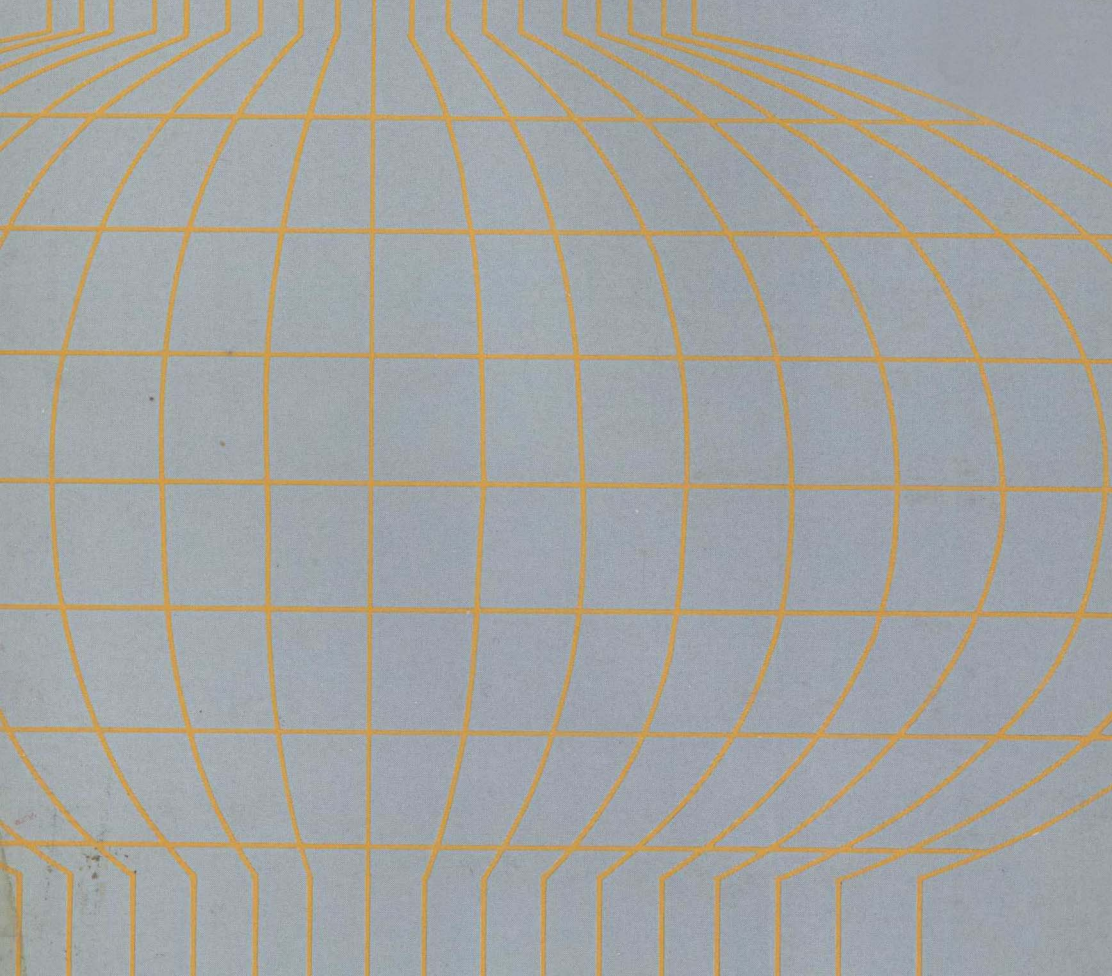


# **The Finance of International Business**

**Brian Kettell**



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**Graham & Trotman**  
*Publishers*

Published in 1979 by  
Graham & Trotman Limited  
Bond Street House  
14 Clifford Street  
London W1X 1RD  
United Kingdom

© Brian Kettell, 1979

ISBN: 0 86010 151 7

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Printed in England by MCorquodale (Newton) Ltd.,  
Newton-le-Willows, Lancashire.

