Part 1: The International Financial Environment 1
1. Multinational Financial Management: An Overview 2
2. International Flow of Funds 22
3. International Financial Markets 50
4. Exchange Rate Determination 85
5. Currency Derivatives 103

Part 2: Exchange Rate Behavior 153
7. International Arbitrage and Interest Rate Parity 188
8. Relationships among Inflation, Interest Rates, and Exchange Rates 214

Part 3: Exchange Rate Risk Management 249
9. Forecasting Exchange Rates 250
10. Measuring Exposure to Exchange Rate Fluctuations 280
11. Managing Transaction Exposure 307
12. Managing Economic Exposure and Translation Exposure 346

Part 4: Long-Term Asset and Liability Management 369
13. Direct Foreign Investment 370
14. Multinational Capital Budgeting 387
15. International Acquisitions 422
16. Country Risk Analysis 446
17. Multinational Cost of Capital and Capital Structure 472
18. Long-Term Financing 500

Part 5: Short-Term Asset and Liability Management 529
19. Financing International Trade 530
20. Short-Term Financing 549
21. International Cash Management 569

Appendix A: Answers to Self Test Questions 606
Appendix B: Supplemental Cases 618
Appendix C: Using Excel to Conduct Analysis 640
Appendix D: International Investing Project 647
Appendix E: Discussion in the Boardroom 650
Glossary 658
Index 665
## Contents

Preface, xvii

**Part 1: The International Financial Environment**

### Chapter 1: Multinational Financial Management: An Overview

- Managing the MNC, 2
- Facing Agency Problems, 3
- Governance: How SOX Improved Corporate Governance of MNCs, 3
- Why Firms Pursue International Business, 5
- Theory of Comparative Advantage, 6
- Imperfect Markets Theory, 6
- Product Cycle Theory, 6
- How Firms Engage in International Business, 7
- International Trade, 8
- Licensing, 8
- Franchising, 9
- Joint Ventures, 9
- Acquisitions of Existing Operations, 9
- Establishing New Foreign Subsidiaries, 9
- Summary of Methods, 10
- Valuation Model for an MNC, 11
- Domestic Model, 11
- Valuing International Cash Flows, 12
- Uncertainty Surrounding an MNC's Cash Flows, 14
- Organization of the Text, 15
- Summary, 16
- Point Counter-Point: Should an MNC Reduce Its Ethical Standards to Compete Internationally?, 16
- Self Test, 16
- Questions and Applications, 17
- Advanced Questions, 17
- Discussion in the Boardroom, 19
- Running Your Own MNC, 19

Blades, Inc. Case: Decision to Expand Internationally, 19
Small Business Dilemma: Developing a Multinational Sporting Goods Corporation, 20
Internet/Excel Exercises, 21

### Chapter 2: International Flow of Funds

- Balance of Payments, 22
- Current Account, 22
- Capital and Financial Accounts, 23
- International Trade Flows, 25
- Distribution of U.S. Exports and Imports, 26
- U.S. Balance-of-Trade Trend, 26
- International Trade Issues, 28
- Events That Increased International Trade, 28
- Trade Friction, 31
- Governance: Should Managers Outsource to Satisfy Shareholders?, 32
- Factors Affecting International Trade Flows, 34
- Impact of Inflation, 34
- Impact of National Income, 34
- Impact of Government Policies, 35
- Impact of Exchange Rates, 35
- Interaction of Factors, 36
- Correcting a Balance-of-Trade Deficit, 36
- Why a Weak Home Currency Is Not a Perfect Solution, 37
- International Capital Flows, 38
- Distribution of DFI by U.S. Firms, 38
- Distribution of DFI in the United States, 39
- Factors Affecting International Portfolio Investment, 41
- Impact of International Capital Flows, 41
- Agencies That Facilitate International Flows, 42
- International Monetary Fund, 42
- World Bank, 43
- World Trade Organization, 44
- International Financial Corporation, 44
International Development Association, 45
Bank for International Settlements, 45
Organization for Economic Cooperation and Development, 45
Regional Development Agencies, 45
How International Trade Affects an MNC's Value, 45
Summary, 46
Point Counter-Point: Should Trade Restrictions Be Used to Influence Human Rights Issues?, 46
Self Test, 46
Questions and Applications, 47
Advanced Questions, 47
Running Your Own MNC, 47
Blades, Inc. Case: Decisions to Use International Financial Markets, 47
Small Business Dilemma: Use of the Foreign Exchange Markets by the Sports Exports Company, 48
Internet/Excel Exercises, 49

