Chapter 1
Globalization and the Multinational Enterprise
Globalization and the Multinational Enterprise: Learning Objectives

• Examine the requirements for the creation of value
• Consider the basic theory, comparative advantage, and its requirements for the explanation and justification for international trade and commerce
• Discover what is different about international financial management
Globalization and the Multinational Enterprise: Learning Objectives

- Detail which market imperfections give rise to the multinational enterprise
- Consider how globalization process moves a business from domestic focus to financial relationships and composition global in scope
- Examine possible causes to the limitations to globalization in finance
Globalization and Creating Value in the MNE

• Transnational firms are those with ownership thoroughly dispersed internationally and as a result are often managed from a global perspective

• Building firm value in a global business requires
  – An open marketplace
  – Strategic management
  – Access to capital

• The firm value pyramid illustrates the concept of building firm value
Exhibit 1.1 Creating Firm Value in Global Markets

The challenge to building firm value—value for all stakeholders including stockholders, corporate stakeholders, and social community—is in the expansion and development of all three sides of the global pyramid: an open marketplace; access to affordable capital; and high-quality strategic management.
The Theory of Comparative Advantage

• The *theory of comparative advantage* provides a basis for explaining and justifying international trade in a model assumed to enjoy
  – Free trade
  – Perfect competition
  – No uncertainty
  – Costless information
  – No government interference
The Theory of Comparative Advantage

- The features of the theory are as follows;
  - Exporters in Country A sell goods or services to unrelated importers in Country B
  - Firms in Country A specialize in making products that can be produced relatively efficiently, given Country A’s endowment of factors of production (land, labor, capital, and technology)
  - Country B does the same with different products (based on different factors of production)
The Theory of Comparative Advantage

– Because the factors of production cannot be transported, the benefits of specialization are realized through international trade

– The *terms of trade*, the ratio at which quantities of goods are exchanged, shows the benefits of excess production

– Neither Country A nor Country B is worse off than before trade, and typically both are better off (albeit perhaps unequally)
The Theory of Comparative Advantage

- For an example of the benefits of free trade based on comparative advantage, assume Thailand is more efficient than Brazil at producing both sports shoes and stereo equipment.

- With one unit of production (a mix of land, labor, capital, and technology), efficient Thailand can produce either 12 shipping containers of shoes or 6 shipping containers of stereo equipment.

- Brazil, being less efficient in both, can produce only 10 containers of shoes or 2 containers of stereo equipment with one unit of input.
The Theory of Comparative Advantage

• A production unit in Thailand has an absolute advantage over a production unit in Brazil in both shoes and stereo equipment

• Thailand has a larger relative advantage over Brazil in producing stereo equipment (6 to 2) than shoes (12 to 10)

• As long as these ratios are unequal, comparative advantage exists

• The following exhibit illustrates total world (in this example) production and consumption if there was no trade and if each country completely specialized in one product
Exhibit 1.2  The Theory of Comparative Advantage: A numerical Example of Brazil and Thailand

<table>
<thead>
<tr>
<th>Production if No Trade</th>
<th>Shoe Production (ctrs)</th>
<th>Stereo Production (ctrs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand produces and consumes</td>
<td>$300 \times 12 = 3,600$</td>
<td>$700 \times 6 = 4,200$</td>
</tr>
<tr>
<td>Brazil produces and consumes</td>
<td>$300 \times 10 = 3,000$</td>
<td>$700 \times 2 = 1,400$</td>
</tr>
<tr>
<td>Total world production and consumption</td>
<td>6,600</td>
<td>5,600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Complete Specialization</th>
<th>Shoe Production (ctrs)</th>
<th>Stereo Production (ctrs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand produces only stereo equipment</td>
<td>1,000 \times 6 = 6,000</td>
<td></td>
</tr>
<tr>
<td>Brazil produces only shoes</td>
<td>$1,000 \times 10 = 10,000$</td>
<td></td>
</tr>
<tr>
<td>Total world production and consumption</td>
<td>10,000</td>
<td>6,000</td>
</tr>
</tbody>
</table>
The Theory of Comparative Advantage

• Clearly the world in total is better off because there are now 10,000 containers of shoes (instead of just 6,600), as well as 6,000 containers of stereo equipment (instead of just 5,600)

• However, the goods are not distributed across international boundaries!
The Theory of Comparative Advantage

• Trade can resolve that distribution problem
• While total production of goods has increased with the specialization process, international trade at a certain range of prices (containers of shoes for a container of stereo equipment) can be distributed between the countries
• This exchange ratio will determine how the larger output is distributed
Exhibit 1.3  Trade at Thailand’s domestic “Price”

