International Business 7e

by Charles W.L. Hill

McGraw-Hill/Irwin

Chapter 11

The Global Capital Market

Introduction

- The rapid globalization of capital markets facilitates the free flow of money around the world
- Traditionally, national capital markets have been separated by regulatory barriers
- Therefore, it was difficult for firms to attract foreign capital
- Many regulatory barriers fell during the 1980s and 1990s, allowing the global capital market to emerge
- Today, firms can list their stock on multiple exchanges, raise funds by issuing equity or debt to investors from around the world, and attract capital from international investors

Benefits Of The Global Capital Market

- There are market functions that are shared by both domestic and international capital markets
- However, global capital markets offer some benefits not found in domestic capital markets

Functions Of A Generic Capital Market

- Capital markets bring together investors and borrowers
- Investors include corporations with surplus cash, individuals, and non-bank financial institutions
- Borrowers include individuals, companies, and governments
- Markets makers are the financial service companies that connect investors and borrowers, either directly or indirectly
- Commercial banks are indirect market makers, and investment banks are direct market makers
- Capital market loans can be equity (stock) or debt (cash loans or bonds)

Classroom Performance System

Which of the following are market makers?

a) commercial banks

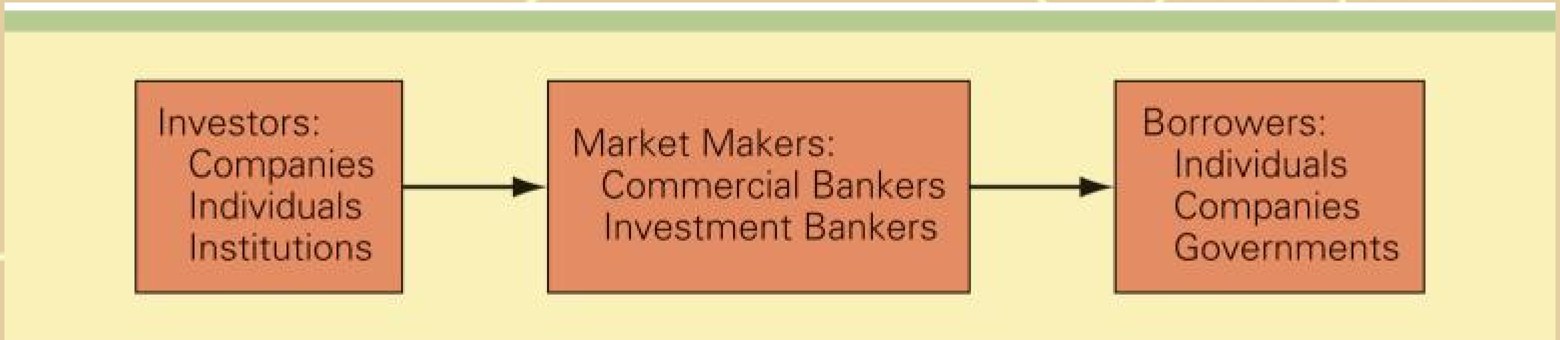
b) pension funds

c) insurance companies

d) governments

Functions Of A Generic Capital Market

Figure 11.1: The Main Players in a Generic Capital Market



Attractions Of The Global Capital Market

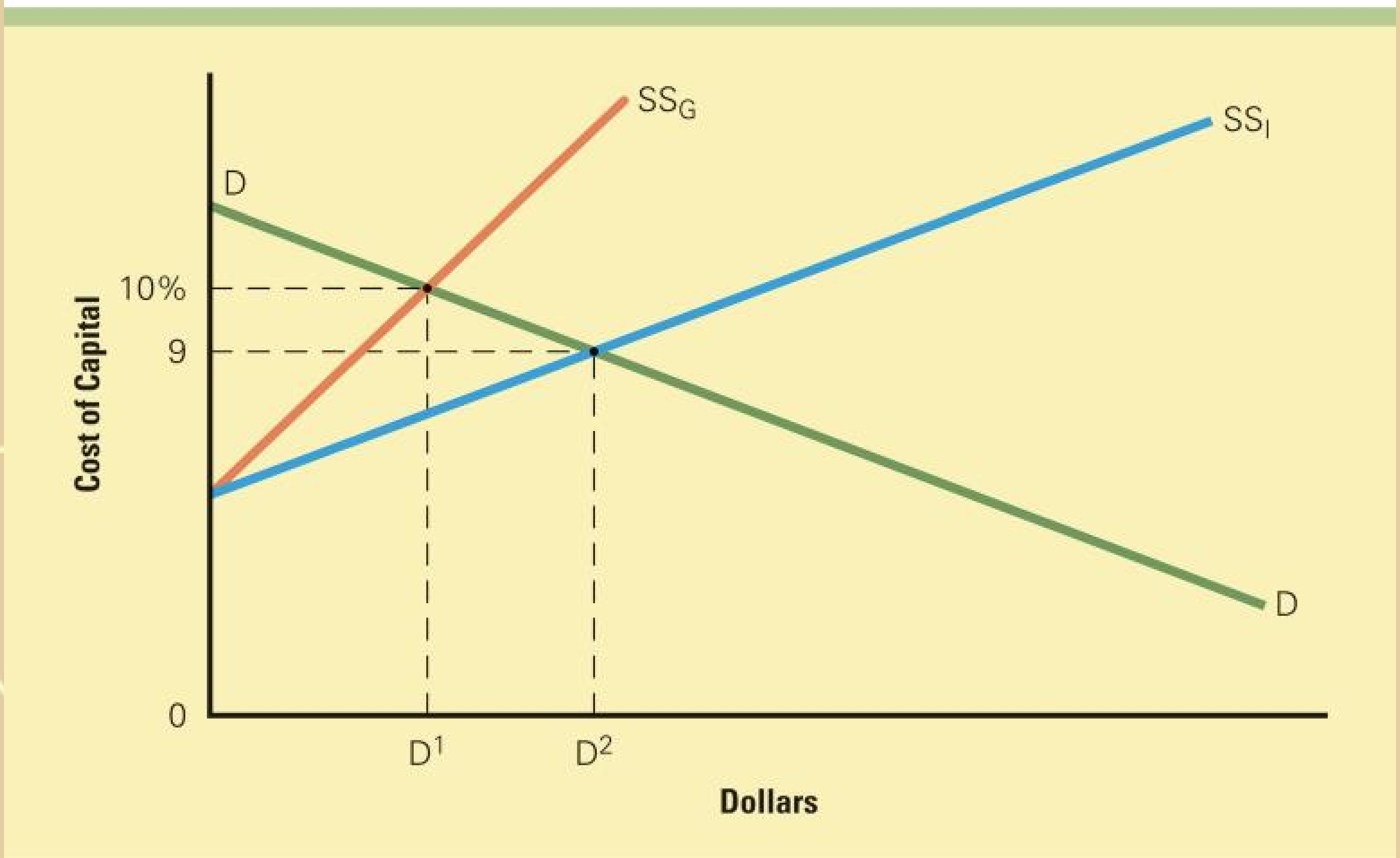
Borrowers benefit from:

- the additional supply of funds global capital markets provide
- the associated lower cost of capital (the price of borrowing money or the rate of return that borrowers pay investors)

- The cost of capital is lower in international markets because the pool of investors is much larger than in the domestic capital market

