The Finance of International Business

Brian Kettell

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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 to 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

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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.

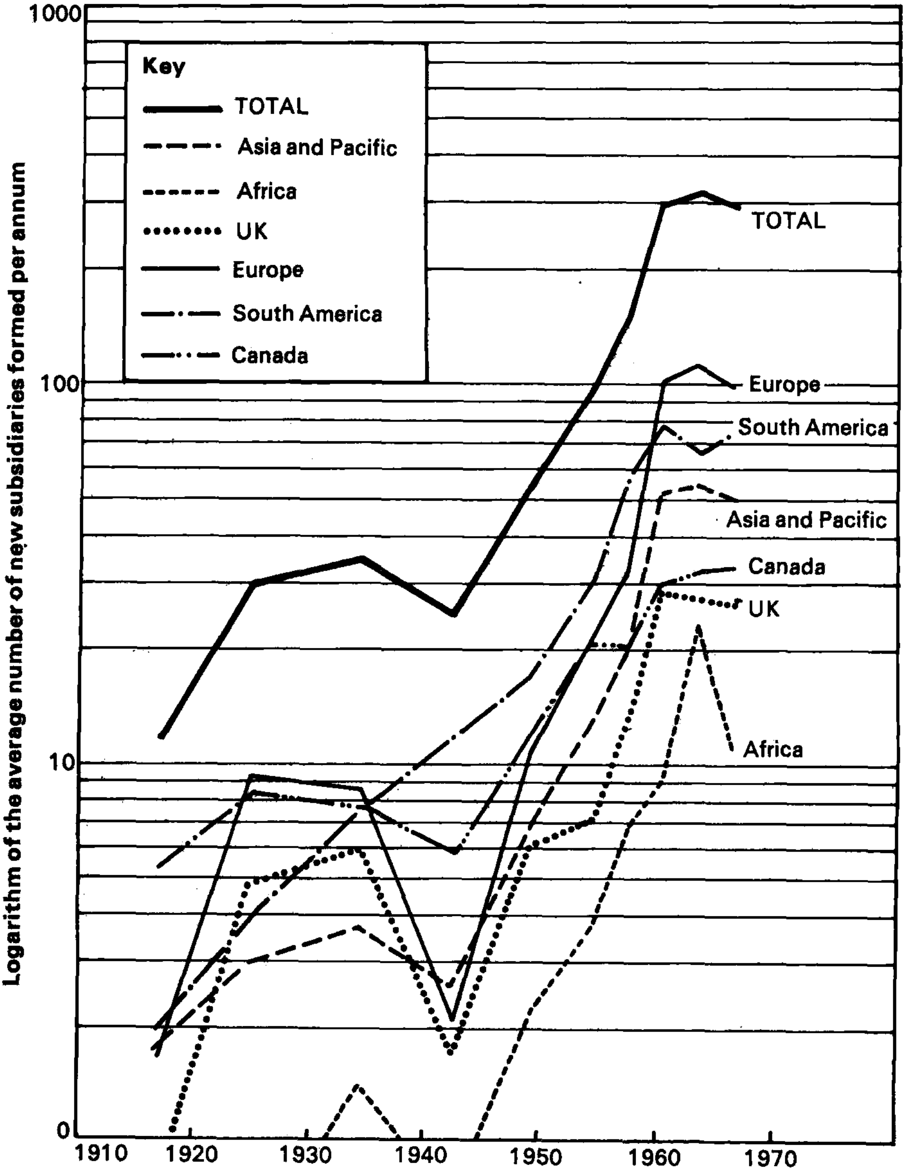
In the 1960s there was a significant growth in the average number of new subsidiaries formed per annum by geographical area by certain continental European-based multinational enterprises (Figure 1.2).

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[1]. 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.