

**1. Until quite recently, the Euro was considered a success. However, its viability is now in question. Briefly describe the rationale for introducing the Euro. Why is it in difficulty now? What are two possible outcomes of the current Euro crisis? Why created?**

Created in January 1999 in order to create economic growth that would be fostered with actions that also reinforced European unity, linking together the European nations for trade and political purposes

In order to achieve its goals to harmonize member states & foster economic growth, a single currency would ideally establish a monetary cooperation among 17/28 EU member states having its own single internal market.

- **Obvious Advantages**
- No more need to change money when you arrived in another country
- No more uncertainty on the part of importers about what a contract would actually end up costing
- or exporters about what promised payment would actually be worth
- Shared currency would strengthen the sense of European unity
- fluctuation risks and exchange costs eliminated

**Why is it in difficulty now?**

-Loss of economic flexibility

-Europe is not fiscally integrated

-Legal right for Europeans are free to work in euro-zone, but cultural & language barriers still exist – lack of this integration makes euro-zone Europeans still less geographically mobile.

Therefore, the downfalls of one country have near direct effects onto other Euro-Zone nations...

As interest rates converged across Europe, the formerly high-interest-rate countries went, predictably, on a borrowing spree & ran up enormous debts (e.g. Greece, Ireland)

Ireland & Spain's real estate boom's bubble burst, leading to a real estate market crashed in Spain and Ireland. Their governments felt the burden decreases in government revenues.

Ireland's government attempted to bail out Irish banks, which lead to an increase in their debt deficit, public debt, and unemployment rates → vicious circle.  
& concerns that Spanish banks face the same fate...

Consequences:

-debtors must payback lenders with smaller incomes. Only way is to cut spending even more, further depressing the economy and still be in the vicious circle. Only way to get out of and avoid vicious circle is monetary expansion that heads off deflation,

But Greece, Spain, Ireland and other Euro-zone countries cannot because they don't have their own monies needed to get costs in line.

Potential lenders lost confidence, interest rates on the debt rose, undermining future prospects, leading to a further loss of confidence and even higher interest rates.

**What are 2 possible outcomes of Euro Crisis? ("choose any 2 of 4")**

- Tough it out - Austerity could lead to depression-like economy.
- Debt restructuring - could bring the vicious circle of falling confidence and rising interest costs to an end.
- Default and devalue - Any euro-zone country that hinted at leaving the currency would trigger a devastating run on its banks as depositors rushed to move their funds to safer locales.
- Deeper integration -Stronger countries cover weaker countries debt and finances. Move toward a federation

**2. Assume that you are the CFO for a Canadian producer of aircraft engines and that your company has received an order for 150 engines from an aircraft manufacturer in Australia. It is valued at \$20 million Canadian dollars and payment will be due upon**

**delivery of the engines which will occur nine months from now. The customer insists on paying you in Australian dollars. Should you accept these terms? What are the risks in doing so? What options are available to offset any risk? Being 9 months away,**

unpredicted changes in future exchange rates will have adverse consequences for the firm.

**Risks:**

-Government restrictions on currency convertibility. Australia, like Canada, is a freely convertible currency. However, 9 months from now is August 2014, and the Australian government could impose restrictions on currency convertibility that will effect the deal and leave the Canadian at risk of profit losses. E.g. restricting residents' ability to convert the domestic currency into a foreign currency and restricting domestic businesses' ability to take foreign currency out of the country in order to 1) Preserving foreign exchange reserves and 2) Capital flight - a fear that free convertibility will lead to a run on their foreign exchange reserves

-F/X movements:

Australian dollar might depreciate against the Canadian dollar, and the Canadian dollar would appreciate against the Australian dollar by the time the transaction has been executed (in 270 days or 9 months).

**Reasons:**

Currency values are extremely difficult to predict with any accuracy.

The demand and supply of the Australian currency and/or Canadian currency can effect the f/x rate.