<table>
<thead>
<tr>
<th></th>
<th>Shoe Production plus/minus trade (ctrs)</th>
<th>Stereo Production plus/minus trade (ctrs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand produces 6,000 containers of stereo equipment and exports 1,800 containers</td>
<td>0 + 3,600 = 3,600</td>
<td>6,000 − 1,800 = 4,200</td>
</tr>
<tr>
<td>Brazil produces 10,000 containers of shoes and exports 3,600 containers</td>
<td>10,000 − 3,600 = 6,400</td>
<td>0 + 1,800 = 1,800</td>
</tr>
<tr>
<td>World production and consumption</td>
<td>10,000</td>
<td>6,000</td>
</tr>
</tbody>
</table>
**Exhibit 1.4 Trade at Brazil’s domestic “Price”**

<table>
<thead>
<tr>
<th>Description</th>
<th>Shoe Production plus/minus trade (ctrs)</th>
<th>Stereo Production plus/minus trade (ctrs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand produces 6,000 containers of stereo equipment and exports 1,400 containers</td>
<td>$0 + 7,000 = 7,000$</td>
<td>$6,000 - 1,400 = 4,600$</td>
</tr>
<tr>
<td>Brazil produces 10,000 containers of shoes and exports 7,000 containers</td>
<td>$10,000 - 7,000 = 3,000$</td>
<td>$0 + 1,400 = 1,400$</td>
</tr>
<tr>
<td>World production and consumption</td>
<td>10,000</td>
<td>6,000</td>
</tr>
</tbody>
</table>
## Exhibit 1.5  Trade at a Price
Reached by Free Bargaining

<table>
<thead>
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<th>Shoe Production plus/minus trade (ctrs)</th>
<th>Stereo Production plus/minus trade (ctrs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand produces 6,000 containers of stereo equipment and exports 1,600 containers</td>
<td>0 + 6,400 = 6,400</td>
<td>6,000 − 1,600 = 4,400</td>
</tr>
<tr>
<td>Brazil produces 10,000 containers of shoes and exports 6,400 containers</td>
<td>10,000 − 6,400 = 3,600</td>
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</tr>
<tr>
<td>World production and consumption</td>
<td>10,000</td>
<td>6,000</td>
</tr>
</tbody>
</table>
The Theory of Comparative Advantage: Limitations

- Although international trade might have approached the comparative advantage model during the nineteenth century, it certainly does not today;
  - Countries do not appear to specialize only in those products that could be most efficiently produced by that country’s particular factors of production
  - At least two of the factors of production (capital and technology) now flow easily between countries (rather than only indirectly through traded goods and services)
  - Modern factors of production are more numerous than this simple model
  - Comparative advantage shifts over time
The Theory of Comparative Advantage

• Comparative advantage is still, however, a relevant theory to explain why particular countries are most suitable for exports of goods and services that support the global supply chain of both MNEs and domestic firms.

• The comparative advantage of the 21st century, however, is one which is based more on services, and their cross border facilitation by telecommunications and the Internet.
Exhibit 1.6  Global Outsourcing of Comparative Advantage

MNEs based in many industrial countries are outsourcing intellectual functions to providers based in traditional emerging market countries.
**Exhibit 1.7  What is Different About International Financial Management?**

<table>
<thead>
<tr>
<th>Concept</th>
<th>International</th>
<th>Domestic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Culture, history and institutions</td>
<td>Each foreign country is unique and not always understood by MNE management</td>
<td>Each country has a known base case</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>Foreign countries’ regulations and institutional practices are all uniquely different</td>
<td>Regulations and institutions are well known</td>
</tr>
<tr>
<td>Foreign exchange risk</td>
<td>MNEs face foreign exchange risks due to their subsidiaries, as well as import/export and foreign competitors</td>
<td>Foreign exchange risks from import/export and foreign competition (no subsidiaries)</td>
</tr>
<tr>
<td>Political risk</td>
<td>MNEs face political risks because of their foreign subsidiaries and high profile</td>
<td>Negligible political risks</td>
</tr>
<tr>
<td>Modification of domestic finance theories</td>
<td>MNEs must modify finance theories like capital budgeting and cost of capital because of foreign complexities</td>
<td>Traditional financial theory applies</td>
</tr>
<tr>
<td>Modification of domestic financial instruments</td>
<td>MNEs utilize modified financial instruments such as options, futures, swaps, and letters of credit</td>
<td>Limited use of financial instruments and derivatives because of fewer foreign exchange and political risks</td>
</tr>
</tbody>
</table>
Market Imperfections: A Rationale for the MNE

• Firms become multinational for one or several of the following reasons:
  – Market seekers – produce in foreign markets either to satisfy local demand or export to markets other than their own
  – Raw material seekers – search for cheaper or more raw materials outside their own market
  – Production efficiency seekers – produce in countries where one or more of the factors of production are cheaper
  – Knowledge seekers – gain access to new technologies or managerial expertise
  – Political safety seekers – establish operations in countries considered unlikely to expropriate or interfere with private enterprise
Exhibit 1.8 Trident Corp: Initiation of the Globalization Process

Phase One: Domestic Operations

- **U.S. Suppliers** (domestic)
  - All payments in U.S. dollars.
  - All credit risk under U.S. law.

