Chapter Objectives:

Understand why it is important to study international finance.

Distinguish international finance from domestic finance.
Chapter One Outline

- What’s Special about “International” Finance?
- Goals for International Financial Management
- Globalization of the World Economy
- Multinational Corporations
- Organization of the Course
- Summary

What’s Special about “International” Finance?

- Nations are sovereign & set their own policies →
  1. Foreign Exchange Risk
  2. Political Risk
  3. Market Imperfections
  4. Expanded Opportunity Set
1. Foreign Exchange Risk

- The risk that foreign currency profits may evaporate in home-currency terms due to unanticipated/unfavorable exchange rate movements:
  - A year ago, a US investor bought 120 shares of Toyota at ¥10,000 per share (worth ¥1.2m)
    - the FX rate was $1 = ¥100 \rightarrow her dollar cost was $12,000
  - Now, a year later, suppose that her investment is worth 10% more in Yen: ¥1,320,000
    - However, because the yen has depreciated to $1 = ¥119 this U.S. investor has actually lost money in dollar terms:
      \[
      \frac{¥1,320,000}{¥119¥/$} = $11,092 \quad < \quad $12,000
      \]

2. Political Risk

- Sovereign governments have the right to regulate the movement of goods, capital, and people across their borders.
  - These laws (or their enforcement) sometimes change in unexpected ways.
    - Thai government curbs on “speculators”, Dec.’06
    - Zimbabwe’s decision re: local ownership of firms, March’08
    - Venezuelan (’09)/Russian (’14) actions vs. foreign food firms
    - Short sales limits in US-UK-OZ (’08) & Germany (’10); U.S. tax lawsuits; Spanish & French majority-voting laws (’13)
What’s Special?

2a. Operational Risk:

- **Risk Briefing** rates operational risk in 150 markets on a scale of 0-100. The overall scores are an aggregate of underlying scores for ten categories of risk: security, political stability, government effectiveness, legal and regulatory, macroeconomic, foreign trade and payments, financial, tax policy, labor market, and infrastructure. The model is run when events require it, and at least once a quarter for each country.

2b. Political Stability:

<table>
<thead>
<tr>
<th>Country</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zimbabwe</td>
<td>8.8</td>
</tr>
<tr>
<td>Chad</td>
<td>8.5</td>
</tr>
<tr>
<td>Congo Kinshasa</td>
<td>8.2</td>
</tr>
<tr>
<td>Camerun</td>
<td>8.0</td>
</tr>
<tr>
<td>Sudan</td>
<td>8.0</td>
</tr>
<tr>
<td>Iraq</td>
<td>7.9</td>
</tr>
<tr>
<td>Afghanistan</td>
<td>7.8</td>
</tr>
<tr>
<td>Central African Republic</td>
<td>7.8</td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>7.8</td>
</tr>
<tr>
<td>Haiti</td>
<td>7.8</td>
</tr>
<tr>
<td>Pakistan</td>
<td>7.8</td>
</tr>
<tr>
<td>Zambia</td>
<td>7.8</td>
</tr>
</tbody>
</table>

*On a scale of 0-10, where 0 is very vulnerable and 10 is least vulnerable

Source: Economist Intelligence Unit
What’s Special about “International” Finance?

- 3. Market Imperfections
  - Legal restrictions on movement of goods, people, and money
  - Transactions costs
  - Shipping costs
  - Tax arbitrage

Market Imperfections & Political Risk: The Example of Nestlé

- Nestlé used to issue two different classes of common stock (bearer shares & registered shares).
  - Foreigners were only allowed to buy bearer shares.
  - Swiss citizens alone could buy registered shares.
  - The bearer stock was more expensive. (why?)
- On November 18, 1988, Nestlé lifted restrictions imposed on foreigners, allowing them to hold registered shares as well as bearer shares
- What do you think happened?
The Example of Nestlé (continued)

- Following this, the price spread between the two types of shares narrowed dramatically.
  - This implies that there was a major transfer of wealth from foreign shareholders to Swiss shareholders.
- Foreigners holding Nestlé bearer shares
  - Exposed to political risk in a country that is (was?) widely viewed as a haven from such risk.
- The Nestlé episode illustrates
  - The importance of market imperfections
  - The peril of political risk.
4. Expanded Opportunity Set

- It doesn’t make sense to play in only one corner of the sandbox.
- True for
  - Corporations:
  - 
  - 
  - 
  - Individual investors: diversify risk
What’s Special about “International” Finance?

4. Expanded Opportunity Set
- It doesn’t make sense to play in only one corner of the sandbox.
- True for
  ◆ Corporations:
    ■ source inputs and sell outputs where it maximizes profits
    ■ reduce operational risk
  ◆ Individual investors: diversify risk

What’s Special about “International” Finance?

4. Expanded Opportunity Set
- It doesn’t make sense to play in only one corner of the sandbox.
- True for
  ◆ Corporations:
    ■ source inputs and sell outputs where it maximizes profits
    ■ reduce operational risk
    ■ minimize financing costs
  ◆ Individual investors: grow returns & diversify risk
The focus of the course is to equip students with the “intellectual toolbox” of an effective global manager—but what goal should this effective global manager be working toward?

- Maximization of shareholder wealth?
- or
- Other Goals?

Maximize Shareholder Wealth

- Long accepted as a goal in the Anglo-Saxon countries, but:
  - Worries exist about investors’ ST horizons
    - Jack Welch (FT March 2009) – “oxymoron”
    - Warren Buffett – “ST investors = traders, not investors”
    - “sustainable value” folks
  - Even in US/UK/OZ, complications arise:
    - Who / where are the shareholders?
    - In what currency should managers maximize shareholders’ wealth?
Other Goals

- In other countries, shareholders are viewed as merely one among many “stakeholders” of the firm including:
  - Employees
  - Suppliers
  - Customers

- In Japan, managers have typically sought to maximize the value of the *keiretsu*—a family of firms to which the individual firms belongs.