**Solutions:**

In order to ensure & offset this risk, the Canadian firm needs to engage in hedging. Relative instruments that can apply in this situation include 1) forward exchange contract between the two companies. And if the Australian company does not agree, then 2) the Canadian company can engage in a forward exchange deal with its bank.

1) Between the two companies:

In order to offset risk, Canadian company (exporter of the products) and Australian company (importer of the products) may want to engage in a forward exchange contract (i.e. agree to exchange currency and execute the deal at some specific date in the future). Exchange rates governing such future transactions are referred to as forward exchange rates, which the two companies will agree upon to apply in the transaction in 270 days (9 months) .

This can eliminate the risk of the unknown future movements of the spot exchange rate after 9 months (real-time exchange rate of a deal/transaction being exchange the same day), and isolate the 9 months as lead time versus profit/loss risk.

This forward exchange contract acts as an insurance, hedge the foreign exchange risk that the future in 9 months might hold. Typically these contracts are 30, 90, and 180 days, but can also but up to several years – in this case, 270 days (9 months).

2) Canadian company can engage in a forward exchange contract much like the aforementioned one, however, instead of with the Australian company, it will be with the bank.

**3) What is meant by the word ‘strategy’? Using Procter & Gamble as an example, describe how the company could pursue each of the following strategies: international, localization, and global standardization. What is meant by the word ‘strategy’?**

- Actions that managers must take to attain the goals of the firm
- For most firms, the preeminent goal is to maximize the value of the firm for its owners i.e. maximize shareholders’ wealth

**Describe how P&G can pursue each strategy:**

International:

-P&G would have need core competency, more centralized, and the rest decentralized in vertical differentiation.

-They would need worldwide product divisions in horizontal differentiation

-They would have a moderate need for coordination

-They would need few integrating mechanisms

-There would be moderate performance ambiguity to overcome (international is the 3<sup>rd</sup> lowest strategy for performance ambiguity)

-They would have a moderate need for cultural controls

Advantages – transfer core competencies to foreign markets

Disadvantages – lack of local responsiveness, inability to realize location economies, failure to exploit experience curve effects.

#### Localization:

P&G would have decentralized in vertical differentiation

-They would need worldwide area structure in horizontal differentiation

-They would have a low need for coordination

-They would need no integrating mechanisms

-There would be low performance ambiguity to overcome (localization is the lowest strategy for performance ambiguity)

-They would have a low need for cultural controls

Advantages for P&G include customize product offerings and marketing in accordance with local responsiveness

Disadvantages -inability to realize location economies, failure to exploit experience curve effects, failure to transfer core competences to foreign markets.

#### Global standardization:

-P&G would have some centralization in vertical differentiation

-They would need worldwide product divisions in horizontal differentiation

-They would have a high need for coordination

- They would need many integrating mechanisms
- There would be high performance ambiguity (global standardization is the 2<sup>nd</sup> highest strategy for performance ambiguity)
- They would have a high need for cultural controls

Advantages for P&G would include exploiting experience curve effects, exploit location economies. But disadvantages as there would be a lack of local responsiveness.

- 4) “The choice of strategy for a multinational firm must depend on a comparison of the benefits of the strategy (in terms of value creation) with the costs of implementing it (as defined by organizational architecture necessary for implementation). On this basis, it may be logical for some firms to pursue a localization strategy and still others a transnational strategy.” Is this statement correct? If so, why? If not, why not?**

Localization Strategy:

- Multinational Firm would have decentralized in vertical differentiation
- They would need worldwide area structure in horizontal differentiation
- They would have a low need for coordination
- They would need no integrating mechanisms
- There would be low performance ambiguity to overcome (localization is the lowest strategy for performance ambiguity)
- They would have a low need for cultural controls

Advantages for the Multinational firm include customize product offerings and marketing in accordance with local responsiveness

Disadvantages

- inability to realize location economies, failure to exploit experience curve effects, failure to transfer core competences to foreign markets.

