THIRD EDITION

MULTINATIONAL BUSINESS FINANCE

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PREFACE

The unifying theme of this third edition of *Multinational Business Finance* is that financial managers of multinational firms must perceive and respond to imperfections in world product, factor, and financial markets. If these markets were at all times identical to domestic markets for the same products, factors, and financial instruments, multinational firms would have no particular reason to thrive, and the tasks of their financial managers would be indistinguishable from the tasks performed by domestic financial managers.

The unprecedented growth of multinational business activity in the past several decades came about in part because multinational firms successfully identified their comparative advantages in perceiving and reacting to the various market imperfections. *Multinational Business Finance* is concerned with developing the body of knowledge, attitudes, and skills needed by persons who are, or who will be, charged with making financial decisions for such global enterprises.

The existence of market imperfections means that many of the most important decisions in financial management of a multinational firm have no domestic counterpart but arise solely because products, factors of production, or financial resources and claims are transferred across national borders and from one economy or market to another. There is no counterpart in domestic business for the selling of securities denominated in one currency to raise funds for expenditure in another currency, for the need to protect the value of future cash flows from damage caused by unexpected exchange rate changes, or for many of the considerations that influence analysis of a firm's foreign investment decision, cost of capital, and financial structure.

The third edition of *Multinational Business Finance* is appropriate for the same audiences as the first (1973) and second (1979) editions. Earlier editions have been widely used in international financial management courses at universities, company management development programs, and management institutes in the United States and abroad. A French edition, *La Gestion Financière des Enterprises Multinationales*, is published in Paris by the Club du Livre de Management, and an illegal pirate version is available in Taiwan. (The latter presumably represents an imperfection in the world market for books!)

Readers will find *Multinational Business Finance* most meaningful if they have background knowledge or experience equivalent to a basic finance course using a text such as J. Fred Weston and Eugene F. Brigham's *Essentials of Managerial Finance* (Dryden Press) or James C. Van Horne's *Fundamentals of Financial Management* (Prentice-Hall). A previous course in international economics is desirable, but the text has been designed to cover sufficient economic material so that a separate background is not essential.

The third edition of *Multinational Business Finance* has been substantially revised to incorporate theoretical and empirical research that has appeared in the past three years. A new section on capital market segmentation has been added to an expanded and improved discussion of cost of capital. Discussion of the international monetary system has been expanded and separated from the chapters on foreign exchange markets and management. A new chapter on the foreign exchange market and speculative activities has been added. Recent empirical work on exchange rate prediction has been added to the chapter on foreign exchange forecasting. Foreign exchange exposure is treated both from the perspective of changes promulgated by the Financial Accounting Standards Board as Statement Number 52 and in terms of the economic or cash flow implications of exchange rate changes. Discussion of the direct foreign investment decision has been updated and now includes the modern theory of internalization. New survey material has been added to the coverage of evaluation of performance. International banking developments, such as the increase in sovereign risk and the U.S. International Banking Act of 1978, have been added. Obsolete material from the second edition has been deleted, and thus the overall size of the book has not increased significantly.

The authors are grateful to the numerous professors who used the second edition of this book and provided detailed suggestions for changes. In particular, Lemma Senbet (University of Wisconsin) provided a valuable suggestion on reordering the chapters. Other valuable suggestions on specific topics were made by Laura Kelly and Alfred Hofflander (both of UCLA), Laura Smyth (Foreign Credit Insurance Association), Vinod Bavishi (University of Connecticut), Vihang Errunza (McGill University), Hany Shawky (State University of New York at Albany), and Harald Vestergaard (Cope-

hagen School of Economics and Business Administration). Kaare Dullum (Novo Industri A/S) made a particularly valuable contribution to the expanded treatment of segmented capital markets and cost of capital.

The authors continue to be greatly indebted to the reviewers and contributors to the first and second editions, which naturally still form the basis of the third edition. We are especially thankful to the three principal reviewers of the second edition: Gunter Dufey of the University of Michigan, Donald Lessard of MIT, and Alan Shapiro of the University of Southern California. In addition, a significant contribution was made by Frederick Choi of New York University. The authors would also like to recognize valuable inputs from David Bates (Omark Industries), Michael Brooke (University of Manchester, England), Robert Carlson (Wake Forest University), Payson Cha (The Cha Group, Hong Kong), Chi Ming Cha (The Cha Group, Hong Kong), Robert Cornu (Cranfield School of Management, England), Steven Dawson (University of Hawaii), Claudio de la Fuente (Security Pacific National Bank), William R. Folks, Jr. (University of South Carolina), Lewis Freitas (University of Hawaii), Ian Giddy (Columbia University), David Heenan (University of Hawaii), David N. Hepburn, Jr. (Wells Fargo Bank), Kenneth Knox (Tektronix, Inc.), Lee Remmers (INSEAD, France), R. J. Rummel (University of Hawaii), John Scott (Hyster Company), Norman Toy (Columbia University), and Richard Wright (McGill University).