# **AUTHOR'S NOTE**

## **RELAXATION OF UNITED KINGDOM EXCHANGE CONTROLS**

In the United Kingdom Budget Statement of 12 June 1979 the following exchange control relaxations were announced.

### **Outward direct investment**

(i) For new investments, the use of foreign currency purchased at the current market rate in the official exchange market ('official exchange') will be permitted, on application to the Bank of England, up to a total of £5 million per investment project per year. Under the old rules, described in chapter 4, most direct investment abroad had to be financed by foreign currency borrowing or out of profits retained abroad, official exchange being available only in 'super-criterion' cases.

(ii) UK companies will no longer be expected to repatriate annually at least two-thirds of the net taxed earnings of their subsidiaries overseas.

(iii) Existing foreign currency borrowing will be repayable with official exchange in five equal annual instalments; and new authorised borrowing will similarly be repayable over five years to the extent that repayment cannot be met out of the annual entitlement to official exchange in (i) above. In addition it was announced that sterling could again be used by UK resident merchants to finance third country trade.

### **Outward portfolio investment**

(i) Investors will no longer be required to maintain cover in the form of foreign currency securities or investment currency equal to 115 per cent of the value of amounts borrowed to finance portfolio investment.

(ii) Official exchange will be allowed for interest payments on foreign currency borrowing for portfolio investment.

With effect from 19 July 1979, the following additional exchange relaxations were announced:

(i) Currency will be available without limit at the official exchange rate for all outward direct investment, and foreign currency borrowing to finance such investment can be repaid at the official rate;

(ii) UK residents can invest at the official exchange rate in most securities denominated and payable solely in the currencies of

other EEC countries, with the exception of unit and investment trusts;

(iii) Foreign currency borrowing by UK residents to finance outward portfolio investment which has been outstanding for at least up to 19 July 1979 will be repayable at the official rate.

# Foreword

**by Andreas R. Prindl**

The literature dealing with the growth of multinational enterprises is itself expanding at an equally rapid pace. Many new studies are appearing which deal with the multinational company's political influence, its inter-relations with host governments and the effects—positive or negative—on labour or on the local markets where it operates or to which it sells. A growing subsection of that literature takes as its focal point the financial management of these companies. Some analysts, for example, have tried to fit the financing/investment decisions of the multinational corporation (MNC) into more general theories of the firm or corporate finance. Others have focused on describing the different environments the MNC faces in various parts of the world. Such analyses have pointed out unique characteristics of multinational enterprises, particularly their fragmentation into disparate segments, isolated by distance, problems of communications, exchange controls and tax differences.

It has been difficult, however, for businessmen or students to find a compact, straightforward account of the financial management problems of the MNC which is not overly theoretical. Mr. Kettell, in this volume, has had filling this gap as his goal, by bringing together three main elements of the multinational finance function. These sectors, treated sequentially, are the market framework in which the MNC operates, the management of foreign exchange risk, and the international financing decision.

In the chapters on international monetary flows and markets, the author points out the theory of balance of payments accounting and the various mechanisms for dealing with surpluses or deficits in a country's external accounts. This is a clear starting point for understanding the MNC's financial decisions, because any prediction of the movement of currency values or interest rate levels will in part be predicted on analysis of balance of payments positions, how a country's payment flows go awry, and what government authorities may do to bring imbalances back to equilibrium.

Multinationals themselves, of course, can add to disequilibrating forces by their own actions; they are in any case directly affected—more than other economic groups—by balance of payments corrective measures.

From that introduction, the foreign exchange markets—the counter over which international monetary flows pass—are described. The functions of foreign exchange transactions are

diverse; the inter-relationships and special functions of the spot and forward exchange markets and deposit markets are brought out with examples. Paralleling a practical description of market mechanics is a chapter on the determination of exchange rate parities.