Chapter 3: International Financial Markets 50
Foreign Exchange Market, 50
History of Foreign Exchange, 50
Foreign Exchange Transactions, 51
Foreign Exchange Quotations, 54
Interpreting Foreign Exchange Quotations, 56
Forward, Futures, and Options Markets, 58
International Money Market, 59
Origins and Development, 60
Money Market Interest Rates among Currencies, 61
Standardizing Global Bank Regulations, 61
International Credit Market, 63
Syndicated Loans, 63
International Bond Market, 64
Euromarket, 64
Development of Other Bond Markets, 65
International Stock Markets, 66
Issuance of Stock in Foreign Markets, 66
Issuance of Foreign Stock in the United States, 66
Listing of Stock by Non-U.S. Firms on U.S. Stock Exchanges, 67
Governance: Effect of Sarbanes-Oxley Act on Foreign Stock Offerings, 67
Investing in Foreign Stock Markets, 67
How Stock Market Characteristics Vary among Countries, 70
How Financial Markets Facilitate MNC Functions, 70
Summary, 71
Point Counter-Point: Should Firms That Go Public Engage in International Offerings?, 72
Self Test, 72
Questions and Applications, 72
Advanced Questions, 73
Running Your Own MNC, 74
Blades, Inc. Case: Exposure to International Flow of Funds, 74
Small Business Dilemma: Identifying Factors That Will Affect the Foreign Demand at the Sports Exports Company, 75
Internet/Excel Exercises, 75

Appendix 3: Investing in International Financial Markets, 76

Chapter 4: Exchange Rate Determination 85
Measuring Exchange Rate Movements, 85
Exchange Rate Equilibrium, 86
Supply of a Currency, 87
Equilibrium, 88
Factors That Influence Exchange Rates, 89
Relative Inflation Rates, 89
Relative Interest Rates, 90
Relative Income Levels, 92
Government Controls, 92
Expectations, 93
Interaction of Factors, 93
Speculating on Anticipated Exchange Rates, 95
Summary, 97
Point Counter-Point: How Can Persistently Weak Currencies Be Stabilized?, 97
Self Test, 98
Questions and Applications, 98
Advanced Questions, 99
Discussion in the Boardroom, 100
Running Your Own MNC, 100
Blades, Inc. Case: Assessment of Future Exchange Rate Movements, 101
Small Business Dilemma: Assessment by the Sports Exports Company of Factors That Affect the British Pound's Value, 101
Internet/Excel Exercises, 102

Chapter 5: Currency Derivatives 103
Forward Market, 103
How MNCs Use Forward Contracts, 104
Non-Deliverable Forward Contracts, 107
Currency Futures Market, 108
Contract Specifications, 108
Trading Futures, 108
Comparison of Currency Futures and Forward Contracts, 110
Pricing Currency Futures, 110
Credit Risk of Currency Futures Contracts, 111
Speculation with Currency Futures, 111
How Firms Use Currency Futures, 112
Closing Out a Futures Position, 113
Trading Platforms for Currency Futures, 114
Currency Options Market, 114
Option Exchanges, 114
Over-the-Counter Market, 114
Currency Call Options, 115
Factors Affecting Currency Call Option Premiums, 115
Speculating with Currency Call Options, 116
Hedging with Currency Call Options, 116
Currency Put Options, 119
Factors Affecting Currency Put Option Premiums, 119
Speculating with Currency Put Options, 120
Hedging with Currency Put Options, 120
Contingency Graphs for Currency Options, 122
Contingency Graph for a Purchaser of a Call Option, 122
Contingency Graph for a Seller of a Call Option, 123
Contingency Graph for a Buyer of a Put Option, 124
Contingency Graph for a Seller of a Put Option, 124
Governance: Should an MNC's Managers Use Currency Derivatives to Speculate?, 124
Conditional Currency Options, 124
European Currency Options, 126
Summary, 126
Point Counter-Point: Should Speculators Use Currency Futures or Options?, 126
Self Test, 127
Questions and Applications, 127
Advanced Questions, 130
Discussion in the Boardroom, 132
Running Your Own MNC, 132
Blades, Inc. Case: Use of Currency Derivative Instruments, 133
Small Business Dilemma: Use of Currency Futures and Options by the Sports Exports Company, 134
Internet/Excel Exercises, 134
Appendix A: Currency Option Pricing, 135
Appendix B: Currency Option Combinations, 139
Part 1 Integrative Problem: The International Financial Environment, 152
Part 2: Exchange Rate Behavior

