Handbook of International Financial Management

SWEENY
and
RACHLIN

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EDITED BY ALLEN SWEENY
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He has contributed to various professional journals and is the author of *Accounting Fundamentals for Nonfinancial Executives* and *R.O.I. Basics for Nonfinancial Executives*. He also coauthored *Budgeting Fundamentals for Nonfinancial Executives* and, most recently, coedited the *Handbook of Budgeting* published by John Wiley & Sons.

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His associations with major corporations and his numerous clients both in the United States and internationally bring him a reputation among business professionals. He has lectured around the world in such countries as Venezuela, Brazil, Belgium, Mexico, England, Italy, Malaysia, Switzerland, Israel, Canada, Guatemala, Singapore, Nigeria, and Australia.

His books include *How to Use Return on Investment as a Management Tool, Return on Investment—Strategies for Profit, Profit Strategies for Business, Successful Techniques for Higher Profit,* and *Managing Cash Flow and Capital During Inflation*. He is a coeditor of the *Handbook of Budgeting* and a contributor to magazines and to the *Controller's Handbook*. Four of his books have been chosen as main selections by The Executive Program, a Macmillan Book Club.

Mr. Rachlin received a B.B.A. from Pace University in accounting and an M.B.A. from St. John's University in management and economics.

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Preface

The growth of international business, and the attendant rise of the multinational firm, has been one of the most significant business developments since the end of World War II. The *Handbook of International Financial Management* is concerned with the specific skills, concepts, and techniques that must be employed by those who are or will be charged with the financial management of these ever-increasing global enterprises.

It has been written *by* practicing professionals for practitioners. It has been written *about* all aspects of the unique and critical role that the international financial function plays in the overall success of an international business.

The nineteen chapters that follow draw on the expertise of senior executives, consultants, bankers, and other experts from a variety of prominent multinational institutions. They discuss such topics as:

- Organizing the international financial function
- Understanding, forecasting, and reporting exchange exposure
- Managing and minimizing exchange loss
- Political and economic risk analysis of foreign investments
- Capital budget analysis of foreign investments
- Analysis of foreign acquisitions and mergers
- Foreign licensing as an alternative to direct investment
- International banking and cash management
- Accounting and auditing in the international arena
- Budgeting and control for international operations
- International tax planning and execution

Our very special thanks to the twenty-one authors of this handbook who found time in their already busy schedules to contribute so significantly to this project. We are also particularly grateful to Ines Botero H. for her invaluable administrative assistance and to Bill Sabin and his competent staff at McGraw-Hill for their guidance and support.

Robert Rachlin
Allen Sweeny

Contents

One: The Size, Scope, and Significance of International Business

JAMES BURTLE

James Burtle is professor of economics at Iona College in New Rochelle, New York. Mr. Burtle previously was managing editor of *The International Country Risk Guide*, published by International Reports; vice president in the economics department of W. R. Grace & Company, responsible for exchange rate forecasting and advising on foreign exchange management; and staff member of the International Labor Office in Geneva, Switzerland. He has written numerous articles on international economics and finance and has coauthored *The Great Wheel, The International Monetary System*, with the late Sidney Rolfe. He has served as a member of the Advisory Committee to the U.S. Office of Management and the Budget on the presentation of the U.S. balance of payments and has testified before the Senate Banking Committee on international monetary reform and the operation of foreign exchange markets. Mr. Burtle earned both his B.A. and M.A. degrees from the University of Chicago.

Today most major companies have a key officer who is exclusively concerned with international finance; typically, he or she heads a staff of significant size. This is a relatively recent development—twenty years ago international finance usually was one of the many responsibilities of the corporate treasurer or chief financial officer, since international finance rarely required separate company personnel.

International finance management has gained in importance in most businesses for several reasons. Overall, financial management, domestic and international, has become more complicated and professionalized. Money management is more difficult in a world of floating exchange rates than in one of fixed exchange rates. Finally, and probably most important, international business has grown much more rapidly than business in general. Some writers now estimate that about one-third of the world's gross national product (GNP) is produced under the management of international businesses; a more precise estimate is impossible, because accurate figures are not available for either world output or output of international businesses.[1] International businesses certainly have gained enormously in significance. Moreover, the organization of international business has been almost totally transformed.

Before World War I, most international investment was portfolio—for the purchase of bonds and stocks of companies over which the purchaser has no significant control. Direct investment—over which the parent company exercises control—was less important. In the 1920s, direct investment became more significant, rising to about 25 percent of lending abroad. In the 1930s, portfolio investment declined, and direct investment showed only small increases. After World War II and particularly after the establishment of currency convertibility in Europe in 1958, there was a surge in foreign investment; however, unlike investment in the pre-1914 era, the surge was mainly in direct investment.

