CHAPTER 1 GLOBALIZATION AND THE MULTINATIONAL FIRM

ANSWERS & SOLUTIONS TO END-OF-CHAPTER QUESTIONS AND PROBLEMS

QUESTIONS

1. Why is it important to study international financial management?

Answer: We are now living in a world where all the major economic functions, i.e., consumption, production, and investment, are highly globalized. It is thus essential for financial managers to fully understand vital international dimensions of financial management. This global shift is in marked contrast to a situation that existed when the authors of this book were learning finance some twenty years ago. At that time, most professors customarily (and safely, to some extent) ignored international aspects of finance. This mode of operation has become untenable since then.

2. How is international financial management different from domestic financial management?

Answer: There are three major dimensions that set apart international finance from domestic finance. They are:

1. foreign exchange and political risks,
2. market imperfections, and
3. expanded opportunity set.

3. Discuss the major trends that have prevailed in international business during the last two decades.

Answer: The 1990s brought a rapid integration of international capital and financial markets. Impetus for globalized financial markets initially came from the governments of major countries that had begun to deregulate their foreign exchange and capital markets. The economic integration and globalization that began in the eighties is picking up speed in the 1990s via privatization. Privatization is the process by which a country divests itself of the ownership and operation of a business venture by turning it over to the free market system. Trade liberalization and economic integration continued to proceed at both the regional and global levels. In Europe, many EU member countries have adopted the common currency, euro, that has become the second global currency after the U.S. dollar.

4. How is a country's economic well-being enhanced through free international trade in goods and services?

Answer: According to David Ricardo, with free international trade, it is mutually beneficial for two countries to each specialize in the production of the goods that it can produce *relatively* most efficiently and then trade those goods. By doing so, the two countries can increase their combined production, which allows both countries to consume more of both goods. This argument remains valid even if a country can produce both goods more efficiently than the other country. International trade is not a 'zero-sum' game in which one country benefits at the expense of another country. Rather, international trade could be an 'increasing-sum' game at which all players become winners.

5. What considerations might limit the extent to which the theory of comparative advantage is realistic?

Answer: The theory of comparative advantage was originally advanced by the nineteenth century economist David Ricardo as an explanation for why nations trade with one another. The theory claims that economic well-being is enhanced if each country's citizens produce what they have a comparative advantage in producing relative to the citizens of other countries, and then trade products. Underlying the theory are the assumptions of free trade between nations and that the factors of production (land, buildings, labor, technology, and capital) are relatively immobile. To the extent that these assumptions do not hold, the theory of comparative advantage mayl not realistically describe international trade.

6. What are multinational corporations (MNCs) and what economic roles do they play?

Answer: A multinational corporation (MNC) can be defined as a business firm incorporated in one country that has production and sales operations in several other countries. Indeed, some MNCs have operations in dozens of different countries. MNCs obtain financing from major money centers around the world in many different currencies to finance their operations. Global operations force the treasurer's office to establish international banking relationships, to place short-term funds in several currency denominations, and to effectively manage foreign exchange risk.

7. Ross Perot, a former Presidential candidate of the Reform Party, which is a third political party in the United States, had strongly objected to the creation of the North American Trade Agreement (NAFTA), which nonetheless was inaugurated in 1994. Perot feared the loss of American jobs to Mexico where it is much cheaper to hire workers. What are the merits and demerits of Perot's position on NAFTA? Considering the recent economic developments in North America, how would you assess Perot's position on NAFTA?

Answer: Since the inception of NAFTA, many American companies indeed have invested heavily in Mexico, sometimes relocating production from the United States to Mexico. Although this might have temporarily caused unemployment of some American workers, they were eventually rehired by other industries often for higher wages. At the same time, Mexico has been experiencing a major economic boom. It seems clear that both Mexico and the U.S. have benefited from NAFTA. Perot's concern appears to have been ill founded.