Chapter 6: Government Influence on Exchange Rates

Exchange Rate Systems, 154
Fixed Exchange Rate System, 154
Free Float Exchange Rate System, 156
Managed Float Exchange Rate System, 158
Pegged Exchange Rate System, 158
Currency Boards Used to Peg Currency Values, 161
Dollarization, 163
Classification of Exchange Rate Arrangements, 163
A Single European Currency, 164
Membership, 165
Impact on European Monetary Policy, 165
Impact on Business within Europe, 165
Impact on the Valuation of Businesses in Europe, 166
Impact on Financial Flows, 166
Impact on Exchange Rate Risk, 167
Status Report on the Euro, 167
Government Intervention, 167
Reasons for Government Intervention, 167
Direct Intervention, 168
Indirect Intervention, 173
Intervention as a Policy Tool, 172
Influence of a Weak Home Currency on the Economy, 172
Influence of a Strong Home Currency on the Economy, 172
Summary, 174
Point Counter-Point: Should China Be Forced to Alter the Value of Its Currency?, 174
Self Test, 175
Questions and Applications, 175
Advanced Questions, 176
Discussion in the Boardroom, 176
Running Your Own MNC, 176
Small Business Dilemma: Assessment of Central Bank Intervention by the Sports Exports Company, 178
Internet/Excel Exercises, 178
Appendix 6: Government Intervention during the Asian Crisis, 179

Chapter 7: International Arbitrage and Interest Rate Parity

International Arbitrage, 188
Locational Arbitrage, 188
Chapter 10: Measuring Exposure to Exchange Rate Fluctuations 280

Is Exchange Rate Risk Relevant?, 280
Purchasing Power Parity Argument, 280
The Investor Hedge Argument, 280
Currency Diversification Argument, 281
Stakeholder Diversification Argument, 281
Response from MNCs, 281

Types of Exposure, 281
Transaction Exposure, 282
Estimating "Net" Cash Flows in Each Currency, 282
Measuring the Potential Impact of the Currency Exposure, 284
Assessing Transaction Exposure Based on Value at Risk, 286

Economic Exposure, 289
Economic Exposure to Local Currency Appreciation, 291
Economic Exposure to Local Currency Depreciation, 291
Economic Exposure of Domestic Firms, 292
Measuring Economic Exposure, 292

Translation Exposure, 295
Does Translation Exposure Matter?, 295
Determinants of Translation Exposure, 296
Examples of Translation Exposure, 297
Summary, 297
Point Counter-Point: Should Investors Care about an MNC’s Translation Exposure?, 298
Self Test, 298
Questions and Applications, 299
Advanced Questions, 300
Discussion in the Boardroom, 304
Running Your Own MNC, 304
Blades, Inc. Case: Forecasting Exchange Rates by the Sports Exports Company, 305
Internet/Excel Exercises, 306

Chapter 11: Managing Transaction Exposure 307

Transaction Exposure, 307
Identifying Net Transaction Exposure, 307
Adjusting the Interest Policy to Manage Exposure, 308

Governance: Aligning Manager Compensation with Hedging Goals, 308

Hedging Exposure to Payables, 308
Forward or Futures Hedge on Payables, 309
Money Market Hedge on Payables, 309
Call Option Hedge, 310
Summary of Techniques Used to Hedge Payables, 313
Selecting the Optimal Technique for Hedging Payables, 313
Optimal Hedge versus No Hedge, 316
Evaluating the Hedge Decision, 316

Hedging Exposure to Receivables, 317
Forward or Futures Hedge on Receivables, 317
Money Market Hedge on Receivables, 317
Put Option Hedge, 318
Selecting the Optimal Technique for Hedging Receivables, 320
Optimal Hedge versus No Hedge, 323
Evaluating the Hedge Decision, 323