It is important, however, to keep in perspective the relative importance of direct and portfolio investment compared with overseas lending by banks. Data for the United States—from which there is the best information on international capital—indicate that bank capital has risen more rapidly than direct investment and that, as a source of U.S. capital abroad, bank capital has become almost as important as direct investment. As shown in Exhibit 1-1, the net U.S. position abroad in the private sector increased from $49.3 billion in 1960 to $516.6 billion in 1980. In the same period, direct investment abroad increased 6.8-fold from $31.9 billion to $215.6 billion, while bank loans outstanding showed a 38.5-fold increase from $5.3 billion to $203.9 billion. There were also rapid increases in nonbank loans, and portfolio investment—as indicated by privately held foreign securities—increased at about the same rate as direct investment, although from a smaller base. It should be stressed, however, that a substantial part of the lending abroad of U.S. banks might not have taken place if there had not been a jump in direct investment abroad. (The data in Exhibit 1-1 indicate book values for direct investments.) In addition, the multinational corporations borrow heavily abroad. As shown in Exhibit 1-2, based on a survey by the U.S. Department of Commerce, assets of U.S. companies abroad in 1977 were

EXHIBIT 1-1 U.S. Investment Position Abroad, Private Sector
($ Billions)

	(1) Direct investment	(2) Foreign securities, privately held	(3) Outstanding nonbank loans	(4) Outstanding bank loans	(5) Total
1960	31.9	9.6	2.6	5.3	49.3
1965	49.5	15.2	4.8	12.0	81.5
1970	75.5	21.0	8.6	13.8	118.8
1971	83.0	23.5	9.6	16.9	133.1
1972	89.9	27.6	11.4	20.7	149.7
1973	101.3	27.4	13.8	26.7	169.2
1974	110.1	28.2	17.0	46.2	201.5
1975	124.1	34.9	18.3	59.8	237.1
1976	136.8	44.2	20.3	81.1	282.4
1977	146.0	49.4	22.3	92.6	310.2
1978	162.7	53.4	28.1	130.8	375.0
1979	187.9	56.8	31.5	157.0	433.2
1980	215.6	62.5	34.7	203.9	516.6

Note: Investment positions are book values, thus excluding borrowings for U.S. businesses abroad.

SOURCE: U.S. Department of Commerce, *Survey of Current Business*, August 1982, p. 45; August 1981, p. 56; August 1978, p. 57; October 1977, p. 23; August 1976, p. 32; October 1975, p. 32; August 1974, p. 5; October 1972, p. 21.

EXHIBIT 1-2 Assets Abroad of U.S. Companies, Direct Investments, 1977 ($ Billions)

Mining	4
Petroleum	136
Manufacturing	259
Trade	19
Finance[a]	44
Other	28
Total	490

[a] Excludes banking.
SOURCE: U.S. Department of Commerce, *Survey of Current Business*, October 1981, p. 40.

$490 billion. These U.S. companies abroad in 1977 had a book value of $146 billion (Exhibit 1-1) but had borrowed $344 billion to bring their total assets up to $490 billion. A significant part of the $344 billion in estimated borrowings undoubtedly came from the U.S. bank loans outstanding abroad at $92.6 billion in 1977. (See Exhibit 1-1, column 4).

Although data on foreign direct investment positions are less readily available for countries other than the United States, other developed countries are not unimportant in the direct investment scene. Exhibit 1-3 shows

EXHIBIT 1-3 Direct Investment Positions Abroad, Major Developed Countries (End of Year, $ Billions)

	1967	1971	1973	1975	1976
United States	56.6	83.0	101.3	124.1	136.8
United Kingdom	17.5	23.7	26.9	30.8	32.1
West Germany	3.0	7.3	11.9	16.0	19.9
Japan (fiscal years)	1.5	4.4	10.3	15.9	19.4
Switzerland	5.0	9.5	11.1	16.9	18.6
France	6.0	7.3	8.8	11.1	11.9
Canada	3.7	6.5	7.8	10.5	11.1
Netherlands	2.2	4.0	5.5	8.5	9.8
Sweden	1.7	2.4	3.0	4.4	5.0
Belgium-Luxembourg	2.0	2.4	2.7	3.2	3.6
Italy	2.1	3.0	3.2	3.3	2.9
All other (estimate)	4.0	5.1	6.3	15.1	16.8
Total	105.3	158.6	198.8	259.8	287.9