Other Goals

- As shown by a series of corporate scandals at companies (e.g., Enron, WorldCom, Refco, Parmalat, Olympus, etc.), top managers may pursue their own private interests at the expense of shareholders when they are not closely monitored.

- These episodes highlight the importance of *corporate governance*, *i.e.*, the financial and legal framework for regulating the relationship between a firm’s management and its shareholders.
Other Goals

- These types of issues can be much more serious in many other parts of the world, especially emerging and transitional economies, such as Venezuela and Russia (or even Thailand), where legal protection of shareholders is weak or virtually non-existent.

- No matter what the other goals, they may not be achieved in the long term if the maximization of (long-term) shareholder wealth is not given due consideration.

Globalization of the World Economy: Recent Trends

- Emergence of Globalized Financial Markets
- Advent of the Euro
- Trade Liberalization & Economic Integration
- Privatization
Emergence of Globalized Financial Markets

- Deregulation of Financial Markets (including “capital account liberalization” in many emerging markets)
  + Advances in Technology
  = Greatly reduced information & transactions costs,
  ➔ which has led to:
- Financial Innovations, such as
  - Currency futures and options
  - Multi-currency bonds
  - Cross-border stock listings
  - Hedge Funds, International mutual funds

Advent of the Euro

- A momentous event in the history of world financial systems.
- Currently Europeans in 19 countries use the common currency on a daily basis.
- Up to 13 more countries that have joined or want to join the EU may adopt the euro (*Denmark is currently in ERM II, 4 more may join*)
- If the Euro survives, its “transaction domain” may become larger than the USD’s in the near future.
Euro Area

23 Countries “participating” in the euro:
- Austria
- Belgium
- Cyprus
- Czech Republic
- Denmark
- Estonia
- Finland
- France
- Germany
- Greece
- Hungary
- Ireland
- Italy
- Latvia
- Lithuania
- Luxembourg
- Malta
- Netherlands
- Poland
- Portugal
- Slovakia
- Slovenia
- Spain
- Sweden
- UK

Euro Area

ERM II
- Unilaterally adopted
- Other EU members
- Eurozone
Value of the Euro in U.S. Dollars

January 1999 to 2015: Ups & Downs...

Value of the US Dollar in Yen

1999 to 2015: an even wilder ride?
Economic Integration

- Over the past 50 years, international trade increased about twice as fast as world GDP.
- There has been a sea change in the attitudes of many of the world’s governments who have abandoned mercantilist views and embraced free trade as the surest route to prosperity for their citizenry.
- With the current crisis, will this last?
  - Protectionism? Trade credit availability?

Liberalization of Protectionist Legislation

- The General Agreement on Tariffs and Trade (GATT) a multilateral agreement among member countries has reduced many barriers to trade.
- The World Trade Organization has the power to enforce the rules of international trade.
  - Example: U.S. vs. Antigua – what can the latter do?
- On January 1, 2005 the end of the era of quotas on imported textiles ended.
NAFTA

- The North American Free Trade Agreement (NAFTA) called for phasing out impediments to trade between Canada, Mexico and the United States over a 15-year period. Almost there!
- For Mexico, the ratio of export to GDP increased dramatically – from 2.2% in 1973 to 28.7% in 2001 (to more than 30% today – why?)
- In theory, the increased trade should result in increased numbers of jobs and a higher standard of living for all member nations.

Privatization

- The selling off state-run enterprises to investors is also known as “Denationalization”.
- Often seen in socialist economies in transition to market economies.
- By most estimates this increases the efficiency of the enterprise.
- Often spurs a tremendous increase in cross-border investment.
Multinational Corporations

- **Definition**: a firm that has incorporated in one country and has production and sales operations in other countries.
- There are about 60,000 MNCs in the world.
- Many MNCs obtain raw materials from one nation, financial capital from another, produce goods with labor and capital equipment in a third country and sell their output in various other national markets.

Top 10 non-financial MNCs
(2013 = latest data, ranked by foreign assets)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company Name</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>General Electric Co</td>
<td>United States</td>
</tr>
<tr>
<td>2</td>
<td>Royal Dutch Shell plc</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>3</td>
<td>BP plc</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>4</td>
<td>Toyota Motor Corporation</td>
<td>Japan</td>
</tr>
<tr>
<td>5</td>
<td>Total SA</td>
<td>France</td>
</tr>
<tr>
<td>6</td>
<td>Exxon Mobil Corporation</td>
<td>United States</td>
</tr>
<tr>
<td>7</td>
<td>Vodafone Group Plc</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>8</td>
<td>GDF Suez</td>
<td>France</td>
</tr>
<tr>
<td>9</td>
<td>Volkswagen Group</td>
<td>Germany</td>
</tr>
<tr>
<td>10</td>
<td>Chevron Corporation</td>
<td>United States</td>
</tr>
</tbody>
</table>
Top 10 non-financial MNCs

- Rankings are typically fairly stable.
- The last few years have been anything but typical
  - General Motors dropped from the top 10
    - Surprise…
  - Ranked by sales, the top 5 have generally been oil companies
    - since 2006

The Organization of this Course

World Financial Markets and Institutions
Part I Chapters 5, 7, 14; Supplements
ATA: Chapters 11-12-13

Macroeconomic Environment
Where do FX rates come from?
Part II Chapters 3, 2, 6

Foreign Exchange Exposure and Management

Financial Management of the MNC
Part III Chapters 9, 8; ATA, Chapter 10

Part IV Chapters 17-18
End Chapter One