- **Trident Corporation** (Los Angeles, USA)

- **Mexican Suppliers**
  - Are Mexican suppliers dependable?
  - Will Trident pay US$ or Mexican pesos?

- **Canadian Buyers**
  - Are Canadian buyers creditworthy?
  - Will payment be made in US$ or C$?

Phase Two: Expansion into International Trade
The Globalization Process

- The globalization process is the structural and managerial changes and challenges experienced by a firm as it moves from domestic to global in operations.
- We will examine the case of Trident, a young firm that manufactures and distributes an array of telecommunication devices:
  - Trident’s initial strategy is to develop a sustainable competitive advantage in the U.S. market.
  - Trident is currently constrained by its small size, other competitors, and lack of access to cheap capital.
The Globalization Process

• In Phase One, Trident is not itself international or global in its operations
• However, some of its competitors, suppliers or buyers may be
• This is one of the key drivers pushing Trident into Phase Two, the first transition of the globalization process
• This is the Global Transition I: *The Domestic Phase to The International Trade Phase*
The Globalization Process

• In the *International Trade Phase*, Trident responds to globalization factors by importing inputs from Mexican suppliers and making exports sales to Canadian buyers

• Exporting and importing products and services increases the demands of financial management over and above the traditional requirements of the domestic-only business
The Globalization Process

- First, direct *foreign exchange risks* are now borne by the firm
  - Pricing and payments may be in different currencies
  - The value of these foreign currency receipts and payments can change, creating a new source of risk
- Second, the evaluation of the credit quality of foreign buyers and sellers is now more important than ever; this is known as *credit risk management*
  - Potential for non-payment of exports and non-delivery of imports
  - Differences in business and legal systems and practices
The Globalization Process

- If Trident is successful in its international trade activities, it will soon need to establish foreign sales and service affiliates.
- This step is often followed by establishing manufacturing operations abroad or by licensing foreign firms to produce and service Trident’s products.
- This is the Global Transition II: *The International Trade Phase to The Multinational Phase*
The Globalization Process

• Trident’s continued globalization will require it to identify the sources of its competitive advantages.

• This variety of strategic alternatives available to Trident is called the foreign direct investment sequence which include the creation of foreign sales offices, licensing agreements, manufacturing, etc.

• Once Trident owns assets and enterprises in foreign countries it has entered the multinational phase of globalization.
Exhibit 1.9  Trident’s Foreign Direct Investment Sequence
The Limits to Financial Globalization

- The growth in the influence and self-enrichment of corporate insiders
- The next exhibit illustrates the agency problems
Exhibit 1.10 The Potential Limits of Financial Globalization

There is a growing debate over whether many of the insiders and rulers of organizations with enterprises globally are taking actions consistent with creating firm value or consistent with increasing their own personal stakes and power.

If these influential insiders are building personal wealth over that of the firm, it will indeed result in preventing the flow of capital across borders, currencies, and institutions to create a more open and integrated global financial community.

Summary of Learning Objectives

• Financial management is an integral part of a firm’s strategy. This course analyzes how a firm’s financial management tasks evolve as it pursues global strategic opportunities and new constraints unfold.

• The evolution of firms from domestic to multinational is called the globalization process. A firm may enter into international trade transactions, then international contractual arrangements and ultimately the acquisition of foreign subsidiaries. This final stage is when a firm truly becomes a multinational.
Summary of Learning Objectives

• This globalization process results in a firm becoming increasingly influenced by exchange rate movements and other global political and economic forces in general

• The decision whether or not to invest abroad may require the MNE to enter into global licensing agreements, joint ventures, acquisitions or Greenfield investments
Summary of Learning Objectives

• The theory of competitive advantage is based on one country possessing a relative advantage in the production of goods compared to another country.

• Imperfections in national markets for products, factors of production and financial assets translate into market opportunities for MNEs.

• Strategic motives drive the decision to invest abroad and become an MNE. Firms could be seeking new markets, raw materials, production efficiencies, access to technology or political safety.