FIS3616

International Business Finance

UNSW

Study Notes for the 2018 Semester 1 FINS3616 Final Exam

Larissa Zhang

1: Globalization and the Multinational Corporation

Globalization: increasing connectivity and integration of countries and corporations and people within them

International trade growth

Globalization and the growth of international trade and capital flows

Trade liberalization

- Enables free trade between countries
- Gains from trade if each nation **specializes** in the production of those goods in which it has a **comparative advantage**
- Advances in information technology increased the share of services and made the world seem smaller
  - Allowing for **outsourcing**: shifting of non-strategic functions to specialist firms to reduce costs
  - New focus for trade policy: increasing the international tradability of services

International efforts to promote free trade

- *Free Trade Agreements*
  - 1947: General Agreement on Tariffs and Trade
  - 1986 – 1994: World Trade Organization
- *Regional Trade Agreements*
  - European Union
  - North American Free Trade Agreement (NAFTA) 1994
  - Association of South East Asian Nations (ASEAN) 1967
  - Chinese Australian Free Trade Agreement (ChAFTA) 2015

Trade openness

Benefits of openness

- Channels **savings** to most productive uses
- Domestic recessions can be buffered through **borrowing** abroad
- **Risks** are shared → cost of capital decreases → firms invest more → increases growth

Costs of openness

- Capital may not be used wisely
  - Low interest rates → consumption binge → unrealistically high asset prices with worldwide booms
- **Foreign capita**l can leave quickly → financial volatility and sector vulnerability
- Loss of **fiscal autonomy** – difficulty in taxing profits → MNCs shift profits across countries to avoid tax
- Capital control effectiveness decreases

Development and globalization of financial markets

- *Securitization*
    - Repackaging of “pools” of loans or other receivables to create a new financial instrument
    - Much more widespread in 1980s and 1990s

    - Global Financial Crisis (2008-2010)
        - Longest and deepest recession/financial crisis in the post-war era
        - Scale and depth of crisis raised issues with how well the global financial system worked
        - Regulatory issues: central banks pumped money into banks → expansionary monetary and fiscal policies

- *Globalization of financial markets*
    - **Trends in financial openness**
        - 1980s countries began to allow foreigners to invest in their markets
        - Creation of new asset class – emerging markets
    - **New financial landscape – derivatives**
        - *Derivative security*: an investment whose payoff over time is derived from the performance of underlying assets

- The spectacular growth in derivatives and securitization considerably increased the complexity in the financial intermediation business

    - **Positive**: dramatically improved the ability of banks and corporations to manage risk
        - Hedge risks using derivatives contracts
        - Accessibility to foreign markets

    - **Negative**: increasingly difficult for governments to regulate their domestic capital markets
        - Complexity and opaqueness of the financial system that put stress on the risk management systems of banks and companies

Multinational corporations

Transnational corporations: a parent company in the firm’s originating country and operating subsidiaries, branches and affiliates abroad

How Multinational corporations enter foreign markets

- Exporting/Importing
- *Licensing*: gives local firms right to manufacture their products in exchange for a fee
- *Franchising*: the firm provides sales or service strategies in exchange for fees
- *Joint venture*: two or more firms form a new legal entity, jointly owned by all of the firms
- *Greenfield*: starting company from scratch
- *Foreign Direct Investment (FDI)*: when a company from one country buys at least 10% of a company in another country

Goals of an MNC

Maximise shareholder wealth by making investments in projects whose returns are sufficiently large to compensate its shareholders for the risk involved in the projects

Investment time horizon

- Appropriate time horizon for management: long term – shareholder maximization often short-term focused
- Investment today maximizes shareholder value if the *current value of future benefits > cost of investment*

Agency theory

- Problems that arise from the separation of ownership and control
- Principals must design contracts that motivate the agent to perform actions and make decisions that are in the best interests of the principals

Corporate governance: legal/financial structure controlling the relationship between shareholders and management

- Establish the framework within which the managers operate and mitigate the principal-agent problem

Effects of MNCSs

- Trade openness and economic risk
  - Countries should focus on the variability of economic growth
  - Prevent additional external risks from international shocks that cause deeper recessions
  - Adverse implications for the job security of the employees

- Allocative efficiency: employing capital where it is most productive
  - Belief that the government must intervene to better spread the newly created wealth
  - Helping those that have been displaced by globalization

- Anti-globalization
  - Encompasses separate social movements, united in their opposition to the globalization of corporate economic activity
  - Global laissez-faire capitalism is detrimental to poor countries and to disadvantaged people in rich countries

- Fear that MNC activities will harm the environment
  - Degradation of environmental standards (***the race-to-bottom effect***)
  - Heavily polluting industries relocate to countries with lower standards, in particular to developing countries (***the pollution-haven effect***)

- Globalization as a threat to employment in their own country
  - Globalization destroys some jobs and creates others
  - "Creative destruction"
  - Internationalization of the labour market → outsourcing blue-collar manufacturing jobs to lower-cost countries

Methods of overcoming agency problems:

METHOD	PROS	CONS
INDEPENDENT BOARD OF DIRECTORS	Protection of minority shareholders' interests Increased risk sharing	Not sufficiently independent of management
PARTIAL CONCENTRATION OF OWNERSHIP AND CONTROL IN THE HANDS OF A LARGE SHAREHOLDER	A large shareholder has the self-interest to monitor management's activities to prevent abuses	Possible collusion between management and large shareholder against smaller shareholders Reduced liquidity in the stock
EXECUTIVE COMPENSATION WITH OPTIONS OR BONUSES RELATED TO PERFORMANCE	Provides a direct incentive to maximize stock price	Rewards management for good luck Subject to manipulation and possible short-term focus to allow management to get rich
CLEARLY DEFINED FIDUCIARY DUTIES FOR CEOS WITH CLASS-ACTION LAW SUITS	Provides a complementary disciplining device	Increases legal costs and enriches lawyers at the expense of stock holders
HOSTILE TAKEOVERS AND PROXY CONTESTS	Directly disciplines had management	Provides an incentive for raiders to expropriate wealth from creditors and employees

Other important international players

International banks

- Emergence of more consolidated financial institutions at the global level
- Deregulation of the financial services sector – banks were often protected from foreign takeovers, through explicit regulation or through political manoeuvring

International institutions

- International Monetary Fund (IMF)
  - Ensure the stability of the international monetary and financial system
  - Achieved through surveillance and technical assistance
- The World Bank
  - Development, poverty alleviation and advising
- Multilateral development banks
  - Regional development banks
  - Provide financing and grants
- World Trade Organization (WTO)
  - Mediates trade disputes
- Organization for Economic Cooperation and Development (OECD)
  - Examines, devises and coordinates policies across 34 relatively wealthy nations
  - Foster sustainable economic growth and employment, rising standards of living and financial stability
- Bank for International Settlements (BIS)
  - Fosters international monetary and financial cooperation
- European Union (EU)
  - Cooperation among countries in this region