International Financial Management

Second Edition

Rita M. Rodriguez
E. Eugene Carter

INTERNATIONAL FINANCIAL MANAGEMENT

SECOND EDITION

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Preface

The tool kit of a financial officer operating in the international area is formed by contributions from several traditional disciplines. International monetary economics, usually referred to as international finance, provides the framework for understanding the environment where international business takes place. Corporate finance contributes the analytical concepts to manage the funds of an enterprise. Financial market theory furnishes the basis to appraise the institutions where funds are traded. The objective of this book is to scan these fields, to select those tools which individuals working in the area of applied international finance will find useful, and to illustrate their application in practice.

In Part One we focus on the assessment of the external position of countries. In this endeavor we center the analysis around the accounts presented in the balance of payments for the given country. Part Two deals with the problems that firms encounter as a result of dealing in a diversity of currencies. The financial problems associated with international trade are discussed in some detail. Also studied are the financial opportunities and risks involved in foreign operations other than trade.

Part Three approaches the issue of international capital budgeting. The first two chapters in the section deal with the problems attendant to the determination of the relevant cash flows and discount rate. The last two chapters of Part Three consider other theories of the motivation for foreign direct investment and the analysis of portfolio capital budgeting in the international setting. Finally, Part Four deals with financial markets on two levels. The international capital markets that operate independently of national boundary lines, the so-called Euro-dollar markets, are analyzed first. Then, a framework for studying specific capital markets is presented while showing some of the major characteristics of the most important capital markets in Europe. Appendices dealing with comparative accounting practices, discounting, project risk evaluation, and the Euro-dollar multiplier follow the appropriate chapters. We also include appendices at the end of the book containing a glossary, present value tables, and material on international taxation. Bibliographies accompany each chapter to aid those who are particularly interested in specific subject areas.

In the second edition our major concern has been to update various institutional figures and improve the basic presentation. The balance among the major portions of the book is relatively unchanged. We have included more material on purchasing power parity and interest rate parity in Chapter 4, 5, and 6 with a new appendix to Chapter 5. Major text changes are in the tax appendix. Other changes are seen in Part One, which deals with the new method of presenting the U.S. balance of payments and with a discussion of monetarism and the balance of payments; Part Two's approach to foreign exchange exposure; Chapter 7's analysis of exposure management; Chapter 12's discussion of legal and historical analyses of foreign direct investment; and Chapter 14's discussion of the Euro-dollar market. Although many instructors preferred cases of the length in the first edition, many others preferred more cases and/or shorter cases. To that end, we have added several cases, deleted one, and condensed many others. The especially long cases of the first edition (i.e., Cummins Engine and FNCB Finance) have been cut in half, but we have hopefully retained most of the key elements that we used for our teaching, as discussed in the Instructor's Manual. On balance, we hope that the content changes and the editorial improvement will make the book more useable to a wide audience while continuing to serve well the basic group reached with the first edition. Our thanks to the many professors and financial executives (many of whom are listed below) whose ideas helped us complete this new edition. Naturally, there is always a conflict of views, with a solution in the null set. However, we hope that the balance we have chosen here, together with what we have said about particular topics, will be welcomed.

The text is ideally designed for upper-level undergraduates or MBA/MS students who have completed introductory courses in finance and economics. There are exercises, questions, and cases at the end of most chapters, which can be used by the instructor to emphasize different points. Some instructors will want to include all the cases in their courses, perhaps using the chapters only for casual or background reading. Given the detail with which some of these cases may be handled (computer output and other materials are included in the Instructor's Manual), these cases and exercises can require at least 20 class sessions. Additional cases could be used in the remaining classes in a typical 30-class, one-semester course. Other instructors will prefer to emphasize the text and exercises supplemented by articles. The detail of these chapters and exercises easily can support 20 or more classes. The supplementary articles and notes on various capital markets and other items (which are available through us) could complete the one-semester course.