This area is still controversial, as the author's portrayal of several major theoretical approaches to understanding exchange rate changes points out. There is general agreement that, over the long run, differentials in productivity and inflation rates will directly influence a country's international competitiveness and the value of its currency measured against others. Yet short-term exchange rate movements, often quite dramatic in scope, can be based on expectations, speculative positions or even a sort of panic, none of which may be justified by longer-term economic fundamentals. Indeed, occasionally one feels that a good guide to understanding runs on the exchange markets would be to study the behaviour and delusions of crowds.

Conversely, a government may delay a corrective movement of its exchange rate, although warranted by economic forces, most commonly these days through 'dirty floating'. Kettell points out how the international monetary system has evolved since World War II to deal with disequilibrium and the conflicting motives of national governments.

The core of the book, mirroring the primary distinguishing characteristic of the MNC, is the function of foreign exchange exposure management in the firm. He follows a stage by stage approach of pointing out firstly the problems of *defining* foreign exchange exposures, then of *measuring* and *identifying* exposed positions. The consolidation rules ordained by each country's accounting profession are the starting point for defining one standard type of exposure: that arising from consolidating the financial statements of a parent multinational and those of its several subsidiaries, when these are carried in a number of currencies. Contrasted with such accounting treatment are two other types of exchange exposure: transaction risk and economic risk. The latter can be particularly critical in a firm's decision making and planning, yet correspondingly difficult to project or quantify.

Kettell's analysis offers managerial guidelines towards controlling and managing these exposures, once defined and identified. Chapter 8 concentrates on *internal* measures open to the MNC to change or protect its positions worldwide, Chapter 9 on the *external* techniques available. It is commonly supposed that buying or selling currencies forward for a future maturity date is the principal hedging method, whereas this may be the last technique utilized by a sophisticated multinational, and then only for residual net positions. Nearly a dozen internal, and an equal number of

external hedging applications are described; all of these need to be considered in light of their appropriateness and cost-effectiveness.

The text concludes with two chapters on Euro-currency and international capital markets, combining a run-down of market participants, volumes and constraints with guidelines as to how MNCs tap these markets for funding or investment of their surplus liquidity. Kettell shows how these flexible, wide-spread financial markets complement the needs and the structure of the MNC itself.

The author provides a further service to the reader by summarizing throughout the book a number of theories about the MNC financial function. Recent, sometimes seminal, writings of academics and businessmen are reviewed and their contribution to understanding the decision making process weighed.

Thus, the following text gives a succinct guide to parts of a complex financial function, a guide which can be used by businessmen who have dealt primarily with domestic financial problems or by economics or business students. These days, we are all involved with MNCs—we may manage or be employed by them, lend to or borrow from them, or, if in government, attempt to understand (and often circumscribe) their activities. With certainty, our major firms will be in competition with multinational companies of one kind or another, either for customers, or in a world where resources are finite and being used up at a worrisome pace, for raw materials. The growth of multinationals has also complemented and fostered the mutual interdependence of nations, vastly accelerating a trend which began in the 17th century with exploration voyages and colonizing expeditions. To understand this interdependence is imperative for any thinking person; to study one of its constituent parts—the finance function of the MNC—is one part of the process.

Tokyo  
June, 1979



## Acknowledgements

The author would like to thank the generous assistance provided on selected chapters by Peter Muller, Assistant Vice President, Morgan Guaranty Trust, New York; John Atkin, Economist at Citibank; B C White, Assistant Manager, Lloyds Bank and Assistant Examiner, Finance and Foreign Trade and Foreign Exchange, Institute of Bankers; Stephen Bell, Senior Economic Assistant, HM Treasury. Responsibility for any error remains with the author.

The publishers are indebted to the following organisations for permission to reproduce previously published material: Amex Bank Limited, The Banker, J F Chown & Company Limited, Continental Illinois Ltd, The Economic Intelligence Dept of the Bank of England, the Economist Intelligence Unit Ltd, Euromoney, The Export Credit Guarantee Dept, The Federal Reserve Board of New York, The Financial Management Association and A C Shapiro and D P Rutenberg, Harper and Row Ltd, Harvard University Press, Her Majesty's Stationery Office, The International Chamber of Commerce, The Institute of Bankers, Macmillan, Morgan Guaranty Trust Company, South Western Publishing Company, Phillips & Drew, John Wiley and Sons Ltd.

