

# INTERNATIONAL BUSINESS FINANCE

Suk H. Kim

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**UNIVERSITY OF DETROIT**



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# PREFACE

*International Finance* is a field with great promise of growth. Enrollment at colleges and universities in this discipline has expanded rapidly. Furthermore, a truly phenomenal growth in interest in the subject by practitioners and governments has occurred in the 1970s, a trend which should continue.

The reason for the interest and growth is not hard to find. Although some foreign business operations have existed for centuries, the world has entered an era of unprecedented global economic activity with worldwide production and distribution. International finance has become more important as it serves increasing world trade and foreign investment.

The international business community is experiencing dramatic fluctuations and keener competition because the international economic environment has changed radically in the last ten years. Since 1973, a predictable international monetary system has changed to a volatile exchange system. The creation of OPEC has shifted wealth from the major industrial countries to the major oil exporting countries. New institutions and markets such as the Eurocurrency markets have integrated segmented national capital markets. Governments have taken a more active role in regulating both domestic and international financial markets. These factors have made it necessary for managements to become much more aware of the international financial environment.

Most large and many medium-size companies in the United States have international business operations of one type or another. In recent years, it has become clear that even companies without for-

eign investment can be significantly affected by events in the international environment. If business school graduates understand the basic elements of international finance, they will be at an advantage to move their companies forward.

The formal recognition of the importance of international business was slow in the United States. It was not until the later 1960s that awareness of the problems associated with international operations began to have a clear impact on business education. By this time, it was recognized that existing theories and techniques of finance based on business experience within the United States were neither general nor universal. The teaching of international finance began to appear in business school curricula in the mid-1960s and it was markedly accelerated during the early 1970s.

In recent years, more and more individuals have been urging business schools to meet this challenge. They argue that all business school graduates must have a comprehensive grasp of international business and its environment. The American Assembly of Collegiate Schools of Business (AACSB) has responded positively to this challenge. Since 1974, the AACSB has taken a series of steps to alter its accreditation standards in order to include a requirement that the international dimension of business be added to the curricula.

This book can be used in international finance courses at universities, company management development programs, and management institutes. In writing this book, it was my intention to provide an operationally useful analysis of the international financial system to international business managers. Three special features of the text are conciseness, readability, and practicability. The book should motivate the reader to seek out additional knowledge and courses to upgrade his or her understanding in the field of international finance.

This text consists of five major parts. Part One (Chapters 1 and 2) discusses major environmental differences and the motives for both world trade and foreign investment. Part Two (Chapters 3 through 5) deals with the forces that affect the relative prices of currencies in international markets. These forces include the balance of payments, the international monetary system, and the foreign exchange market. Part Three (Chapters 6 through 8) covers sources of international finance. One major facet of financial management is to raise funds on favorable terms. In the case of international finance, this involves those sources of funds to finance world trade and foreign investment. Part Four (Chapters 9 through 12) discusses the management of assets. The second major facet of financial management is the efficient al-

location of funds among assets. The decision to invest abroad must consider various environmental differences such as disparities in exchange rates, differences in taxes, and differences in risk factors. Part Five (Chapters 13 through 15) describes techniques for controlling the operations of a multinational company. Accurate financial data are especially important in international business where operations are typically supervised from a distance. Multinational taxation is an important part of international finance because it has a pervasive effect on all aspects of multinational operations. Once the company establishes foreign subsidiaries, international transfer pricing becomes an important dimension of pricing strategies.

I wish to thank those individuals who have provided the constructive advice critical to the successful development of this text. I would like to express my thanks to Dean Donald Byrne (University of Detroit) for his support and encouragement. I gratefully acknowledge many comments and suggestions from my friends: Raj Aggarwal (University of Toledo), Gerald Cavanagh, S. J. (University of Detroit), William George (University of Detroit), Henry Guithues (St. Louis University), Seung Kim (St. Louis University), George Philippatos (University of Tennessee), Robert Redlin (University of Detroit), Charlton Schoeffler (University of Detroit), and S. Srinivasulu (Eastern Michigan University).

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Suk H. Kim  
Detroit, Michigan

### ABOUT THE AUTHOR

Dr. Suk H. Kim, an Associate Professor of International Business Finance, is the Acting Chairman of the Department of Accounting and Finance at the University of Detroit. He received his MBA from Pepperdine University and his Ph.D. in Finance from St. Louis University.

Dr. Kim's expertise is documented by his record of publication and the recognition of the academic community. He has published four college textbooks and 30 articles on international business finance and capital budgeting. Recent articles have appeared in such prestigious journals as the *Columbia Journal of World Business*, the *Journal of International Business Studies*, the *Engineering Economist*, *Management Accounting*, *Internal Auditor*, the *Journal of Financial Education*, and the *Collegiate Forum*. Several current finance textbooks cite his earlier findings and researchers from this field refer to his work when establishing the groundwork for further exploration.