8. In 1995, a working group of French chief executive officers was set up by the Confederation of French Industry (CNPF) and the French Association of Private Companies (AFEP) to study the French corporate governance structure. The group reported the following, among other things: "The board of directors should not simply aim at maximizing share values as in the U.K. and the U.S. Rather, its goal should be to serve the company, whose interests should be clearly distinguished from those of its shareholders, employees, creditors, suppliers and clients but still equated with their general common interest, which is to safeguard the prosperity and continuity of the company". Evaluate the above recommendation of the working group.

Answer: The recommendations of the French working group clearly show that shareholder wealth maximization is not a universally accepted goal of corporate management, especially outside the United States and possibly a few other Anglo-Saxon countries including the United Kingdom and Canada. To some extent, this may reflect the fact that share ownership is not wide spread in most other countries. In France, about 15% of households own shares.

9. Emphasizing the importance of voluntary compliance, as opposed to enforcement, in the aftermath of such corporate scandals as those involving Enron and WorldCom, U.S. President George W. Bush stated that while tougher laws might help, “ultimately, the ethics of American business depends on the conscience of America’s business leaders.” Describe your view on this statement.

Answer: There can be different answers to this question. If business leaders always behave with a high ethical standard, many of the corporate scandals we have seen lately might not have happened. Since we cannot fully depend on the ethical behavior on the part of individual business leaders, the society should protect itself by adopting the rules/regulations and governance structure that would induce business leaders to behave in the interest of the society at large.

10. Suppose you are interested in investing in shares of Nokia Corporation of Finland, which is a world leader in wireless communication. But before you make investment decision, you would like to learn about the company. Visit the website of Yahoo (http://finance.yahoo.com) and collect information about Nokia, including the recent stock price history and analysts’ views of the company. Discuss what you learn about the company. Also discuss how the instantaneous access to information via internet would affect the nature and workings of financial markets.

Answer: As students might have learned from visiting the website, information is readily available even for foreign companies like Nokia. Ready access to international information helps integrate financial markets, dismantling barriers to international investment and financing. Integration, however, may help a financial shock in one market to be transmitted to other markets.

MINI CASE: NIKE AND SWEATSHOP LABOR

Nike, a company headquartered in Beaverton, Oregon, is a major force in the sports footwear and fashion industry, with annual sales exceeding $ 12 billion, more than half of which now come from outside the United States. The company was co-founded in 1964 by Phil Knight, a CPA at Price Waterhouse, and Bill Bowerman, college track coach, each investing $ 500 to start. The company, initially called Blue Ribbon Sports, changed its name to Nike in 1971 and adopted the “Swoosh” logo—recognizable around the world—originally designed by a college student for $35. Nike became highly successful in designing and marketing mass-appealing products such as the Air Jordan, the best selling athletic shoe of all time.

Nike has no production facilities in the United States. Rather, the company manufactures athletic shoes and garments in such Asian countries as China, Indonesia, and Vietnam using subcontractors, and sells the products in the U.S. and international markets. In each of those Asian countries where Nike has production facilities, the rates of unemployment and under-employment are quite high. The wage rate is very low in those countries by U.S. standards—the hourly wage rate in the manufacturing sector is less than $ 1 in each of those countries, compared with about $ 20 in the United States. In addition, workers in those countries often operate in poor and unhealthy environments and their rights are not particularly well protected. Understandably, host countries are eager to attract foreign investments like Nike's to develop their economies and raise the living standards of their citizens. Recently, however, Nike came under worldwide criticism for its practice of hiring workers for such a low rate of pay—"next to nothing" in the words of critics—and condoning poor working conditions in host countries.

Initially, Nike denied the sweatshop charges and lashed out at critics. But later, the company began monitoring the labor practice at its overseas factories and grading the factories in order to improve labor standards. Nike also agreed to random factory inspections by disinterested parties.

Discussion points

1. Do you think the criticism of Nike is fair, considering that the host countries are in dire needs of creating jobs?
2. What do you think Nike's executives might have done differently to prevent the sensitive charges of sweatshop labor in overseas factories?
3. Do firms need to consider the so-called corporate social responsibilities in making investment decisions?

