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### PREFACE



### APPROACH

The basic thrust of this third edition of Foundations of Multinational Financial Management is to provide a conceptual framework within which the key financial decisions of the multinational firm can be analyzed. As in the fifth edition of Multinational Financial Management, my more comprehensive book on this topic, 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.

Foundations 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

Foundations of Multinational Financial Management is a shorter version of my other text, Multinational Financial Management (MFM). It emphasizes broad concepts and practices rather than extensive quantitative material. Compared to MFM, Foundations reduces the

range and complexity of the subject matter covered. Although *Foundations* is intended primarily for an undergraduate audience, it is suitable for use in masters level courses where there is not enough time to cover the full range of topics dealt with in MFM or where the students do not have the necessary preparation for using MFM. It is also suitable for use in bank management and other executive development programs.

#### **FEATURES**

Foundations of Multinational Financial Management presumes a knowledge of basic corporate finance, economics, and algebra. However, it assumes no prior knowledge of international economics or international finance and is, therefore, self-contained in that respect. For those who are not familiar with MFM, here are some of the distinctive features that have led to its widespread adoption. These features have been incorporated and enhanced in *Foundations*.

Distinctive topic coverage includes the following:

- Role of expectations in determining exchange rates (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 and optimum currency areas (Chapter 3)
- Use of the balance-of-payments framework to assess the economic links among nations (Chapter 4)
- Comprehensive discussion of the foreign exchange market and its institutions and mechanisms, including electronic trading (Chapter 5)
- Understanding of currency futures and options contracts (Chapter 6), and their use in exchange risk management (Chapter 9)
- Use of currency risk sharing in international contracts (Chapter 9)
- Identification of the economic, as opposed to accounting, aspects of foreign exchange risk (Chapter 10)
- Development of marketing and production strategies to cope with exchange risk (Chapter 10)
- Analysis of how Japanese firms have coped with yen appreciation (Chapter 10)
- Role of countertrade in financing international trade (Chapter 11)
- Calculating the cost of acceptance financing and factoring (Chapter 11)
- Evaluation of foreign currency denominated debt (Chapter 12)
- Costs and benefits of managing interaffiliate fund flows on a global basis (Chapter 13)
- Integration of tax management with financial management based on the Tax Reform Act of 1986 and subsequent tax law changes (Chapters 13 and 16)
- Use of interest rate and currency swaps (Chapter 14)
- Origins and nature of the Eurocurrency and Eurobond markets (Chapter 14)
- Discussion of new perspectives on the international debt crisis and country risk analysis (Chapter 15)

- Assessment of the cost of capital for foreign investments (Chapter 16)
- Understanding of the nature and consequences of international portfolio investment (Chapter 17)
- Development of global strategies of MNCs (Chapter 18)
- Assessing the true profitability of a foreign operation (Chapter 19)
- Valuation of the growth options often associated with foreign investments (Chapter 19)
- Understanding of political risk measurement and management, with a discussion of the dramatic changes taking place throughout Latin America, Eastern Europe, and China (Chapter 20)

### CHANGES TO THE THIRD EDITION

The third edition of *Foundations of Multinational Financial Management* has been extensively rewritten. The number of chapters has been reduced from 25 to 20 and the material has been reorganized. Specific changes that have been made to the third edition include the following:

- Appendix 1A (The Origins and Consequences of International Trade) provides a
  more 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.
- The section on interest rate parity theory has been transferred from Chapter 7 (Parity Conditions in International Finance) to Chapter 5 (The Foreign Exchange Market) where it provides the link between the spot and forward exchange markets and money markets.
- Chapters 10 (Measuring Economic Exposure) and 11 (Managing Economic Exposure) have been shortened and combined into a new Chapter 10 (Measuring and Managing Economic Exposure).
- Part III (Working Capital Management) has been rearranged and shortened. Chapter 12 (Short-Term Financing) has been consolidated with the previous Chapter 14 (Current Asset Management) into a new Chapter 12 (Current Asset Management and Short-Term Financing).
- The old Part V (Financing Foreign Operations) has now been shifted to come before the old Part IV (Foreign Investment Analysis, which is now Part V). Old Chapter 22 (Swaps) has been consolidated with old Chapter 21 to create a new Chapter 14 (International Financing and International Financial Markets). The aim was to deal with the financing subject matter, including the cost of capital, prior to discussing the investment decision.
- Part VI (International Banking) has been eliminated. Instead, the two chapters comprising it have been shortened and consolidated into one new Chapter 15 (International Banking Trends and Strategies).
- Chapters 19 (The Cost of Capital for Foreign Investments) and 23 (Designing a Global Financing Strategy) have been consolidated into one new Chapter 16 (The Cost of Capital for Foreign Investments).