SOURCE: Organization for Economic Cooperation and Development, *International Investment and Multinational Enterprises*, Paris, 1981, p. 39.

direct investment positions abroad for major countries for 1967, 1971, 1973, 1975, and 1976. Although these statistics are somewhat out of date and may present some problems in comparability between countries, it is safe to conclude that the United States supplies roughly 50 percent of the total foreign direct investment position. The actual data show a small decline in U.S. relative importance from 53.8 percent in 1967 to 47.5 percent in 1976. As indicated in Exhibit 1-4, the host countries of direct investment outflows in 1971 and 1976 were mainly developed countries. Japan was, however, an exception—its percentage of investment in developing countries was roughly half the total. In most cases, companies abroad are affiliates of the parent company. Affiliates are incorporated under the laws of the host country, but a controlling interest in affiliates is held by the parent company. A relatively small proportion of businesses abroad are branches—simple extensions of the parent company not incorporated abroad. In 1980, for exam-

EXHIBIT 1-4 Direct Investment Positions in Developed and Developing Countries, 1971 and 1976

	Investment position		Percent of total	
	1971	**1976**	**1971**	**1976**
United States ($ billions):				
Developed	62.0	107.4[a]	74.7	78.5
Developing	21.0	29.4	25.3	21.5
Total	83.0	136.8	100.0	100.0
United Kingdom (£ billions):				
Developed[b]	4.8	8.5	71.6	75.9
Developing[b]	1.9	2.7	28.4	24.1
Total[b]	6.7	11.2	100.0	100.0
Germany (DM billions):				
Developed	17.1	32.8	71.8	69.8
Developing	6.7	14.2	28.2	30.2
Total	23.8	47.0	100.0	100.0
Japan ($ billions):				
Developed[c]	1.8	7.3	50.0	47.4
Developing[c]	1.8	8.1	50.0	52.6
Total[c]	3.6	15.4[d]	100.0	100.0

[a] Includes $6.2 billion in unallocated investments.
[b] 1975 data used in place of 1976 data; excludes oil.
[c] Fiscal years.
[d] Excludes $500 million unallocated.
SOURCE: Organization for Economic Coöperation and Development, *International Investment and Multinational Enterprises*, Paris, 1981, p. 47.

ple, of about $215 billion in U.S. direct investment abroad, about $33 billion was in branches and $182 billion in affiliates.[2]

The book value position of affiliates depends on two sources of funds. As indicated in Exhibit 1-5, there are outflows of capital from the parent company and income earned by the overseas affiliate that is plowed back into the business. In addition, in calculating the total book value position of the affiliate, there are valuation adjustments (usually small) reflecting the sale or other changes in the values of assets abroad. In 1979, for example, Exhibit 1-5 indicates that the U.S. investment abroad increased to $187.9 billion from $162.7 billion in 1978. This change of $25.2 billion came from $6.3 billion capital outflow from the United States, $19 billion in reinvested earnings of affiliates, and $100 million negative valuation adjustment.

Exhibit 1-6 indicates the relative significance of U.S. direct investment abroad compared with U.S. domestic operations. It is clear that U.S. multinational operations overseas are important compared with their total operations: In 1977, assets of foreign operations of 3425 multinationals were $490 billion or 24.1 percent of these companies' aggregate assets, both foreign and domestic, at $2033 billion. Sales of foreign operations in 1977 at $648 billion were 31.5 percent of total sales, both foreign and domestic, at $2060 billion. Employment of affiliates of businesses abroad in 1977 (7.197 million) was 27.6 percent of total employment in these companies. More up-to-date data are available on capital expenditures of affiliates of U.S. companies. As indicated in Exhibit 1-6, in 1980 foreign affiliates of U.S. companies had capital expenditures (financed by both equity and borrowing) of $42.4 billion. This was 12.5 percent of total U.S. expenditure for plant and equipment ($338.4 billion).[3]

EXHIBIT 1-5 Formation of the U.S. Direct Investment Position, 1950–1980 ($ Billions)

	Capital outflow	Reinvested earnings	Valuation adjustments	Change in position	Total position
1950	0.6	0.5	0.0	1.1	11.8
1960	1.7	1.3	−0.9	2.0	31.9
1965	3.5	1.5	−0.1	5.0	49.5
1970	4.4	3.2	−0.2	7.4	75.5
1975	6.2	8.0	−0.3	14.0	124.1
1976	4.3	7.7	0.8	12.8	136.8
1977	5.5	6.4	−2.7	9.2	146.0
1978	4.7	11.3	0.7	16.7	162.7
1979	6.3	19.0	−0.1	25.2	187.9
1980	2.2	17.0	8.5[a]	27.7	215.6

[a] Reflects a transfer of assets of a U.S. company to a host government.
SOURCE: U.S. Department of Commerce, *Survey of Current Business*, various issues.