Comparison of Hedging Techniques, 324
Hedging Policies of MNCs, 325

Limitations of Hedging, 326
Limitation of Hedging an Uncertain Amount, 326
Limitation of Repeated Short-Term Hedging, 326

Evaluating Long-Term Transaction Exposure, 328
Long-Term Forward Contract, 328
Parallel Loan, 328
Alternatives Hedging Techniques, 329
Leading and Lagging, 329
Cross-Hedging, 329
Currency Diversification, 329

Summary, 330
Point Counter-Point: Should an MNC Risk Overhedging?, 330
Self Test, 330
Questions and Applications, 331
Advanced Questions, 334
Discussion in the Boardroom, 338
Running Your Own MNC, 338
Blades, Inc. Case: Management of Transaction Exposure, 338
Chapter 12: Managing Economic Exposure and Translation Exposure

Economic Exposure, 346
Use of Projected Cash Flows to Assess Economic Exposure, 347
How Restructuring Can Reduce Economic Exposure, 348
Issues Involved in the Restructuring Decision, 351
A Case Study in Hedging Economic Exposure, 352
Savor Co.'s Dilemma, 352
Assessment of Economic Exposure, 352
Assessment of Each Unit’s Exposure, 353
Identifying the Source of the Unit’s Exposure, 353
Possible Strategies to Hedge Economic Exposure, 354
Savor’s Hedging Solution, 356
Limitations of Savor’s Optimal Hedging Strategy, 356
Hedging Exposure to Fixed Assets, 356
Managing Translation Exposure, 357
Use of Forward Contracts to Hedge Translation Exposure, 357
Limitations of Hedging Translation Exposure, 358
Governance: Governing the Hedge of Translation Exposure, 359
Summary, 359
Point Counter-Point: Can an MNC Reduce the Impact of Translation Exposure by Communicating, 360
Self Test, 360
Questions and Applications, 361
Advanced Questions, 361
Discussion in the Boardroom, 362
Running Your Own MNC, 362
Blades, Inc.: Case Assessment of Economic Exposure, 363
Small Business Dilemma: Hedging the Sports Exports Company’s Economic Exposure to Exchange Rate Risk, 364
Internet/Excel Exercises, 364

Part 3 Integrative Problem: Exchange Rate Risk Management, 366
Comparing Risk Ratings among Countries, 457
Actual Country Risk Ratings across Countries, 457
Incorporating Country Risk in Capital Budgeting, 459
Adjustment of the Discount Rate, 459
Adjustment of the Estimated Cash Flows, 459
How Country Risk Affects Financial Decisions, 462
Governance: Governance over the Assessment of Country Risk, 462
Reducing Exposure to Host Government Takeovers, 463
Use a Short-Term Horizon, 463
Rely on Unique Supplies or Technology, 463
Hire Local Labor, 463
Borrow Local Funds, 463
Purchase Insurance, 464
Use Project Finance, 464
Summary, 465
Point Counter-Point: Does Country Risk Matter for U.S. Projects?, 465
Self Test, 465
Questions and Applications, 466
Advanced Questions, 466
Discussion in the Boardroom, 469
Running Your Own MNC, 469
Blades, Inc. Case: Country Risk Assessment, 469
Small Business Dilemma: Country Risk Analysis at the Sports Exports Company, 471
Internet/Excel Exercises, 471