Attractions Of The Global Capital Market

Figure 11.2: Market Liquidity and the Cost of Capital



Attractions Of The Global Capital Market

- Investors also benefit from the wider range of investment opportunities in global capital markets that allow them to diversify their portfolios and lower their risks
- Studies show that fully diversified portfolios are only about 27 percent as risky as individual stocks
- International portfolio diversification is even less risky because the movements of stock prices across countries are not perfectly correlated
- This low correlation reflects the differences in nations' macroeconomic policies and economic policies and how their stock markets respond to different forces, and nations' restrictions on cross-border capital flows

Attractions Of The Global Capital Market

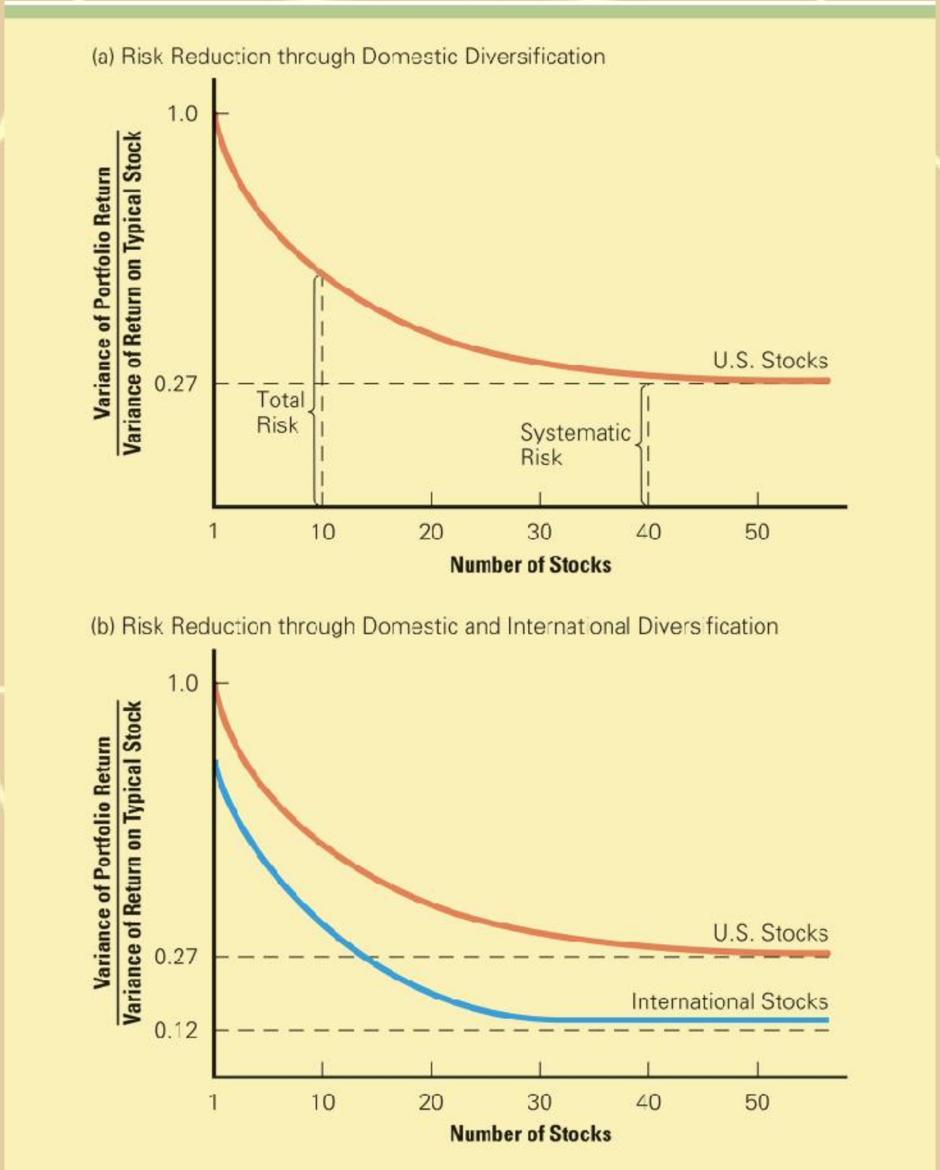


Figure 11.3: Risk Reduction through Portfolio Diversification

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Compared to developed nations, less developed nations have

a) smaller capital markets

b) more investment opportunities

c) similar costs of capital

d) greater liquidity

Classroom Performance System

Which of the following is *not* true of global capital markets

a) they benefit borrowers

b) they benefit sellers

c) they raise the cost of capital

d) they provide a wider range of investment opportunities

Growth Of The Global Capital Market

- Global capital markets are growing at a rapid pace
- In 1990, the stock of cross-border bank loans was just $3,600 billion
- By 2006, the stock of cross border bank loans was $17,875 billion
- The international bond market shows a similar pattern with $3,515 billion in outstanding international bonds in 1997, and $17, 561 billion in 2006
- International equity offerings were $18 billion in 1997 and $377 billion in 2006

Classroom Performance System

In 2006, the stock of cross-border bank loans was about

a) $3,600

b) $7,800

c) $17,800

d) $33,600

Growth Of The Global Capital Market

Two factors are responsible for the growth of capital markets:

1. advances in information technology – the growth of international communications technology and advances in data processing capabilities

❖Financial services companies now engage in 24-hour-day trading – the international capital market never sleeps

❖However, this also means that shocks that occur in one financial market spread around the globe very quickly

Growth Of The Global Capital Market

2. deregulation by governments – has facilitated growth in the international capital markets

❖Traditionally, governments have limited the ability of foreign investors to purchase significant equity positions in domestic companies, and the amount of foreign investment citizens could make

❖Since the 1980s, these restrictions have been falling in response to the development of the Eurocurrency market, and also pressure from financial services companies

❖Deregulation began in the United States, then moved on to other countries including Great Britain, Japan, and France

Classroom Performance System

Historically, the most tightly regulated industry has been

a) agriculture

b) consumer electronics

c) automotives

d) financial services

Growth Of The Global Capital Market

- Many countries have also dismantled capital controls making it easier for both inward and outward investment to occur
- This trend has spread from the developed world to the emerging nations
- The global capital market is expected to continue to grow

Global Capital Market Risks

- Some analysts worry that the deregulation of capital markets and loosening of controls on cross-border capital flows make individual nations more vulnerable to the destabilizing effects of speculative capital flows
- Speculative capital flows may be the result of inaccurate information about investment opportunities
- If global capital markets continue to grow, better quality information is likely to be available from financial intermediaries

The Eurocurrency Market

- A eurocurrency is any currency banked outside of its country of origin
- About two-thirds of all eurocurrencies are Eurodollars (dollars banked outside the United States)
- Other important eurocurrencies are the euro-yen, the euro-pound, and the euro-euro

Classroom Performance System

The term eurocurrency refers to

a) the currency used by the European Union countries

b) any currency banked outside its country of origin

c) currencies purchased in the international equities market

d) bonds sold outside the borrower's country that are denominated in the currency of the country in which they are issued

Genesis And Growth Of The Market

- The eurocurrency market began in the 1950s when the Eastern bloc countries were afraid the United States might seize their holdings of dollars
- So, instead of depositing their dollars in the United States, they deposited them in Europe
- Additional dollar deposits came from Western European central banks and companies that exported to the United States
- In 1957, the market surged again after changes in British laws
- Today, London continues to be the leading center of the eurocurrency market