Conclusion:

-Bad for consumer products firm

-Good for firms who compete with commodity based/dependent products or activities for competitive advantage

Transnational Strategy:

-Multinational Firm would have mixed centralization and decentralized in vertical differentiation

-They would need an informal matrix in horizontal differentiation

-They would have a very high need for coordination

-They would need very many integrating mechanisms

-There would be very high performance ambiguity to overcome (transnational is the highest strategy for performance ambiguity)

-They would have a very high need for cultural controls

Advantages

- exploit experience curve effects
- exploit location economies
- customize product offerings and marketing in accordance with local responsiveness
- reap benefits of global learning

Disadvantages

-difficult to implement due to organizational problems

Conclusion:

-Not good for firms who depend on rigid organization structure for competitive advantage

**5) What is transfer pricing? Using the CBC Radio One interview with Dennis Howlett, Executive Director of Canadians for Tax Fairness as a reference point, describe how transfer pricing can affect the profits of firms doing business internationally such as Cameco and Google? What types of ethical questions does the practice of transfer pricing raise?**

Transfer pricing: The price at which goods and services are transferred between subsidiary companies of a corporation.

- 26 of more profitable fortune companies paid 0 dollars in federal income tax from 2008-2012. General electric, Verizon, Boeing
- Was not illegal
- Corporate tax avoidance: use complex business process to shift profits into low or no tax jurisdictions
- Apple shifted 74 billion dollars to Ireland
- Cameco has to pay up to 850 million in unpaid taxes, currently in a lawsuit with the Canadian gov't.
- Cameco set up a 17 year agreement in Switzerland to market their uranium for them and sold uranium from Canada to the Swiss subsidiary at 10\$/pound. Uranium went up 100\$ and now 30\$/ pound. Bulk of profits were in Switzerland where they hardly pay taxes. This is transfer pricing. Therefore avoided paying over 850 million. Canadian revenue going through all the years. All profits were taken in Switzerland. All Uranium came from mines in Saskatchewan. World market price for Uranium, so easy to catch them.
- Rule is supposed to have an arm's length relationship, even if subsidiary. Over 60% of world trade goes between companies. More and more difficult to enforce arm length rule. Most companies get away with it.
- TSX companies pay less than 5% in taxes. More than half pay less than 10%.
- Set up subsidiaries in tax havens and shift profits out of Canada and accumulate them when there is very little tax paid.
- Ethical question: Illegal tax evasion (Hiding money in tax havens)
- Google set up a subsidiary in Ireland, sold intellectual property to that subsidiary who then transferred their profits to another subsidiary in Barbados. And set up a subsidiary in Netherlands. They can claim that they paid applicable taxes which amounted to nothing and moved their

money back to Ireland because they paid the applicable taxes in the foreign countries, which is 0.

- Law was not made to create double taxation. In the process of reforming it.
- Ordinary tax payers are taking more of the tax responsibility.
- Undermines the competitiveness of company's.
- Not seeing those profits being reinvested and creating jobs and education.
- Eroding the way to create a competitive country.
- Redistribution of income in order to get the country going.
- Fairness and quality services. Good return for what you're paying for.
- Zero-sum game is lower corporate tax in order to become haven.

**6) Define the terms 'law of one price' and 'purchasing power parity'. Describe how they and the money supply and price inflation influence exchange rates.**

-Law of One Price: law that states that in competitive markets free of trade barriers and transportation costs, identical products sold in different countries must have the same price, when their price is expressed in terms of the same currency

-Purchasing Power Parity: if the law of one price were true for all goods, then the PPP exchange rate could be found from any individual set of prices. It states that if a good costs \$5 USD or 10Yen, then the exchange rate SHOULD be \$1USD:2Yen. That said, change in relative prices will result in a change in exchange rates. PPP also states that a country with a high inflation rate will see depreciation in exchange rates

-Money Supply and Price Inflation: states that if a government increases a money supply (gives everyone money), then there will be a massive increase in the demands of goods, which will result in inflation. PPP then states that inflation increase will cause foreign exchange decrease

- If one country's interest rates are high relative to others', it will attract foreign funds. Why would this be the case?

