, reorganized, and shortened, new material has been added, including the following:

- Many new solved numerical problems in the body of the chapters to illustrate the application of the various concepts and techniques presented in the text, along with new end-of-chapter problems.

- Extensive discussion of the causes and consequences of the Asian and other emerging market currency crises in 1997–1998 (Chapters 1, 2, and 3)

- Addition of a section on project financing to Chapter 12.

The book also contains many new charts and illustrations of corporate practice that are designed to highlight specific techniques or teaching points. Again, the

emphasis is on reinforcing and making more relevant the concepts developed in the body of each chapter. To make the text more suitable as a teaching vehicle, I have added numerous questions and problems at the end of each chapter, most of which are based on up-to-date information and real-life situations.

PEDAGOGY

The pedagogical thrust of the book is greatly enhanced by including the following learning and teaching aids:

1. *Focus on Corporate Practice.* Throughout the text, numerous real-world examples and vignettes provide actual applications of financial concepts and theories. They show students that the issues, tools, and techniques discussed in the book are being applied to day-to-day financial decision making.
2. *Extensive Use of Examples and Illustrations.* Numerous short illustrations and examples of specific concepts and techniques are scattered throughout the body of most chapters.
3. *Lengthier Illustrations of Corporate Practice.* Seven longer illustrations of actual company practices appear at the end of key chapters and are designed to demonstrate different aspects of international financial management.
4. *Problems and Discussion Questions.* There are hundreds of realistic end-of-chapter questions and problems that offer practice in applying the concepts and theories being taught. Many of these questions and problems relate to actual situations and companies.
5. *Learning Objectives.* Each chapter opens with a statement of its action-oriented learning objectives. This statement enhances learning by previewing and guiding the reader's understanding of the materials that will be encountered in the chapter.
6. *Key Terms.* A list of key terms now appears at the end of each chapter. This allows the reader to review and test their knowledge of the new and important terms learned in the chapter.
7. *Internet Resources.* Each chapter now has a new section called "Internet Resources and Exercises" that contains a set of relevant Web sites for that chapter and several exercises that use those Web sites to address various issues that arise in the chapter.
8. *Glossary.* The back of the book contains a glossary that defines all the key terms appearing in the text.
9. *Web Site.* Additional questions, problems, and cases on the book's Web site (www.wiley.com/college/Shapiro) can be accessed by students.
10. *Supplements.* A complete set of ancillary materials is available for adopters of *Multinational Financial Management* to supplement the text. These include

- An Instructor's Manual containing detailed solutions to the end-of-chapter questions and problems and tips for teaching each chapter.
- A Testbank containing over 160 additional questions and problems suitable for use in multiple choice exams.
- A dedicated Web site (www.wiley.com/Shapiro) with additional resources for both students and instructors, including additional questions, problems, cases, and Power Point slides is also available.

THANKS

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A.C.S.

Pacific Palisades

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PART I

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