Growth Of The Global Capital Market

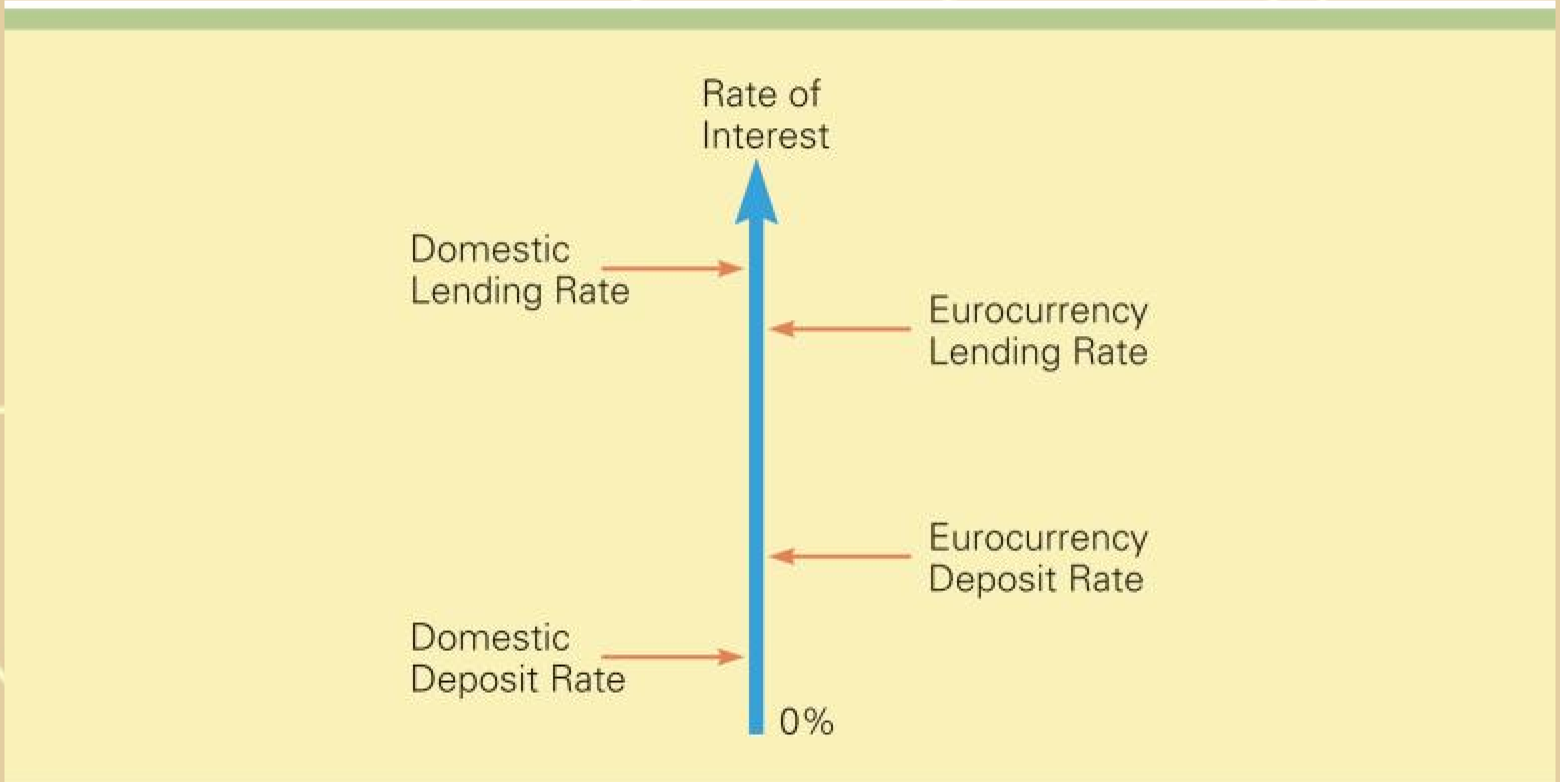
- In the 1960s, the market grew once again when, after changes in U.S. regulations discouraged U.S. banks from lending to non-U.S. residents, would-be borrowers of dollars outside the United States turned to the euromarket as a source of dollars
- The next big increase in the eurocurrency market came after the 1973-74 and 1979-80 oil price increases
- OPEC members avoided potential confiscation of their dollars by depositing them in banks in London

Attractions Of The Eurocurrency Market

- The eurocurrency market is attractive to depositors and borrowers because it is not regulated by the government
- This means that banks can offer higher interest rates on eurocurrency deposits than on deposits made in the home currency
- Similarly, banks can also charge lower interest rates to eurocurrency borrowers than to those who borrow the home currency
- The spread between the eurocurrency deposit and lending rates is less than the spread between the domestic deposit and lending rates giving eurocurrency banks a competitive edge over domestic banks

Attractions Of The Eurocurrency Market

Figure 11.4: Interest Rate Spreads in Domestic and Eurocurrency Markets



Drawbacks Of The Eurocurrency Market

The eurocurrency market has two drawbacks:

1. because the eurocurrency market is unregulated, there is a higher risk of bank failure
2. companies borrowing eurocurrencies can be exposed to foreign exchange risk

The Global Bond Market

- The global bond market grew rapidly during the 1980s and 1990s
- The most common kind of bond is a fixed rate bond which gives investors fixed cash payoffs

There are two types of international bonds:

1. foreign bonds are sold outside the borrower's country and are denominated in the currency of the country in which they are issued
2. eurobonds are underwritten by a syndicate of banks and placed in countries other than the one in whose currency the bond is denominated

Attractions Of The Eurobond Market

The eurobond market is attractive for three main reasons:

1. it lacks regulatory interference – since companies do not have to adhere to strict regulations, the cost of issuing bonds is lower

2. it has less stringent disclosure requirements than domestic bond markets – it can be cheaper and less time consuming to offer eurobonds than to issue dollar-denominated bonds

3. it is more favorable from a tax perspective – eurobonds can be sold directly to foreign investors

The Global Equity Market

- The largest equity markets are in the United States, Britain, and Japan
- Today, many investors invest in foreign equities to diversify their portfolios
- In the future, this type of trend may result in an internationalization of corporate ownership
- Companies are also helping to promote this type of shift by listing their stock in the equity markets of other nations
- By issuing stock in other countries, firms open the door to raising capital in the foreign market, and give the firm the option of compensating local managers and employees with stock

Foreign Exchange Risk And The Cost Of Capital

- Adverse exchange rates can increase the cost of foreign currency loans
- While it may initially seem attractive to borrow foreign currencies, when exchange rate risk is factored in, that can change
- Firms can hedge their risk by entering into forward contracts to purchase the necessary currency and lock in the exchange rate, but this will also raise costs
- Firms must weigh the benefits of a lower interest rate against the risk of an increase in the real cost of capital due to adverse exchange rate movements

Implications For Managers

- Growth in global capital markets has created opportunities for firms to borrow or invest internationally
- Firms can often borrow at a lower cost than in the domestic capital market
- Firms must balance the foreign exchange risk associated with borrowing in foreign currencies against the costs savings that may exist
- The growth of capital markets also offers opportunities for firms, institutions, and individuals to diversify their investments and reduce risk
- Again, though investors must consider foreign exchange rate risk