Inevitably woven into the fabric of the book are ideas received from faculty colleagues and students at institutions where the authors have taught, including the University of California (Berkeley and Los Angeles campuses), Cranfield School of Management (England), University of Hawaii, North European Management Institute (Norway), The Copenhagen School of Economics and Business Administration (Denmark), and Oregon State University. Further ideas came from consulting assignments in Argentina, Belgium, Canada, Hong Kong, Japan, Mexico, the Netherlands, Norway, the United Kingdom, and Venezuela.

Finally, we would like to rededicate this book to our parents, Wilford and Sylvia Eiteman and Harold and Norma Stonehill, who gave us the motivation to become academicians and authors, and our immediate families, Kari, Inger, Marcia, and Naomi, for their patience through the years spent preparing the three editions of this book.

Pacific Palisades, California D.K.E.
Corvallis, Oregon A.I.S.
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CONTENTS

V WORKING CAPITAL MANAGEMENT

VI CONTROL

I

THE MULTINATIONAL CORPORATION AND ITS INTERNATIONAL ENVIRONMENT

1

THE MULTINATIONAL FIRM: ITS RATIONALE, GOALS, AND CONSTRAINTS

For several centuries economists have used the classical economic theory of comparative advantage to explain trade movements between nations. Springing from the writings of Adam Smith and David Ricardo in the eighteenth and nineteenth centuries, the theory in simple terms states that everyone gains if each nation specializes in the production of those goods that it produces *relatively* most efficiently and imports those goods that other countries produce *relatively* most efficiently. The theory has supported free-trade arguments.

The doctrine of comparative advantage made an initial assumption that although the products of economic activity could move internationally, the factors of production were relatively fixed in a geographic sense. Land, labor, and capital were assumed to be internationally immobile. Although the early economists did not use the expression, by implication other such factors as managerial skills and research and development abilities were assumed to be largely attributes of particular nations.

The post–World War II wave of direct foreign investment and the growth of multinational business enterprises is perhaps the major phenomenon of the last half of the twentieth century. This development, which holds such potential for the economic betterment of the world's population, runs counter to the postulates of Smith and Ricardo in that it is based on international mobility of the most important factors of production in the twentieth century. Capital raised in London in the Eurodollar market by a Belgium-based corporation may finance the acquisition of machinery by a subsidiary located in Australia. A management team from French Renault may take over a U.S.-built automotive complex in the Argentine. Clothing for dolls, sewn in Korea on Japanese-supplied sewing machines according to U.S. specifications, may be shipped to northern Mexico for assembly with other components into dolls being manufactured by a U.S. firm for sale in New York and London during the Christmas season. A California-manufactured air bus, the Lockheed L-1011, is powered by British Rolls-Royce engines, while a competing air bus, the Douglas DC-10, flies on Canadian wing assemblies. A Hong Kong bank originally developed with British management and capital buys control of a major upstate New York banking chain, which in turn finances the construction in Korea of ships intended for the Greek merchant marine.

The importance of multinational operations can be gleaned in part from data presented in the appendix to this chapter, which show the growth, size, and worldwide distribution of direct foreign investment. These data underestimate the influence of multinational firms because they exclude those firms' operations in the parent countries. Indeed, most multinational firms regard foreign and parent country operations as an integral whole. From a financial viewpoint this philosophy means that a multinational firm seeks to maximize systemwide objectives.

RATIONALE FOR THE EXISTENCE OF MULTINATIONAL FIRMS

The theme repeated throughout this book is that the multinational firm has a strong economic and business rationale. From an economic perspective host countries welcome multinational firms because they are viewed as agents of technology transfer and host country economic development. Multinational firms strive to take advantage of imperfections in national markets for products, factors of production, and financial assets. From a business perspective multinational firms are eager for opportunities to invest in geographic locations where they can earn a rate of return high enough to compensate them for the perceived level of risk. National and international market imperfections provide these opportunities.

Rate of Return

With respect to rate of return, imperfections in the market for products translate into market opportunities for multinational firms. Large international firms are better able to exploit such competitive factors as economies of scale, managerial and technological expertise, product differentiation, and financial strength than are their local competitors. In fact, multinational firms thrive best in markets characterized by international oligopolistic competition where these factors are particularly critical. In addition, once multinational firms have established a physical presence abroad, they are in a better position than purely domestic firms to identify and implement market opportunities through their own internal information network.

Multinational firms are also well positioned to identify and exploit