# CONTENTS

List of tables	viii
List of figures	xi
Author's note	xiii
<b>Foreword by Andreas Prindl</b>	xv
<b>1 Introduction</b>	1
<b>2 International Financial Flows</b>	9
Appendix 1 The UK Balance of Payments	26
Appendix 2 The US Balance of Payments	32
<b>3 The Foreign Exchange Market</b>	37
Appendix 1 Interest Arbitrage and the Determination of the Forward Exchange Rate	63
Appendix 2 Indices of Exchange Rates	65
<b>4 Factors Affecting Exchange Rates and the Problems     Associated with Forecasting Exchange Rates</b>	66
<b>5 The International Monetary System from 1945 to the     Present</b>	90
Appendix 1 Foreign Exchange Rates	118
<b>6 Financing International Trade</b>	119
Appendix 1	135
<b>7 Foreign Exchange Risk: The Problems of Definition,     Measurement and Identification</b>	136
Appendix 1 A Transaction Loss	165
Appendix 2 A Transaction Gain	166
Appendix 3 Effects of the Use of Different Translation Methods on the Consolidation of Foreign Subsidiaries	167
Appendix 4	170
<b>8 Internal Techniques for Managing Foreign Exchange     Exposure</b>	171
Appendix 1 Exposure Management Techniques	183
<b>9 External Techniques for Managing Foreign Exchange     Exposure</b>	184
Appendix 1 Exchange Financing	207
<b>10 The Euro-Currency Markets</b>	215
Appendix 1	233
<b>11 The International Bond Markets</b>	235
Appendix 1 International Bond Issues	255
Glossary of Foreign Exchange Terms	256
Glossary of Eurobond Terms	257
Bibliography	261
Index	268

# LIST OF TABLES

2.1	Balance of payments	27
2.2	HMG foreign currency debt at 1 April 1977	30
2.3	Foreign currency borrowing by other UK public sector borrowing at 1 April 1977	31
2.4	US international transactions	33
3.1	Examples of spot prices on the London and New York markets	40
4.1	Merchandise trade balance (1971–1977)	70
4.2	Net balance on services	70
4.3	Net capital flows	72
4.4	Effect of Government policy on exchange rates	73
4.5	Monetary targets	77
5.1	Central rates and intervention rates between the European countries participating in the joint float as at 16 November 1978	100
5.2	Distribution of changes in international reserves 1970–1976	103
5.3	US external liabilities and claims	106
5.4	Exchange rate systems	111
5.5	Trade patterns of members of the European Communities	112
5.6	EMS intervention rates at 12 March 1979	116
7.1	An example of where transaction exposure occurs	137
7.2	Where translation exposure occurs	138
7.3	Possibility of exchange exposure	139
7.4	Translation rules in different accounting methods	142
7.5	Translation methods in various countries	143
7.6	Balance presentation of various currencies by subsidiaries	149
7.7	A currency histogram	152

7.8	Decision format	153
7.9	Translation rules of the temporal method	156
7.10	Effect of America's FAS 8 on the parent company of a change in the exchange rate influencing a subsidiary	157
7.11	Effect of translation losses due to FAS 8	158
7.12	Summary of executives' opinions regarding retention, modification or repeal of FAS 8	160
7.13	Translation methods used by British companies	162
8.1	Leading and lagging of receipts	174
8.2	Summary of leading and lagging constraints	175
8.3	Effect of invoicing exports in sterling and imports in dollars combined with a sterling devaluation	176
8.4	Hedging strategies	179
9.1	Comparison of three-month forward rate with actual change in future spot rate	186
9.2	Effective cost of borrowing currencies	192
9.3	General review of taxation treatment—realised gains and losses	193
9.4	General review of taxation treatment—unrealised gains and losses	194
9.5	IMF SDR formula	198
9.6	Composition of the European unit of account	200
10.1	Euro-currency market	215
10.2	Euro-currency interest rates	223
10.3	Interbank rates on 3 month Euro-currency deposits and differentials over domestic rates	225
10.4	Consortium bank results	230
11.1	International financial markets	235
11.2	International bonds	236