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Chapter 12

The Strategy of International Business

Introduction

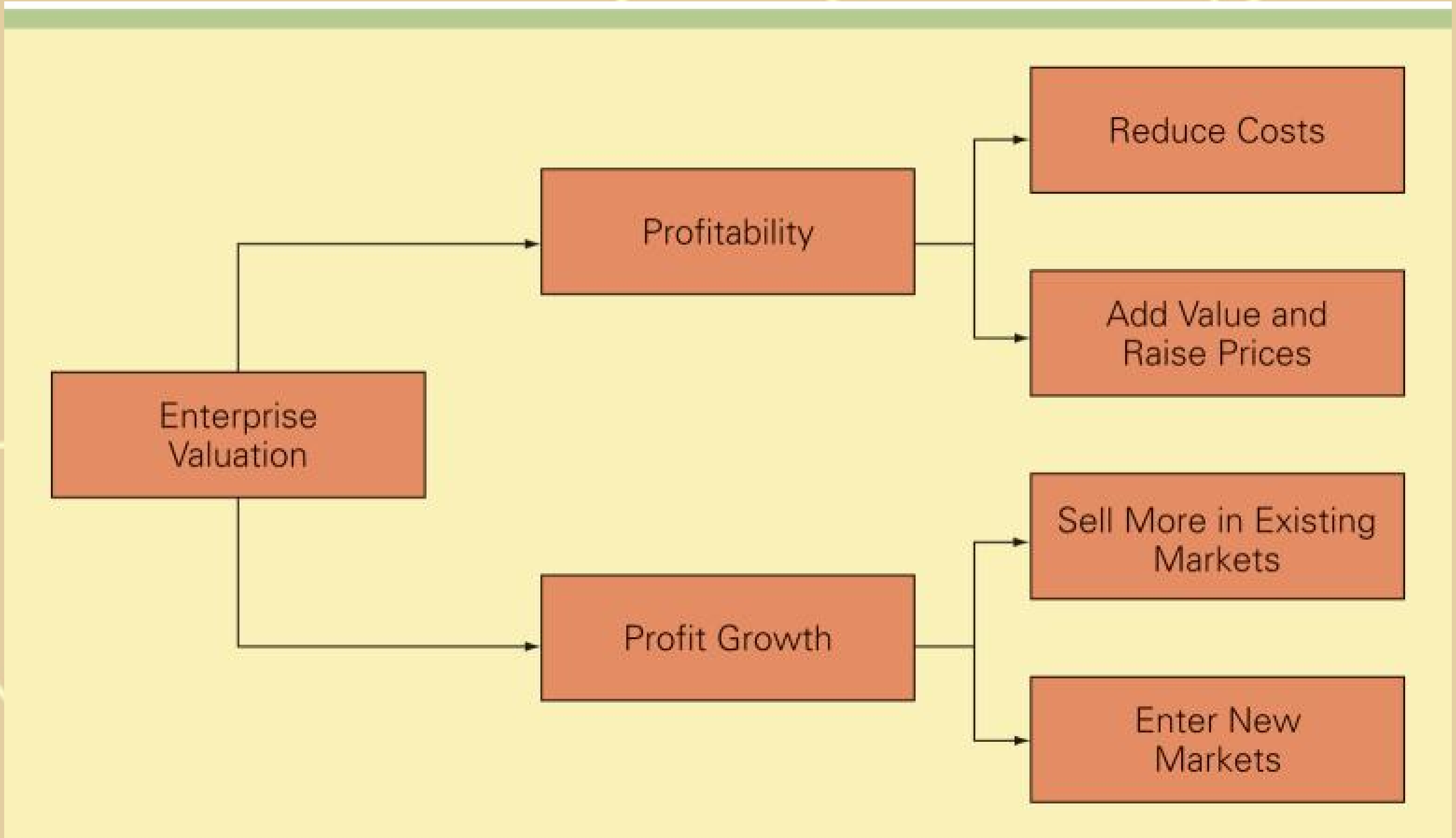
- What actions can managers take to compete more effectively as an international business?
- How can firms increase profits through international expansion?
- What international strategy should firms pursue?

Strategy And The Firm

- A firm's strategy refers to the actions that managers take to attain the goals of the firm
- Profitability can be defined as the rate of return the firm makes on its invested capital
- Profit growth is the percentage increase in net profits over time
- Expanding internationally can boost profitability and profit growth

Strategy And The Firm

Figure 12.1: Determinants of Enterprise Value

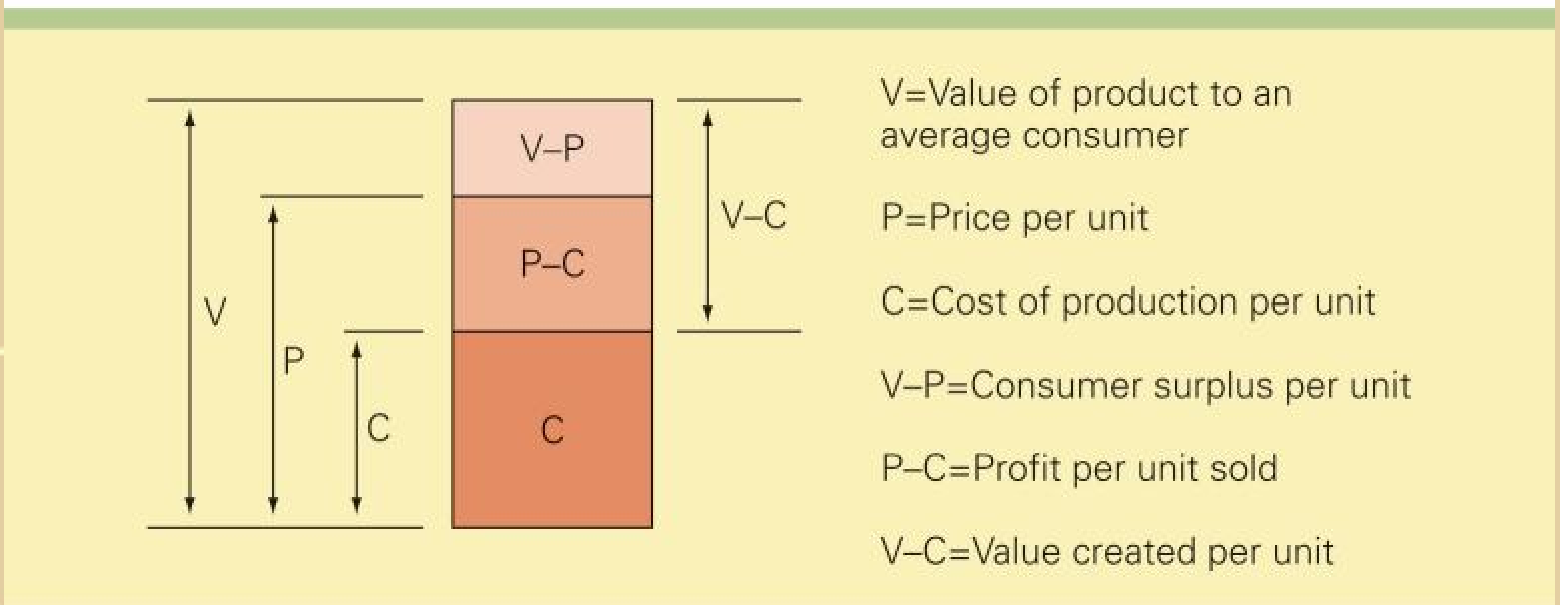


Value Creation

- The value created by a firm is measured by the difference between V (the price that the firm can charge for that product given competitive pressures) and C (the costs of producing that product)
- The higher the value customers place on a firm's products, the higher the price the firm can charge for those products, and the greater the profitability of the firm

Value Creation

Figure 12.2: Value Creation



Classroom Performance System

What is the rate of return the firm makes on its invested capital?

a) Profit growth

b) Profitability

c) Net return

d) Value created

Value Creation

Profits can be increased by:

