Major developments in international finance
- Collapse of communism in Eastern Europe and former Soviet Union
- European Union (EU) and the “euro”
- NAFTA
- Loosening of U.S., foreign bank, and capital market regulations
- Telecommunications technology
- China’s economic development
- Cross-border acquisitions
- Low overseas production costs and easy importation of goods into the U.S.

Multinational enterprises (MNEs)
- MNEs are firms that operate in an integrated fashion in a number of countries.
- MNEs buy and sell goods across national borders and make direct investments in fully integrated operations in other countries.
- MNEs are involved in the traditional aspects of international commerce (sourcing inputs and selling goods) and much more.

Globalization
- Economies, markets and people in different countries are becoming more interconnected everyday.
- Globalization has the potential of raising the standard of living, but can also challenge long-held cultural values about the role of business in society.

Why firms “go global”
- Better production efficiency
- Avoid political, trade, and regulatory hurdles
- Broaden markets
- Seek raw materials and new technology
- Protect the secrecy of processes and products
- Diversify
- Retain customers

Why globalization matters to domestic firms
- Even if a company is a “domestic” company, it must be concerned about global issues because:
  - Foreign competitors may enter their markets and use advantages gained from globalization to out-compete domestic firms.
  - Domestic firms might rely upon foreign suppliers or customers, so exchange rates will affect their profits.
  - Integrated global capital markets will affect the domestic firm’s ability to acquire capital.
Multinational vs. domestic financial management

- Different currency denominations
- Political risk
- Economic and legal ramifications
- Role of governments
- Language and cultural differences

Effect of globalization on financial decision making

- The international environment introduces new opportunities and challenges.
  - A larger investment opportunity set is available.
  - With greater investment opportunities, there is a greater need for investment capital.
  - Introduces other tax systems, exchange rates, regulatory environments, and political systems.

Effect of globalization on financial decision making

- Fundamentally, financial decision making does not change in a global environment. It still focuses on stockholder wealth maximization.
- Historically, segmented international markets have led to equilibria being achieved within countries, but not across countries.
- Globalization allows for the exchange of resources and goods across national borders and for an equilibrium that smooths wages, costs, and prices across the global financial environment.

Primary goal of the firm: Maximizing stockholder value

- Stockholders own the firm, and they elect directors who hire managing executives.
- Directors monitor managers and set the strategic direction for the firm and determine managers’ compensation.
- Management’s overriding goal is to create value for stockholders.
  - Do firms have any responsibilities to society at large?
  - Is stock price maximization good or bad for society?
  - Should firms behave ethically?

Stockholder value

\[
\text{Value} = \sum_{t=0}^{N} \frac{CF_t}{(1+r)^t}
\]

- \(CF_t\) represents expected cash flows at time \(t\) and \(r\) is the discount rate for the cash flows.
- The value of a firm is the present value of the cash flows the firm is expected to provide investors in the future.
- This valuation equation will be used throughout the course to value stocks, bonds, projects, and companies.

Social responsibility

- Sometimes the goal of maximizing stockholder value appears to be at odds with what is good for society.
- Some argue that a singular focus on stockholder value is often too short-sighted.
- Others argue that market participants acting in their own self-interest leads to an Adam Smith-like equilibrium that efficiently allocates resources.
- Should firms pursue multiple goals?
Stockholder vs. stakeholder wealth maximization

- In some areas of the world (like Europe and Asia), firms focus on maximizing stakeholder wealth.
- Stakeholders are all those parties that have an interest in the firm. They include stockholders, employees, customers, banks, suppliers, the community, etc.
- In Japan and Korea, managers often focus on maximizing the benefit to their interlocking business groups (called keiretsus in Japan and chaebols in Korea).

Agency relationships

- An agency relationship exists whenever a principal hires an agent to act on his/her behalf and delegates decision making authority to the agent.
- Within a corporation, agency relationships exist between:
  - Stockholders and managers
  - Managers and debtholders
  - Managers, stockholders, and debtholders

Stockholders vs. managers

- Two extreme positions of how to deal with stockholder-manager problems:
  - Compensate managers solely on the basis of stock price changes.
  - Agency costs are low because managers have high incentive to maximize shareholder wealth.
  - But, compensation would be affected by factors out of managers’ control and it would be hard to get good managers.
  - Stockholders could monitor every managerial action.
  - Costly and inefficient, resulting in high agency costs.

Stockholders vs. debtholders

- Shareholders (through managers) could take risky actions to maximize stock price that are detrimental to creditors.
- In the long run, such actions will raise the cost of debt and ultimately lower stock price.
- If management’s risky actions were to pay off, the benefits would accrue mostly to stockholders, while if they fail, the cost accrues mostly to debtholders.

Stockholders vs. managers

- Some of the actions that can be taken to ease stockholder-manager conflicts include:
  - Aligning manager and firm incentives using managerial compensation plans
  - Shareholders directly intervening
  - The threat of firing managers
  - The threat of a takeover

Stockholders (through managers) vs. debtholders

- Creditors have contractual claims on part of the firm’s earnings stream.
- Stockholders control (through managers) decisions that affect the riskiness of the firm.
- Rates at which creditors lend funds are based upon the firm’s risk, which is based on:
  - Riskiness of the firm’s existing assets.
  - Expectations concerning the riskiness of future asset additions.
  - Existing capital structure.
  - Expectations about future capital structure decisions.
How should firms behave?

- Corporate governance systems provide the financial and legal framework that dictates the relationship between a company’s management and its shareholders.
- Business ethics outline a company’s attitude and conduct toward its employees, customers, community, and stockholders.