11.3	Foreign bonds issued inside the USA	237
11.4	Foreign bonds issued outside the USA	238
11.5	The growth of Euro-bond market 1970–78	239
11.6	Lead managers and co-managers of internationally syndicated bond issues in 1977	243
11.7	Euro-currency bank credits	248
11.8	Average loan rate spreads on new Euro-currency bank credits to governments and state enterprises in selected countries	252
11.9	Average final maturities on new Euro-currency bank credits to governments and state enterprises in selected countries	254

## LIST OF FIGURES

1.1	Average number of new subsidiaries formed by US multinational companies 1914–1970	2
1.2	Average number of new subsidiaries formed by continental European multinational companies 1914–1970	3
1.3	Nations and corporations	4
1.4	Overseas contributions to profits of UK companies	5
2.1	An example of balance of payments accounting	13
2.2	A fixed but adjustable exchange rate	16
2.3	A fixed exchange rate with wide bands	17
2.4	A crawling peg exchange rate	18
2.5	A free floating exchange rate	19
3.1	The pound spot and forward against the pound	45
3.2	The dollar spot and forward against the dollar	45
3.3	The pound in New York	46
3.4	Covered interest arbitrage	63
4.1	Trends of current balances	71
4.2	Official interim targets and actual supply growth rates and the Federal Funds Rate	78
4.3	Purchasing power parity as a forecasting technique of the sterling/dollar exchange rate	86
5.1	US balance of payments	94
5.2	Composition of world reserves	95
5.3	World exports and world reserves	95
5.4	US gold reserves and external liabilities	98
5.5	Withdrawal of sterling from the 'snake in the tunnel'	99
5.6	Movements of spot exchange rates within the joint float of European currencies	102
5.7	London gold price	106

5.8	Swiss gold price	107
6.1	International trade financing under a sixty-day sight-draft transaction: exporter's currency	123
9.1	Three-month forward rate as a predictor of the future sterling/dollar spot rate	187
9.2	Forward sterling rate	188
11.1	An example of a 'tombstone'	242
11.2	Lending margins for prime borrowers in Euromarkets	253

# 1

## Introduction

### THE IMPORTANCE OF MULTINATIONAL COMPANIES

One of the most remarkable economic phenomena of the post-war period has been the rise of the multinational enterprise. Forecasts indicate that the size and importance of multinational companies, defined as business enterprises which own and control activities in different countries, will increase in the second half of the twentieth century.

The average number of new subsidiaries formed per annum by geographical area for a sample of 187 U.S.-based parent multinational enterprises between 1914 and 1970 can be seen from Figure 1. The 1950s were characterised by a significant increase in the growth of overseas subsidiaries of U.S. multinational enterprises.

In the 1960s there was a significant growth in the average number of new subsidiaries formed per annum by geographical area by certain continental European-based multinational enterprises (Figure 1.2).