Dr. Kim is an active member of the Academy of International Business, the Financial Management Association, the Midwest Finance Association, the National Association of Accountants, and the American Institute for Decision Sciences.



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# **PART ONE**

## **Motives for International Transaction**





panies. However, these two types of companies derive their differences from the fact that they do business in different environments. A basic understanding of these differences is essential if the international manager is to function effectively within the international environment.

## ENVIRONMENTAL DIFFERENCES

Successful international operations require adequate information about the environmental factors that affect business operations in foreign countries. In conducting foreign business operations, U.S. methods and techniques should be adjusted to accommodate the customs, attitudes, economic factors, and political factors which prevail in the country of operation.

How do management principles in one country differ from those in other countries? In principle, concepts in the functional business areas of accounting, finance, management, and marketing are as relevant to business management in one country as they are in another country. However, when a business crosses national boundaries, the environment in which these concepts are applied is different. The three types of environmental differences to be described in this section are (1) types of risk, (2) conflicts of interest, and (3) multiple environments.<sup>1</sup> It is important to recognize that these three types of differences are neither mutually exclusive nor exhaustive.

### Types of Risk

The three major types of risk confronted in international business operations are political risks, financial risks, and regulatory risks. Political risks range from moderate actions such as exchange controls to extreme actions such as complete confiscation of all assets. Financial risks involve varying exchange rates, divergent tax laws, different interest and inflation rates, and balance of payments considerations. Regulatory risks are differences in legal systems, overlapping jurisdictions, and restrictive business practices against foreign companies.

If a company plans to invest heavily in foreign countries, it must consider all of these risks for many years ahead. The conduct of busi-

<sup>1</sup> For details, see Stefan H. Robock, Kenneth Simmonds, and Jack Zwick, *International Business and Multinational Enterprises* (Homewood, Ill.: Richard D. Irwin, Inc., 1977), Chapter 3.



ness across national boundaries involves extra dimensions of risk which are rarely confronted in domestic business operations. Ideally, a company should analyze these extra risks to understand underlying causal forces. Then it should develop some specific measures to handle them effectively.

### **Conflicts of Interest**

Various conflicts of interest may occur in international business operations for a variety of reasons. Owners, employees, suppliers, and customers may have different national identities. The interests of sovereign national states may be divergent. The goals of multinational companies and their host countries may be contradictory. Some conflicts of interest may exist within the multinational company. Furthermore, other conflicts may exist in the relationship between the multinational company and the external environment.

Many multinational companies desire to have home-country nationals in key positions for their foreign operations. They tend to hire local persons for nonmanagerial positions. Thus, disparities in salaries and wages are almost inevitable. Most developing countries require multinational companies to hire and train local people for management positions in exchange for local business operations. Many external conflicts relate to profit-motivated decisions which involve the transfer of funds, production, exports and imports, and employment from one country to another. For instance, the desire for foreign exchange remittances by the multinational company and the desire for the local government to restrict these remittances frequently create a serious problem.

### **Multiple Environments**

In addition to the elements of risk and conflict just discussed, multinational companies have a wide variety of operational problems due to the multiplicity of environments in international business. These environmental diversities require different concepts, analytical methods, and information. Hence, multinational companies should identify, evaluate, and predict all the environmental variables. Some important environmental variables are the form of business organization, different institutional settings, and cultural differences.

## THE ORGANIZATION OF THE BOOK

This book consists of five major parts. Part One (Chapters 1 and 2) examines environmental differences and motives for both world trade and foreign investment. Most textbooks for financial management courses are written as though the world stops at the borders of the United States. Most finance courses are also taught in that way. Recent statistics, however, indicate the growing importance of world trade and foreign investment. Hence, it is important to understand the economic basis for world trade and foreign investment.

Part Two (Chapters 3 through 5) deals with the forces that affect the relative prices of currencies in international markets. These forces include the balance of payments, the international monetary system, and the foreign exchange market. Prices of products and investments across national boundaries are expressed in international money. Commercial transactions between countries were once handled under the relatively rigid gold standard. But pursuit of national economic goals—healthy economic growth, full employment, stable prices, and the favorable balance of payments—has led to many changes in the international monetary environment under which business must operate.

Part Three (Chapters 6 through 8) describes sources of international finance. One major facet of financial management is to raise funds on favorable terms. In the case of international financial management, this involves those sources of funds to finance world trade and foreign investment. These funds can come from either internal or external sources. Internal sources of funds such as earnings and depreciation are the major sources of funds for most multinational companies. But external sources of funds such as bank loans and Eurodollars are important as well.

Part Four (Chapters 9 through 12) covers the management of assets. The second major facet of financial management is the efficient allocation of funds among various assets. This part describes the management of current assets, capital budgeting, and risks associated with foreign investment. The objective of current asset management is to protect the purchasing power of assets and to maximize the return on investment. The management of current assets is extremely important for the multinational company. Thus, the complicating international factors and approaches for resolving them should be analyzed carefully. Financial management literature on capital budget-