Suggested Solution to Nike and Sweatshop Labor

Obviously, Nike's investments in such Asian countries as China, Indonesia, and Vietnam were motivated to take advantage of low labor costs in those countries. While Nike was criticized for the poor working conditions for its workers, the company has recognized the problem and has substantially improved the working environments recently. Although Nike's workers get paid very low wages by the Western standard, they probably are making substantially more than their local compatriots who are either under- or unemployed. While

Nike's detractors may have valid points, one should not ignore the fact that the company is making contributions to the economic welfare of those Asian countries by creating job opportunities.

APPENDIX 1A. GAIN FROM TRADE: THE THEORY OF COMPARATIVE ADVANTAGE

PROBLEMS

1. Country C can produce seven pounds of food or four yards of textiles per unit of input. Compute the opportunity cost of producing food instead of textiles. Similarly, compute the opportunity cost of producing textiles instead of food.

Solution: The opportunity cost of producing food instead of textiles is one yard of textiles per 7/4 = 1.75 pounds of food. A pound of food has an opportunity cost of 4/7 = .57 yards of textiles.

2. Consider the no-trade input/output situation presented in the following table for Countries X and Y. Assuming that free trade is allowed, develop a scenario that will benefit the citizens of both countries.

INPUT/OUTPUT WITHOUT TRADE

	Country X	Y	Total
I. Units of Input (000,000)			
Food	70	60	
Textiles	40	30	
II. Output per Unit of Input (lbs or yards)			
Food	17	5	

Textiles	5	2	

III. Total Output (lbs or yards) (000,000)

Food	1,190	300	1,490
Textiles	200	60	260

IV. Consumption (lbs or yards) (000,000)

Food	1,190	300	1,490
Textiles	200	60	260

Solution:

Examination of the no-trade input/output table indicates that Country X has an absolute advantage in the production of food and textiles. Country X can "trade off" one unit of production needed to produce 17 pounds of food for five yards of textiles. Thus, a yard of textiles has an opportunity cost of 17/5 = 3.40 pounds of food, or a pound of food has an opportunity cost of 5/17 = .29 yards of textiles. Analogously, Country Y has an opportunity cost of 5/2 = 2.50 pounds of food per yard of textiles, or 2/5 = .40 yards of textiles per pound of food. In terms of opportunity cost, it is clear that Country X is relatively more efficient in producing food and Country Y is relatively more efficient in producing textiles. Thus, Country X (Y) has a comparative advantage in producing food (textile) is comparison to Country Y (X).

When there are no restrictions or impediments to free trade the economic-well being of the citizens of both countries is enhanced through trade. Suppose that Country X shifts 20,000,000 units from the production of textiles to the production of food where it has a comparative advantage and that Country Y shifts 60,000,000 units from the production of food to the production of textiles where it has a comparative advantage. Total output will now be (90,000,000 x 17 =) 1,530,000,000 pounds of food and [(20,000,000 x 5 =100,000,000) + (90,000,000 x 2 =180,000,000) =] 280,000,000 yards of textiles. Further suppose that Country X and Country Y agree on a price of 3.00 pounds of food for one yard of textiles, and that Country X sells Country Y 330,000,000 pounds of food for 110,000,000 yards of textiles. Under free trade, the following table shows that the citizens of Country X (Y) have increased their consumption of food by 10,000,000 (30,000,000) pounds and textiles by 10,000,000

(10,000,000) yards.

INPUT/OUTPUT WITH FREE TRADE

	Country X	Y	Total
I. Units of Input (000,000)			
Food	90	0	
Textiles	20	90	
II. Output per Unit of Input (lbs or yards)			
Food	17	5	
Textiles	5	2	
III. Total Output (lbs or yards) (000,000)			
Food	1,530	0	1,530
Textiles	100	180	280
IV. Consumption (lbs or yards) (000,000)			
Food	1,200	330	1,530
Textiles	210	70	280