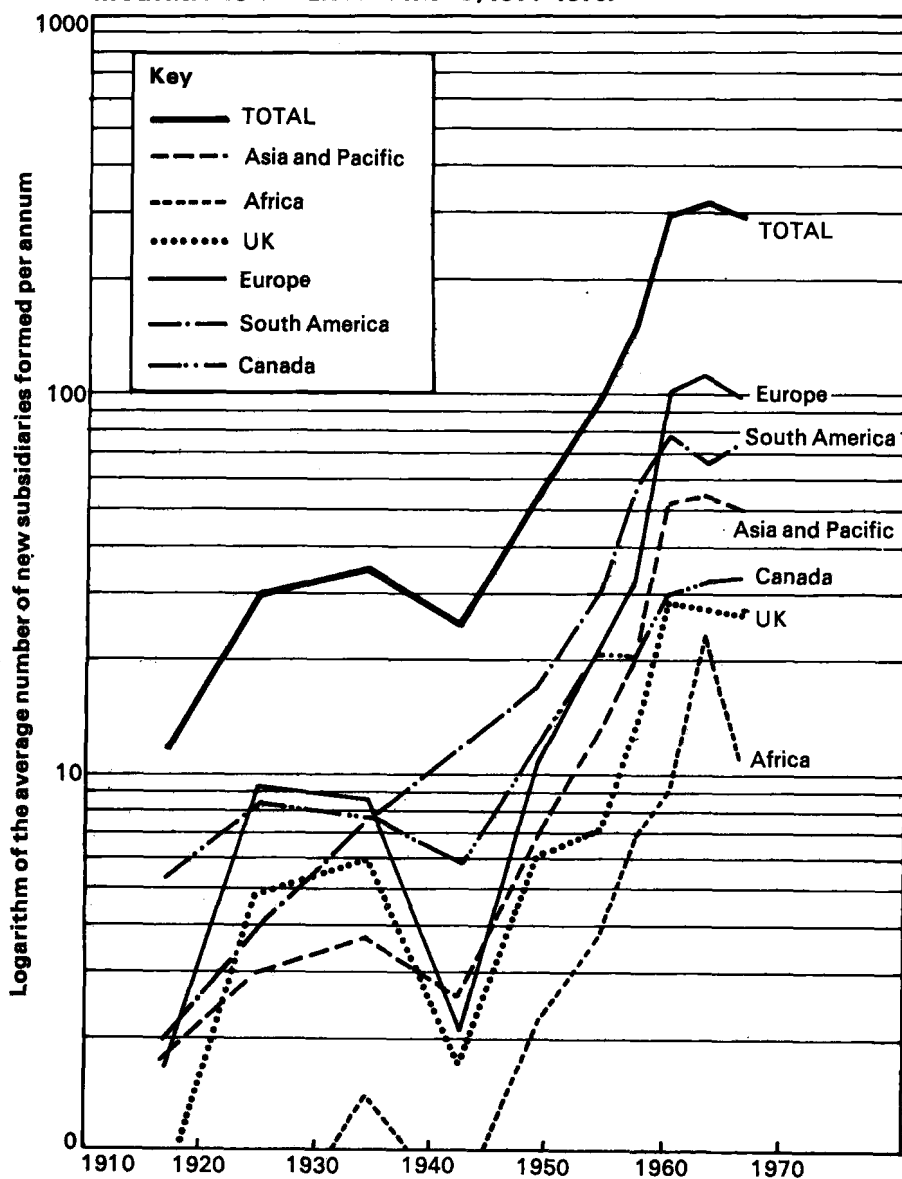
The very high levels of U.S. investment in Europe in the early 1960s described by Servan-Schreiber in *'The American Challenge'* have fallen away in the face of a European riposte<sup>1</sup>. However, despite the recent growth of European investment, the U.S.A. remains the principal foreign investor in most countries because of the cumulative effect of its high level of investment throughout the post war period.

The absolute size of multinational business is such that the annual sales of many multinationals is greater than the Gross National Product of many small to medium-sized economies. As can be seen from Figure 1.3, of the 100 largest economic entities in the world in 1973, 43 places were accounted for by multinational companies.



**Figure 1.1**

**AVERAGE NUMBER OF NEW SUBSIDIARIES FORMED PER ANNUM  
BY GEOGRAPHICAL AREA, FOR A SAMPLE OF 187 US-BASED  
MULTINATIONAL ENTERPRISES, 1914-1970.**



Source : JW Vaupel and JP Curhan, *'The Worlds' Multinational Enterprises'* Geneva, 1974.