THE HEYDAY OF DIRECT INVESTMENT, 1960–1973

Direct investment outflows from 1960 to 1973 increased in the overall Organization for Economic Cooperation and Development (OECD) area at a 12 percent per year rate, about 50 percent greater than the growth rate in current dollars in gross domestic product (GDP) for the area. Since inflation was about 4 percent per year in this period, real growth in direct investment outflows was about 8 percent per year. In the last half of the 1970s, the share of foreign-owned companies in total production in manufacturing was 51 percent in Canada (1974), 28 percent in France (1975), 22 percent in Germany (1976), 24 percent in Italy (1977), and 19 percent in the United Kingdom (1975).[4]

In the early 1970s more than half of direct investment abroad was from U.S. companies. This was all the more striking because exports of U.S. capital were restricted between February 1965 and January 1974 on a voluntary and then mandatory basis (after 1967) to reduce the balance-of-payments deficit. But the contribution of other countries to direct investment was by no means insignificant. Between 1967 (when data on the stock of direct investment abroad are more readily available for major countries) and 1976, as indicated in Exhibit 1-3, the total stock of direct investment abroad jumped from $105.3 billion to $287.9 billion. Of this amount, the United States' share was 53.8 percent in 1967 and 47.5 percent in 1976.

DIRECT INVESTMENT ABROAD SINCE THE MID-1970S

Between 1973 and 1979 direct investment abroad, in real terms adjusted for inflation, slowed to approximately 3 percent per year growth compared with about 8.5 percent from 1960 to 1973.[5] To a large extent this reflects a slower rate of growth in world trade and in output and investment. Moreover, most investment opportunities, particularly in Europe, may already have been tapped.

EXHIBIT 1-6 Indicators of the Relative Importance of U.S. Multinationals, 1977

	U.S. parent	Affiliates abroad	Total	% Affiliates abroad
Assets ($ billions)	1543.0	490.0	2033.0	24.1
Sales ($ billions)	1412.0	648.0	2060.0	31.5
Employment (thousands)	18,885.0	7197.0	26,082.0	27.6
Plant and equipment expenditure, 1980 ($ billions)	296.0	42.4	338.4	12.5

SOURCE: U.S. Department of Commerce, *Survey of Current Business*, July 1981, p. 63, and October 1981, pp. 11, 40.

The exaggerated idea of U.S. companies taking over most of Europe, presented very eloquently in Jean-Jacques Servan-Schreiber's *The American Challenge*, was replaced in some circles by the view that European businesses would become very influential in the United States.[6] From 1968 to 1973 the United States accounted for 45.8 percent of outward investment flows, but from 1974 to 1979 this share had fallen to 29.3 percent. (See

EXHIBIT 1-7 Inward and Outward Direct Investment Flows, 1961–1978
(Percentage Distributions among Thirteen Countries)

	1961–1967	1968–1973	1974–1978
Inward direct investment flows			
Canada	16.2	12.1	3.2
United States	2.6	11.4	26.7
Japan	2.0	1.7	1.2
Australia	15.6	12.9	9.5[a]
Belgium	4.5[b]	6.1	9.4
France	8.2	8.2	15.2
Germany	21.3	16.4	14.7
Italy	11.5	8.3	5.0
Netherlands	4.7	8.5	6.0[c]
Sweden	2.4	1.7	0.5[d]
United Kingdom	9.7	7.4	6.1
Spain	2.7	3.7	3.7
Norway	0.8	1.4	4.1
Outward direct investment flows			
Canada	2.3	4.5	6.2
United States	61.1	45.8	29.3
Japan	2.4	6.7	13.0
Australia	0.7	1.4	1.6[a]
Belgium	0.3[b]	1.4	2.5
France	6.9	5.2	7.8
Germany	7.2	12.5	17.0
Italy	3.6	3.3	2.0
Netherlands	4.4	6.8	9.6[c]
Sweden	2.0	2.4	3.7[d]
United Kingdom	8.7	9.1	9.2
Spain	0	0.3	0.6
Norway	0	0.3	0.9

[a] From 1974 to 1976.
[b] From 1965.
[c] From 1974 to 1978.
[d] From 1974 to 1977.
SOURCE: Organization for Economic Cooperation and Development, *International Investment and Multinational Enterprises*, Paris, 1981, pp. 40 and 41.