Chapter 17: Multinational Cost of Capital and Capital Structure

Background on Cost of Capital, 472
Comparing the Costs of Equity and Debt, 472
Cost of Capital for MNCs, 473
Cost of Equity Comparison Using the CAPM, 475
Implications of the CAPM for an MNC’s Risk, 476
Costs of Capital across Countries, 477
Country Differences in the Cost of Capital, 477
Country Differences in the Cost of Debt, 477
Country Differences in the Cost of Equity, 478
Combining the Costs of Debt and Equity, 480
Estimating the Cost of Debt and Equity, 480
Using the Cost of Capital for Assessing Foreign Projects, 481
Derive Net Present Values Based on the Weighted Average Cost of Capital, 481
Adjust the Weighted Average Cost of Capital for the Risk Differential, 482
Derive the Net Present Value of the Equity Investment, 482
The MNC’s Capital Structure Decision, 486
Influence of Corporate Characteristics, 486
Influence of Country Characteristics, 487
Revising the Capital Structure in Response to Changing Conditions, 488
Interaction between Subsidiary and Parent Financing Decisions, 489
Impact of Increased Debt Financing by the Subsidiary, 490
Impact of Reduced Debt Financing by the Subsidiary, 491
Summary of Interaction between Subsidiary and Parent Financing Decisions, 492
Local versus Global Target Capital Structure, 492
Offsetting a Subsidiary’s High Degree of Financial Leverage, 492
Offsetting a Subsidiary’s Low Degree of Financial Leverage, 492
Limitations in Offseting a Subsidiary’s Abnormal Degree of Financial Leverage, 492
Summary, 493
Point Counter-Point: Should the Reduced Tax Rate on Dividends Affect an MNC’s Capital Structure?, 493
Self Test, 494
Questions and Applications, 494
Advanced Questions, 495
Discussion in the Boardroom, 497
Running Your Own MNC, 497
Blades, Inc. Case: Assessment of Cost of Capital, 497
Small Business Dilemma: Multinational Capital Structure Decision at the Sports Exports Company, 499
Internet/Excel Exercises, 499

Chapter 18: Long-Term Financing

Long-Term Financing Decision, 500
Sources of Equity, 500
Sources of Debt, 501
Governance: Stockholder versus Creditor Conflict, 501
Cost of Debt Financing, 501
Measuring the Cost of Financing, 502
Actual Effects of Exchange Rate Movements on Financing Costs, 504
Assessing the Exchange Rate Risk of Debt Financing, 506
Use of Exchange Rate Probabilities, 506
Use of Simulation, 506
Reducing Exchange Rate Risk, 507
Forward Contracts, 508
Currency Swaps, 508
Parallel Loans, 510
Diversifying among Currencies, 514
Interest Rate Risk from Debt Financing, 515
The Debt Maturity Decision, 515
Chapter 19: Financing International Trade 530

Payment Methods for International Trade, 530
Prepayment, 532
Letters of Credit (L/Cs), 531
Drafts, 532
Consignment, 532
Open Accounts, 532
Trade Finance Methods, 533
Accounts Receivable Financing, 533
Factoring, 533
Letters of Credit (L/Cs), 534
Banker’s Acceptance, 536
Working Capital Financing, 540
Medium-Term Capital Goods Financing (Forfaiting), 541
Countertrades, 544
Agencies That Motivate International Trade, 542
Export-Import Bank of the United States, 542
Private Export Funding Corporation (PEFCO), 544
Overseas Private Investment Corporation (OPIC), 544
Summary, 545
Point Counter-Point: Do MNCs Increase Their Risk When Borrowing Foreign Currency?, 546
Self Test, 546
Questions and Applications, 546
Advanced Questions, 546
Discussion in the Boardroom, 546
Blades, Inc. Case: Use of Foreign Short-Term Financing, 547
Small Business Dilemma: Short-Term Financing by the Sports Exports Company, 548
Internet/Excel Exercises, 548

Chapter 20: Short-Term Financing 549

Sources of Short-Term Financing, 549
Short-Term Notes, 549
Commercial Paper, 549
Bank Loans, 549
Internal Financing by MNCs, 550
Governance: Governance over Subsidiary Short-Term Financing, 550
Why MNCs Consider Foreign Financing, 550
Foreign Financing to Offset Foreign Currency Inflows, 550
Foreign Financing to Reduce Costs, 551
Determining the Effective Financing Rate, 552
Criteria Considered for Foreign Financing, 553
Interest Rate Parity, 553
The Forward Rate as a Forecast, 554
Exchange Rate Forecasts, 555
Actual Results from Foreign Financing, 558
Portfolio Diversification Effects, 561
Repeated Financing with a Currency Portfolio, 562
Summary, 564
Point Counter-Point: Do MNCs Increase Their Risk When Borrowing Foreign Currency?, 564
Self Test, 564
Questions and Applications, 566
Advanced Questions, 566
Discussion in the Boardroom, 567
Blades, Inc. Case: Use of Foreign Short-Term Financing, 567
Small Business Dilemma: Short-Term Financing by the Sports Exports Company, 568
Internet/Excel Exercises, 568

Chapter 21: International Cash Management 569

Multinational Management of Working Capital, 569
Subsidiary Expenses, 569
Subsidiary Revenue, 570
Subsidiary Dividend Payments, 570
Subsidiary Liquidity Management, 570