Instructors with a one-quarter course also could use this text, assuming they have only 20 or 25 classes. If all the topics are to be covered, we suggest having students read Chapters 2 and 3 and the summary to Chapter 4, with the instructor lecturing on various proposals regarding the balance of payments once the students understand the background materials. A single class on the balance of payments for students who are not familiar with the subject might involve reading Chapter 2 and the summaries to Chapters 3 and 4. Chapters 5, 6, and 7 could be read in total, and the more involved framework offered for handling exposure to exchange risk presented in Chapter 9 deleted or left for optional reading. Chapters 10 and 11 outline the basics of international capital budgeting. The additional material from other disciplines and the security/portfolio models in Chapters 12 and 13 could be deleted or reviewed in a lecture. Finally, selected readings from the two chapters on the Euro-markets could complete the text material. Four or five of the simpler cases and the exercises could round out the one-quarter course.

Our approach is to use a simple lecture or case to highlight a problem, then have a chapter and a lecture to suggest various ways of looking at the problem (the theory), and conclude with the application of the theory to the complex real situation presented by another case. Accordingly, the materials in this book can more than fill a one-semester course of 30 or 35 classes. The selection of materials will be at the judgment of the instructor, consistent with the instructor's background and interests, the previous exposure of the students, and their particular needs in the course.

If students have a strong background in international economics. Chapters 2 through 4 can be skipped. For instructors who particularly want to emphasize this topic, additional readings and texts may be assigned with this material used only as background. Similarly, instructors who are not interested in the particular elements of trade credit financing will have their students skip the latter part of Chapter 6, whereas other instructors will want to supplement this material with one of the bank booklets on international financial instruments. Students who have been exposed to international business courses will not need to read the first half of Chapter 12, which brings in various economic and behavioral theories of foreign investment; other instructors will supplement this chapter with readings from the international business area. In some classes, more time can be spent on the various international security portfolio studies and the capital asset pricing model, with the implications of these topics for corporate diversification. With other groups, Chapter 13 can be deleted if this topic is not of interest or if the small amount of algebra included here is beyond the level of the students. Finally, some instructors will not find the institutional material on the Euro-markets contained in Chapter 14 through 16 (Part Four) of relevance or interest to their students.

The table on the next page summarizes some of our suggestions where instructors have a variety of interests and amounts of time to spend on particular topics. Optional choices for a given day are separated by a slash (/). Within reasonable ranges, these topics are fairly self-contained; the instructor may wish to elaborate on the rudiments of some prior topic if desired. We tend to take a chapter per day as written in total, generally in the order of the book, inserting the taxation appendix prior to Chapter 10. Taxation is deliberately presented as an appendix to the book to emphasize the fact that it may be studied at any time.

Thus, the segmentation of the text in various parts and the inclusion of cases, questions, and exercises provide a range of basic materials. In most classes, this material will provide sufficient coverage for a semester. For those instructors who wish further supplemental materials, the four parts of the text are somewhat self-contained, permitting use of the text as a basic book supplemented by other readings. Our desire has been to present a text that has a sufficient amount

	Number of Classes		
Topic	*1*	*2*	*3-5*
Balance of Payments/ Monetary System	Chapter 2 and Summaries, Chapters 3 and 4	Chapter 2 and Summary, Chapter 3, Chapter 4	Chapter 2 Chapter 3 Chapter 4/Britannic Intl. Shipping
Foreign Exchange (FX)	Chapter 5	Chapter 4 (Purchasing Power) and Chapter 5 Chapter 6 (FX Risks) and Citibank/Ken and Joan Morse (Appendix, Chapter 5 optional)	Ken and Joan Morse Chapter 4 (PPP) and Chapter 5 Chapter 6 (FX Risks) and Exercises, Chapter 5 Citibank (Appendix, Chapter 5 optional)
Trade Instruments	Chapter 6 (Trade Instruments)	Chapter 6 (Trade Instruments) AP&M/Chapter 6. Question 6	Chapter 6 (Trade Instruments) Question 6 AP&M
Exposure Management	Chapter 7	Chapter 7 Chapter 8/Continental Group	Chapter 7 Marwick/Continental Group/ Chapter 8 Chapter 9/Green Valley/ Farmatel
International Accounting and Control	Chapter 7 and Appendix, Chapter 8	Chapter 7 Chapter 8	Chapter 7 Chapter 8/Marwick/Farmatel Continental Group/Green Valley
Capital Budgeting	Chapter 10 and Summary, Chapter 11	Chapter 10 Chapter 11/Chaolandia	Chaolandia Chapter 10 Chapter 11
Capital Budgeting and Financial Strategy (Assumes at least one day from Capital Budgeting section above)	Chapter 12/International Tire	Chapter 12 Chapter 13/International Tire/ Cummins Engine/Freeport	International Tire Chapter 12/Cummins Engine Chapter 13 Freeport
Eurocurrency Markets	Chapter 14	Chapter 14 and Appendix, Chapter 14 Exercises on Euro-$/Citicorp Leasing	Chapter 14 Appendix, Chapter 14 and Exercises Citicorp Leasing/ Green Valley
International Capital Markets	Chapters 15 and 16	Chapter 15 Chapter 16/Altos Hornos/FNCB Finance	Chapter 15 Chapter 16 Altos Hornos/FNCB Finance
International Taxation	Appendix 1	Appendix 1 Sola Chemical/Questions 1–4 and 5 (optional)	Soia Chemical Appendix 1 Questions 1–5