- adding value to a product so that customers are willing to pay more for it – a differentiation strategy
- lowering costs – a low cost strategy

- Michael Porter argues that superior profitability goes to firms that create superior value by lowering the cost structure of the business and/or differentiating the product so that a premium price can be charged

Strategic Positioning

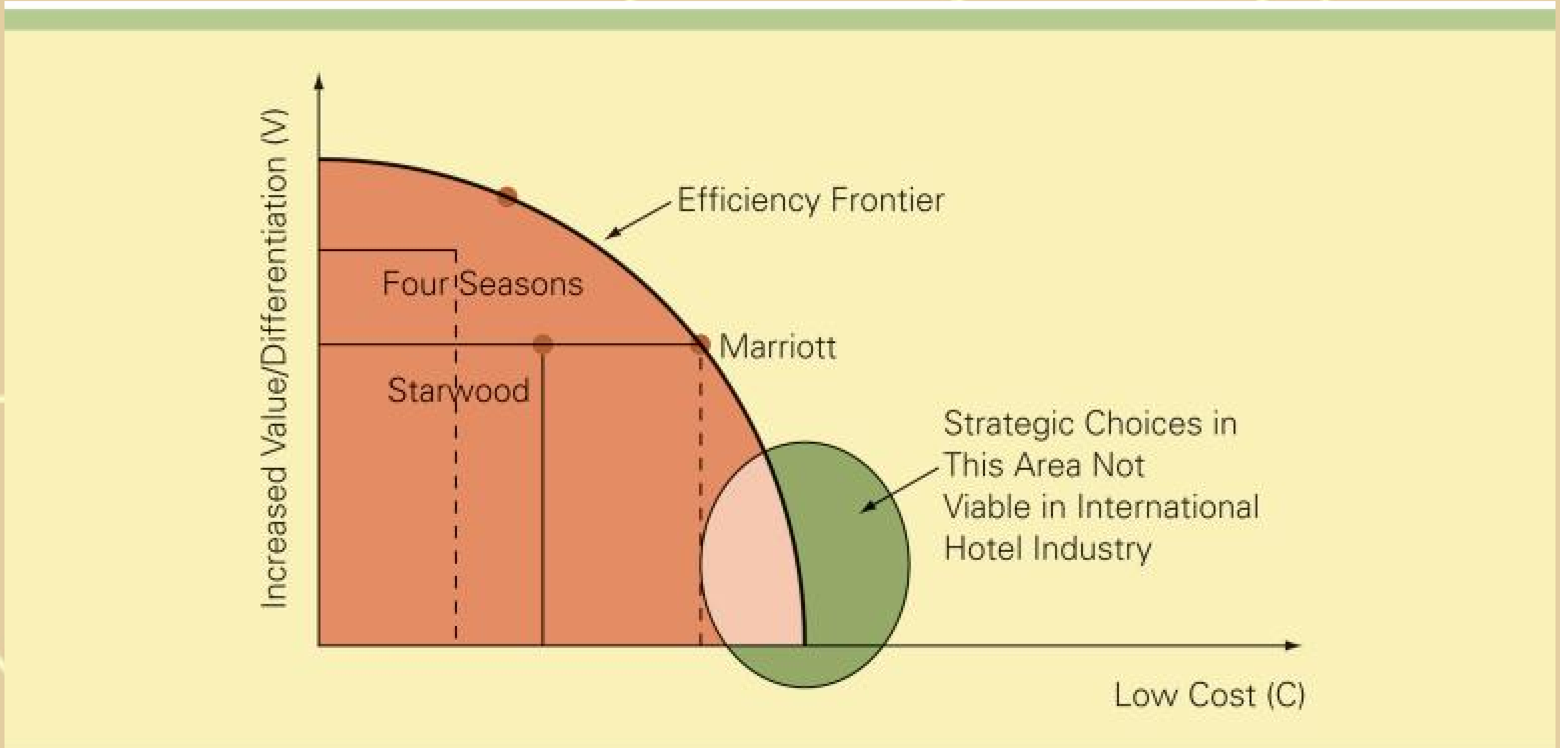
- Michael Porter argues that firms need to choose either differentiation or low cost, and then configure internal operations to support the choice

To maximize long run return on invested capital, firms must:

- pick a viable position on the efficiency frontier
- configure internal operations to support that position
- have the right organization structure in place to execute the strategy

Strategic Positioning

Figure 12.3: Strategic Choice in the International Hotel Industry



Operations: The Firm As A Value Chain

- A firm's operations can be thought of a value chain composed of a series of distinct value creation activities, including production, marketing, materials management, R&D, human resources, information systems, and the firm infrastructure
- Value creation activities can be categorized as primary activities (R&D, production, marketing and sales, customer service) and support activities (information systems, logistics, human resources)

Classroom Performance System

Which of the following is *not* an example of a primary activity?