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 a number of new end-of-chapter problems
- Extensive discussion of the August 1993 currency crises in the European Monetary System and the currency crisis in Mexico in 1994–1995
- Comparing hedging alternatives when there are transaction costs
- Discussion of cross-hedging using a simple regression analysis
- Discussion of how to structure and use currency collars (or range forwards) and currency cylinders to hedge exchange risk
- Discussion of new transfer pricing issues and "earnings-stripping" charges involving foreign company operations in the United States
- Analysis of exchange risk associated with foreign portfolio investments
- Extended discussion on alternative approaches to estimating the cost of capital for foreign operations
- Addition of two new cases, including a comprehensive case on currency forecasting and exchange risk management (Case of the Depreciating Indian Rupee) and another on the assessment of currency risk management (Link Technologies)
- Discussion of Euro-medium term notes
- Discussion of fixed-for-fixed and fixed-for-floating currency interest rate swaps

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 ends of the chapters, 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, there are numerous real-world examples and vignettes that 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 examples and illustrations of specific concepts and techniques are scattered throughout the body of most chapters.
- 3. Lengthier Illustrations of Corporate Practice. There are seven longer illustrations of actual company practices, at the end of key chapters, that 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. The introduction to each chapter also contains a list of key terms. Placing these terms at the beginning of the chapter gives readers added preparation for what is to come.
- 7. **Key Concepts**. Most pages contain one or two key ideas in the margins next to the point where these ideas appear in the text. Highlighting these key ideas serves as an effective study and review tool for students.
- 8. Glossary. The back of the book contains a Glossary that defines all the key terms appearing in the text.
- 9. **Supplements**. A complete set of ancillary materials is available for adopters of *Foundations* to supplement the text. These include:
- An Instructor's Manual and Test Bank containing detailed solutions to the endof-chapter questions and problems, tips for teaching each chapter, and over 160 additional questions and problems suitable for use in multiple-choice exams.
- A Study Guide written by Professor Anderea L. DeMaskey, Villanova University, is available. The Study Guide contains detailed chapter outlines and a number of solved questions and problems.
- Power Point Presentation Graphics available for downloading from the Wiley Web site, http://www.Wiley.com/college/shapiro3e.

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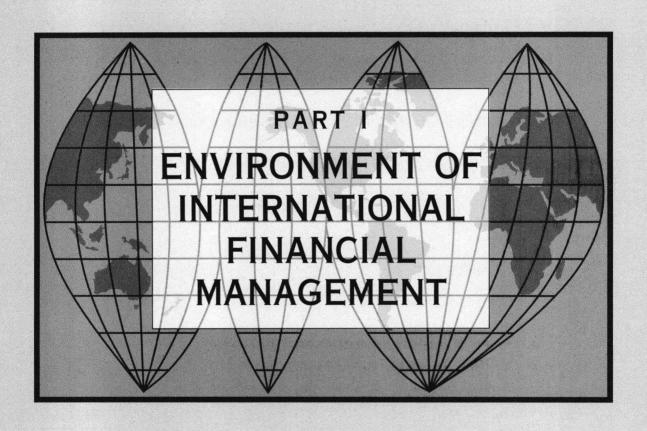
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# INTRODUCTION: MULTINATIONAL ENTERPRISE AND MULTINATIONAL FINANCIAL MANAGEMENT

### **Key Terms**

arbitrage capital asset pricing model capital market imperfections doctrine of comparative advantage exchange controls financial channels financial economics financing decision foreign direct investment global economy globalization process global manager interaffiliate trade credit international diversification internationalization investment decision investment flows leading and lagging less-developed countries (LDCs) licensing market efficiency multinational corporation (MNC) multinational financial system reverse foreign investment risk arbitrage systematic risk tax arbitrage total risk transfer prices unsystematic risk

What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage.

Adam Smith (1776)

### CHAPTER LEARNING OBJECTIVES

- To explain why multinational corporations are the key players in international economic competition today
- To classify the three historical types of multinational corporation (MNC) and explain their motivations for international expansion
- To identify the stages of corporate expansion overseas by which companies gradually become MNCs
- To explain why managers of MNCs need to exploit rapidly changing global economic conditions and why political policymakers must also be concerned with the same changing conditions
- To describe the areas of financial flexibility and opportunity available to financial managers of MNCs for moving money and profits among their affiliated units to maximize overall corporate value and explain why these financial decisions may conflict with national objectives
- To identify the advantages of being multinational, including the benefits of international diversification
- To describe the general importance of financial economics to multinational financial management and the particular importance of the concepts of arbitrage, market efficiency, capital asset pricing, and total risk
- To characterize the global financial marketplace and explain why MNC managers must be alert to capital market imperfections and asymmetries in tax regulations

International business activity is not new. The transfer of goods and services across national borders has been taking place for thousands of years, antedating even Joseph's advice to the rulers of Egypt to establish that nation as the granary of the Middle East. Since the end of World War II, however, international business has undergone a revolution out of which has emerged what is probably the most important economic phenomenon of the latter half of the 20th century: the multinational corporation.