of basic material from which many instructors can select topics for their international corporate finance course.

This textbook reflects our biases and prejudices toward the blending of various disciplines under the umbrella of an international corporate finance framework, and toward the mix of theory, practice, and institutional description. We have benefited from the suggestions on portions of the text from many individuals. Gunter Dufey (University of Michigan), Hai Hong (University of Singapore), and Warren Law (Harvard Business School) commented on the entire first edition manuscript in detail with many useful and insightful suggestions. We thank them of behalf of the readers.

Our appreciation also to Tamir Agmon (Tel Aviv University); Mark Eaker (Duke University); Ian Giddy (Columbia University); Edward M. Graham (Department of the Treasury); Charles Kindleberger, Stephen J. Kobrin, Donald Lessard, Franco Modigliani, James Paddock, and Richard Robinson (Massachusetts Institute of Technology); John Ingersoll (University of Chicago); Michael McIntyre (Wayne State University); David A. Ricks (The Ohio State University); Rostislov Romanoff (Northern Trust); Henry Schloss (University of Southern California); N. Jackendoff (Temple University); Oscar Holzmann (University of South Carolina); Lemma Senbet (University of Wisconsin-Madison); Dennis Logue (Dartmouth); D. M. Pattille (Northeastern University); L. William Murray (University of San Francisco); and Christine Hekman, Robert Stobaugh, Raymond Vernon, and William White (Harvard Business School) for reacting to various ideas and chapters. Our appreciation is offered to Professors Raymond Vernon and Robert Stobaugh for permission to use the Sola Chemical case. With the exception of *Citibank's Foreign Exchange Problems* (a collection of news articles), all of the other cases were authored by Rita M. Rodriguez, and we gratefully acknowledge the assistance or co-authorship of Marc Buxton, Henri de Bodinat, Cesar Duque, Kenneth Morse, Jules Pogrow, L. E. Simmons, Endre Toth and Mark Wallerstein. Dev Purkayastha helped in the preparation of Chapter 8, and Manu Parpia helped in the revision of Part Four. We are also grateful for the outstanding contribution of our first edition editor, Paul McKenney, who endured the convoluted prose emerging from an immigrant's and a technocrat's collaboration. His efforts sharply improved the text.

Completion of the second edition was considerably helped by the careful editorial work of Barbara Satz, and we thank her for her patience. Our thanks also to Marian Hartstein, production editor of the second edition, who managed tardy authors at multiple mailing addresses with patience and effectiveness.

Any deficiencies in style or substance are the responsibility of the authors.

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Contents

CHAPTER 1

Introduction

During recent years, the corporate financial manager has become increasingly concerned with the changing international scene. Fluctuating foreign exchange rates, the power of multinational corporations, balance of payments deficits, and the growth of "petrodollars," have come to be important issues for all U.S. and foreign corporations with international operations. To confront these problems with some hope for resolution requires a knowledge of both the macro-economic environment in which the firm operates (balance of payments, government policies, credit availability) and the micro-economic environment which relates to the specific decisions that the manager will face (how the firm manages its exposure to foreign exchange risk, how it analyzes its capital budgeting problem, how it accommodates the demands for funds from subsidiaries in different countries). Before we embark on the discussion of specific financial problems, however, it may be useful to briefly introduce the business institution that houses the international decision makers: the multinational company.

THE MULTINATIONAL FIRM

For many critics, the multinational firm is a global octopus, which at best is spreading knowledge and technological pollution around the world while swallowing assets everywhere and evading all national attempts to control it.