a) Logistics

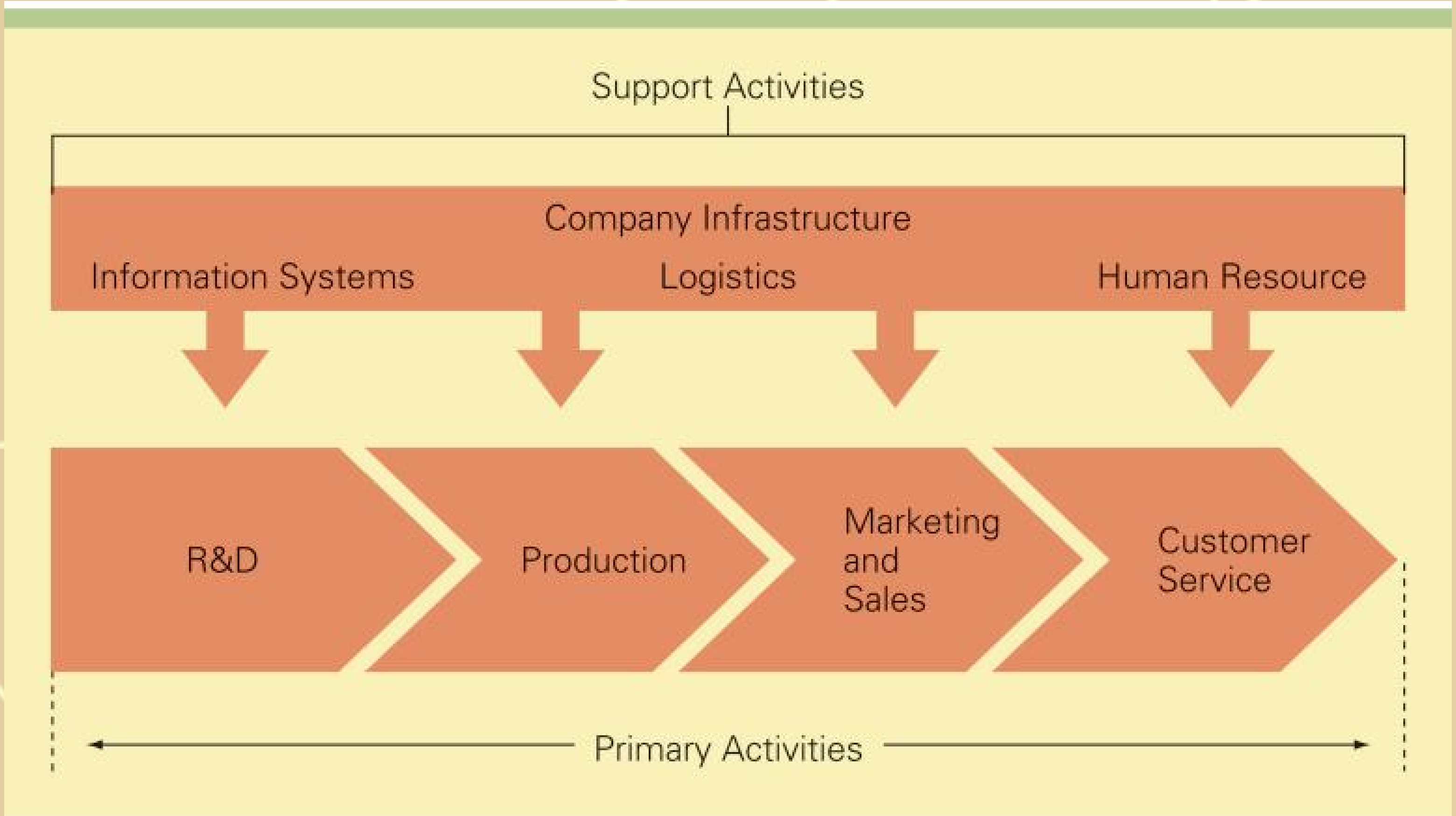
b) Marketing and sales

c) Customer service

d) Production

Operations: The Firm As A Value Chain

Figure 12.4: The Value Chain



Global Expansion, Profitability, And Profit Growth

International firms can:

- expand the market for their domestic product offerings by selling those products in international markets
- realize location economies by dispersing individual value creation activities to locations around the globe where they can be performed most efficiently and effectively
- realize greater cost economies from experience effects by serving an expanded global market from a central location, thereby reducing the costs of value creation
- earn a greater return by leveraging any valuable skills developed in foreign operations and transferring them to other entities within the firm’s global network of operations

Expanding The Market: Leveraging Products And Competencies

- Firms can increase growth by selling goods or services developed at home internationally
- The success of firms that expand internationally depends on the goods or services they sell, and on their core competencies (skills within the firm that competitors cannot easily match or imitate)
- Core competencies enable the firm to reduce the costs of value creation and/or to create perceived value in such a way that premium pricing is possible

Location Economies

❖When firms base each value creation activity at that location where economic, political, and cultural conditions, including relative factor costs, are most conducive to the performance of that activity, they realize location economies (the economies that arise from performing a value creation activity in the optimal location for that activity, wherever in the world that might be)

❖By achieving location economies, firms can:

❖lower the costs of value creation and achieve a low cost position

❖differentiate their product offering

Location Economies

- Firms that take advantage of location economies in different parts of the world, create a global web of value creation activities
- Under this strategy, different stages of the value chain are dispersed to those locations around the globe where perceived value is maximized or where the costs of value creation are minimized

A caveat:

- transportation costs, trade barriers, and political risks complicate this picture

Classroom Performance System

What is created when different stages of a value chain are dispersed to locations where value added is maximized or where the costs of value creation are minimized?

a) Experience effects

b) Learning effects

c) Economies of scale

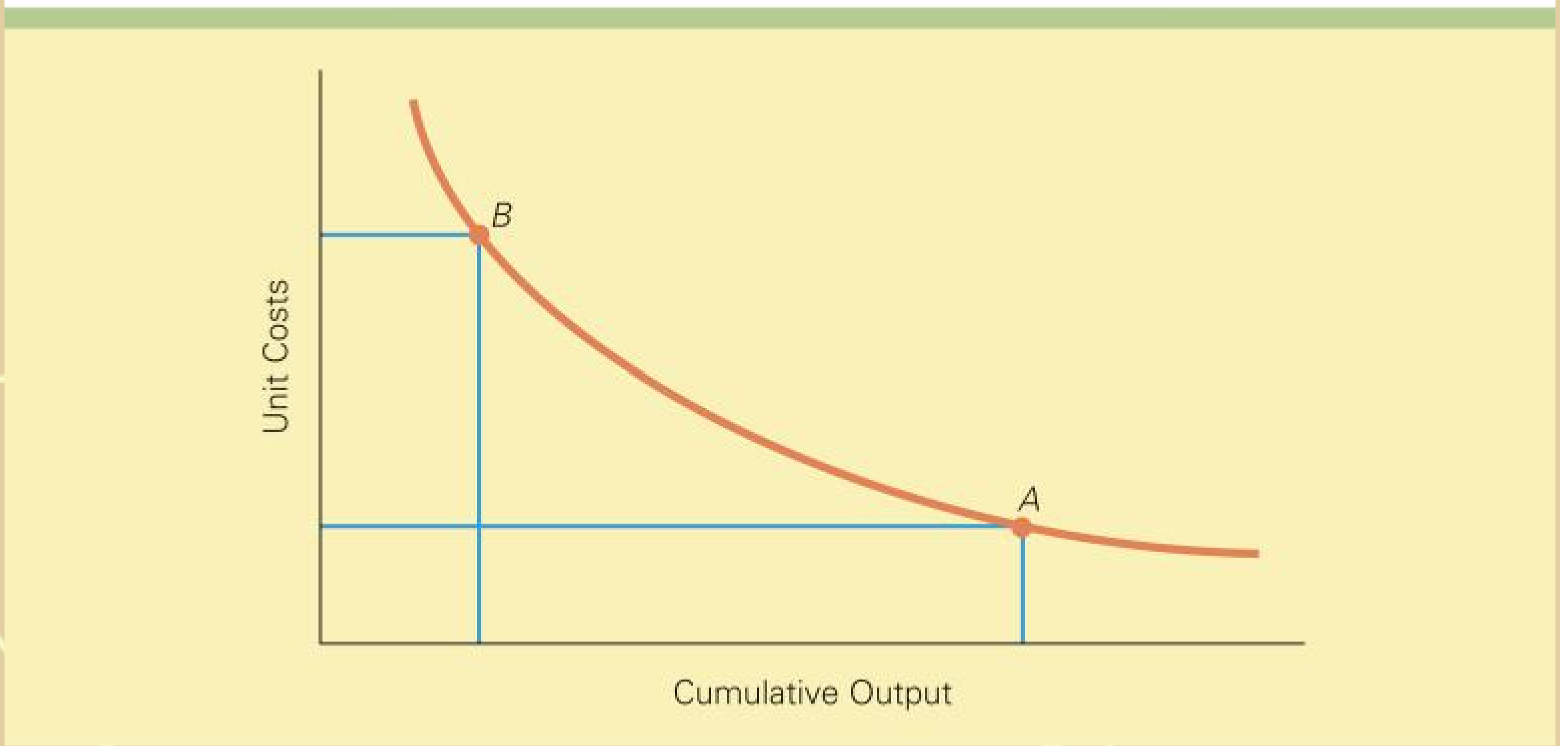
d) A global web

Experience Effects

- The experience curve refers to the systematic reductions in production costs that have been observed to occur over the life of a product
- Learning effects are cost savings that come from learning by doing
- So, when labor productivity increases, individuals learn the most efficient ways to perform particular tasks, and management learns how to manage the new operation more efficiently

Experience Effects

Figure 12.5: The Experience Curve



Experience Effects

❖Economies of scale refer to the reductions in unit cost achieved by producing a large volume of a product

Sources of economies of scale include:

❖spreading fixed costs over a large volume

❖utilizing production facilities more intensively

❖increasing bargaining power with suppliers

❖By moving down the experience curve, firms reduce the cost of creating value

❖To get down the experience curve quickly, firms can use a single plant to serve global markets

Leveraging Subsidiary Skills

It is important for managers to:

- recognize that valuable skills that could be applied elsewhere in the firm can arise anywhere within the firm's global network (not just at the corporate center)
- establish an incentive system that encourages local employees to acquire new skills
- have a process for identifying when valuable new skills have been created in a subsidiary

Summary

- Managers need to keep in mind the complex relationship between profitability and profit growth when making strategic decisions about pricing
- In some cases, it may be worthwhile to price products low relative to their perceived value in order to gain market share

Cost Pressures And Pressures For Local Responsiveness

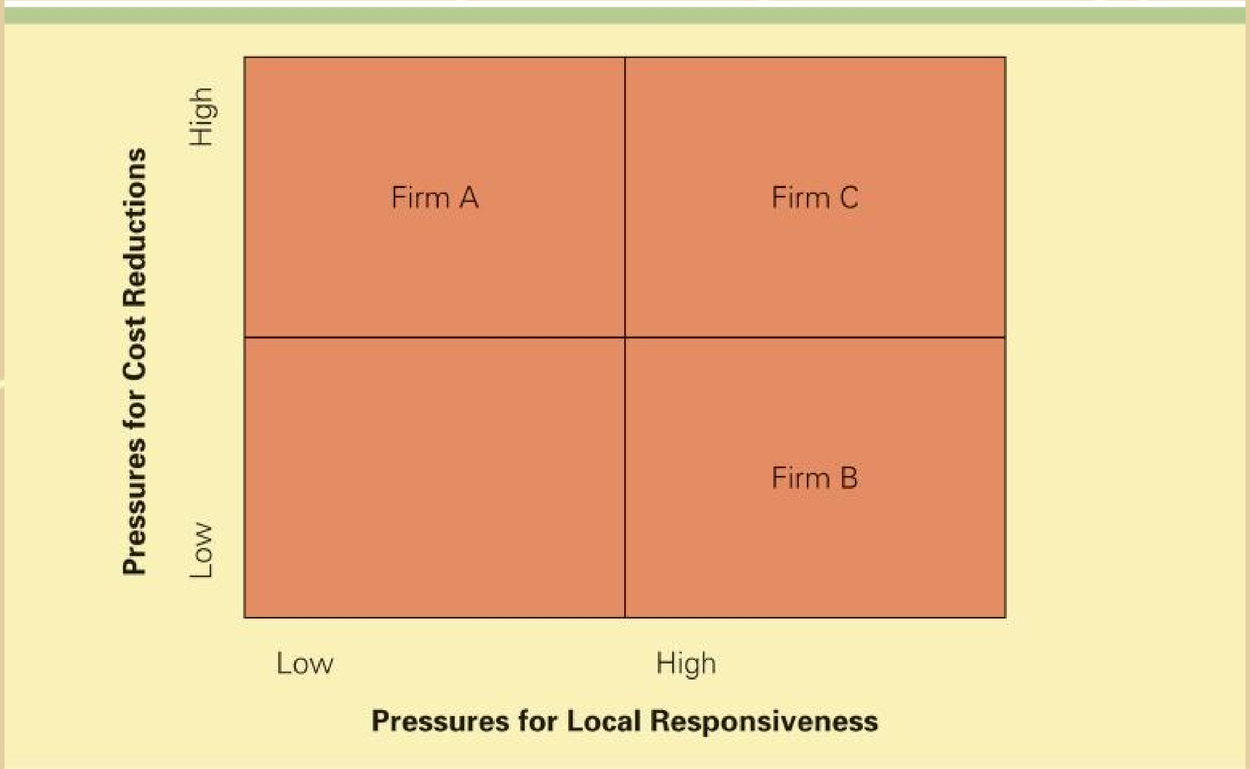
Firms that compete in the global marketplace typically face two types of competitive pressures:

- pressures for cost reductions
- pressures to be locally responsive

- These pressures place conflicting demands on the firm
- Pressures for cost reductions force the firm to lower unit costs, but pressure for local responsiveness require the firm to adapt its product to meet local demands in each market—a strategy that raises costs

Cost Pressures And Pressures For Local Responsiveness

Figure 12.6: Pressures for Cost Reductions and Local Responsiveness



Pressures For Cost Reductions

Pressures for cost reductions are greatest:

- in industries producing commodity type products that fill universal needs (needs that exist when the tastes and preferences of consumers in different nations are similar if not identical) where price is the main competitive weapon
- when major competitors are based in low cost locations
- where there is persistent excess capacity
- where consumers are powerful and face low switching costs

Pressures For Local Responsiveness

Pressures for local responsiveness arise from:

❖differences in consumer tastes and preferences - strong pressures for local responsiveness emerge when consumer tastes and preferences differ significantly between countries

❖differences in traditional practices and infrastructure - pressures for local responsiveness emerge when there are differences in infrastructure and/or traditional practices between countries

Pressures For Local Responsiveness

- **differences in distribution channels** - a firm's marketing strategies needs to be responsive to differences in distribution channels between countries
- **host government demands** - economic and political demands imposed by host country governments may necessitate a degree of local responsiveness

Classroom Performance System

Which of the following is *not* a pressure for local responsiveness?

a) Excess capacity

b) Host government demands

c) Differences in consumer tastes and preferences

d) Differences in distribution channels

Choosing A Strategy

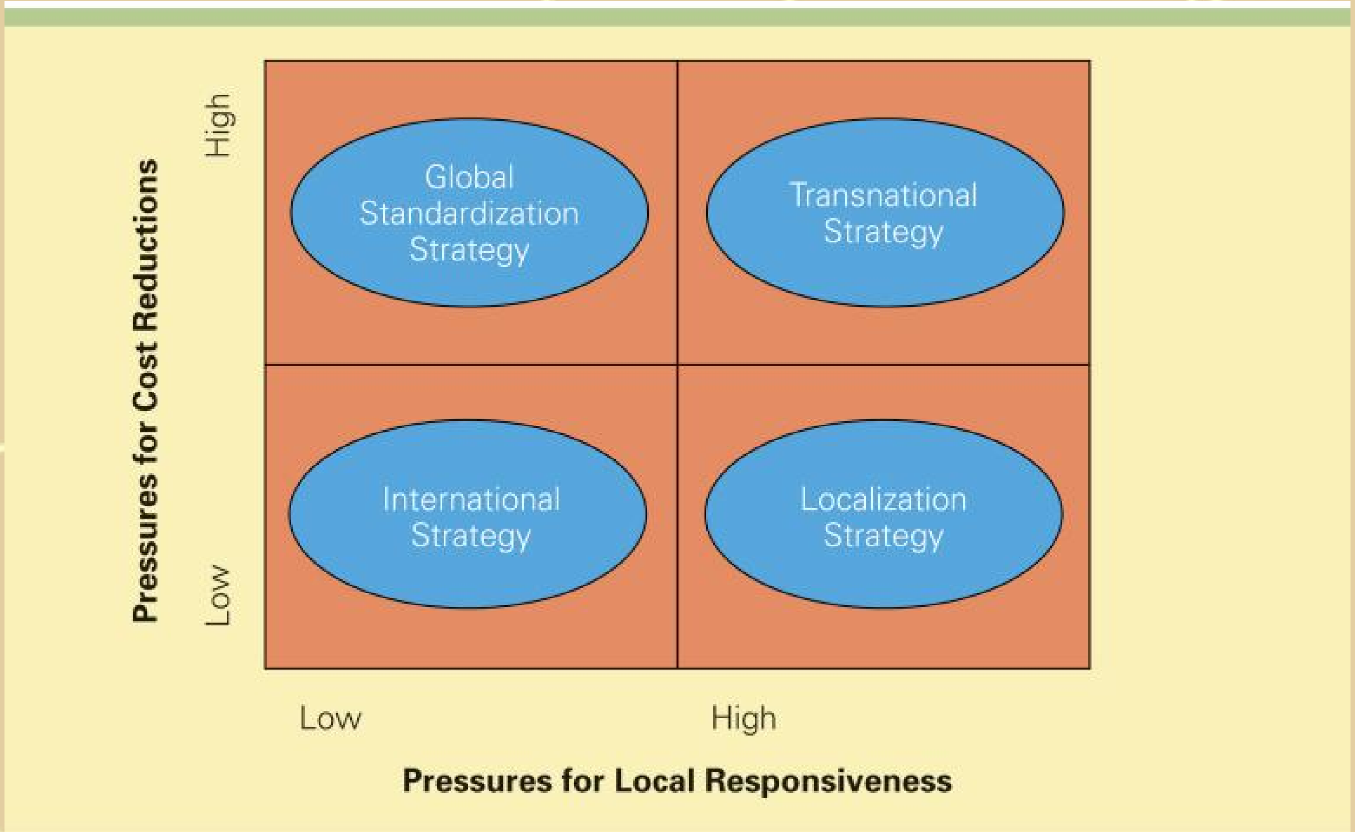
There are four basic strategies to compete in the international environment:

- global standardization
- localization
- transnational
- International

- The appropriateness of each strategy depends on the pressures for cost reduction and local responsivness in the industry

Choosing A Strategy

Figure 12.7: Four Basic Strategies



Global Standardization Strategy

- The global standardization strategy focuses on increasing profitability and profit growth by reaping the cost reductions that come from economies of scale, learning effects, and location economies
- The strategic goal is to pursue a low-cost strategy on a global scale

The global standardization strategy makes sense when:

- there are strong pressures for cost reductions
- demands for local responsiveness are minimal

Localization Strategy

- The localization strategy focuses on increasing profitability by customizing the firm's goods or services so that they provide a good match to tastes and preferences in different national markets

The localization strategy makes sense when:

- there are substantial differences across nations with regard to consumer tastes and preferences
- where cost pressures are not too intense

Transnational Strategy

The transnational strategy tries to simultaneously:

- achieve low costs through location economies, economies of scale, and learning effects
- differentiate the product offering across geographic markets to account for local differences
- foster a multidirectional flow of skills between different subsidiaries in the firm's global network of operations

The transnational strategy makes sense when:

- cost pressures are intense
- pressures for local responsiveness are intense

International Strategy

❖The international strategy involves taking products first produced for the domestic market and then selling them internationally with only minimal local customization

The international strategy makes sense when

- ❖there are low cost pressures
- ❖low pressures for local responsiveness

Classroom Performance System

Which strategy tries to simultaneously achieve low costs through location economies, economies of scale, and learning effects, and differentiate the product offering across geographic markets to account for local differences?

a) Internationalization

b) Localization

c) Global standardization

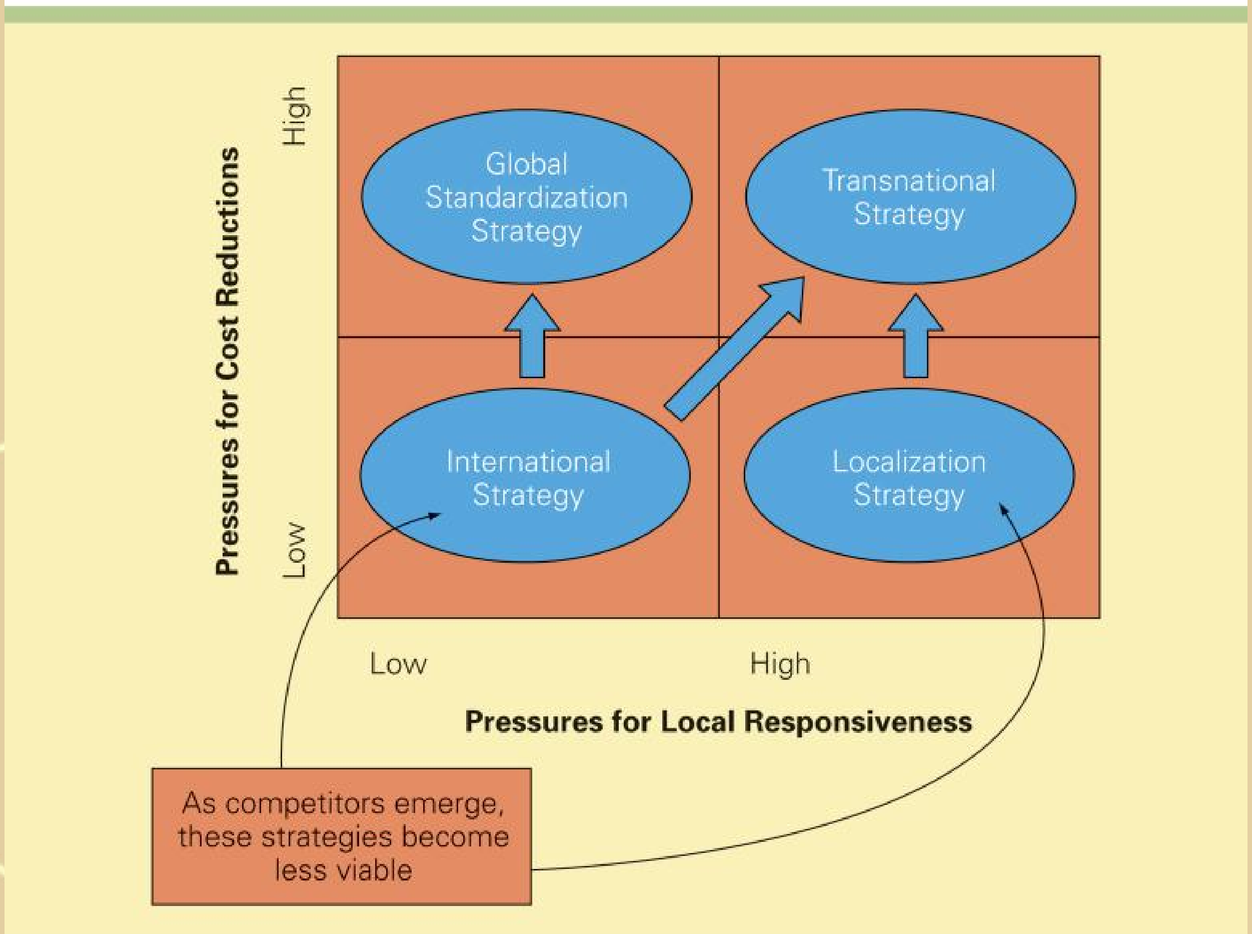
d) Transnational

The Evolution of Strategy

- An international strategy may not be viable in the long term
- To survive, firms may need to shift to a global standardization strategy or a transnational strategy in advance of competitors
- Similarly, localization may give a firm a competitive edge, but if the firm is simultaneously facing aggressive competitors, the company will also have to reduce its cost structures, and the only way to do that may be to shift toward a transnational strategy

The Evolution of Strategy

Figure 12.8: Changes in Strategy over Time



Classroom Performance System

Which strategy makes sense when pressures are high for local responsiveness, but low for cost reductions?

a) Global standardization strategy
b) International strategy
c) Transnational strategy
d) Localization strategy