-Inflation occurs when the money supply increases faster than output increases.

- A country with high inflation should expect its currency to depreciate against the currency of a country with a lower inflation rate.

-Investor psychology can also affect exchange rate movements.

-Expectations on the part of traders can turn into self-fulfilling prophecies and traders can join the bandwagon and move exchange rate based on group expectations.

-Such changes can be important in explaining some short-term exchange rate movement.

- At times government intervention can prevent the bandwagon from starting, but at other times it is ineffective and only encourages traders.
- Purchasing Power Parity (PPP) says that a currency's price should reflect the amount of goods and services it can buy.
- Or the idea that a dollar should buy the same amount in all countries.
- Usually captures the cost of living.
- In the long run, the exchange rate between two countries should move towards the rate that equalizes the prices of an identical basket of goods and services in each country

**7) Debate the relative merits of fixed and floating exchange rate regimes. From the perspective of an international business, what are the most important criteria in a choice between the systems? Which system is more desirable for an international business? Why?**

- Floating exchange rate regime merits:
  - Monetary Policy Autonomy: argument that the removal of the obligation to maintain exchange rate parity would restore monetary control to a government.
  - Trade Balance Adjustments: under the Bretton Woods system, if a country developed a permanent deficit in its balance of trade that could not be corrected by domestic policy, then the IMF would have to agree to a currency devaluation. This adjustment mechanism works much more smoothly under floating exchange rate policies
- Fixed exchange rate regime merits:
  - Monetary Discipline: a fixed exchange rate would ensure that governments no longer give in to political pressures and expand the monetary supply (which causes high inflation rates)
  - Speculation: a fixed exchange rate will limit the destabilizing effects of speculation (floating exchange rates base their facts on speculation)
  - Uncertainty: floating exchange rates also leads to uncertainty which dampens the growth of international trade and investment, whereas fixed rates avoids this and promotes the growth of international trade and investment
  - Trade Balance Adjustments: rejects the floating exchange rates' belief that a floating exchange rate helps adjust trade imbalances. Believes instead that there is no link between exchange rates and trade imbalance
- Which one is better?
  - Exchange rates are extremely important in international business, the most important criteria comes in the form of speculation
  - the most favorable one still remains floating exchange rates because fixed rates that border the Bretton Woods system were proven faulty through speculation. However, if there was a fixed rate that didn't border the Bretton Woods system,

then it might facilitate more rapid growth in international trade and be better off than the current floating exchange rates

**8) Briefly describe the origins and roles of the IMF and World Bank using the Bretton Woods system as a starting point.**

-In 1944, representatives from 44 countries met at Breton Woods to design a new international monetary system

-After the collapse of the gold standard and the Great Depression, they were determined to build an enduring economic order that would facilitate postwar economic growth.

-The consensus was that fixed exchange rates were desirable.

-The agreement reached at Bretton Woods established two multinational institutions: The International Monetary Fund and the World Bank. There was also an agreement for a system of fixed exchange rates that would be ran by the IMF.

**-IMF:**

-The task of the IMF would be to maintain order in the international monetary system to avoid a repetition of economic chaos, through a combination of discipline and flexibility.

-A fixed exchange rate regime imposed discipline in two ways.

-First, the need to maintain a fixed exchange rate puts a brake to competitive devaluation and brings stability to the world trade environment.

-Second, a fixed exchange rate regime imposes monetary discipline on countries, thereby curtailing price inflation.

-The makers of the Bretton Woods agreement wanted to avoid high unemployment, so they build limited flexibility into the system. Two major features of the IMF fostered this flexibility: the lending facilities and adjustable parities.

**-World Bank:**

-The World Bank's initial mission was to help finance the building of Europe's economy by providing low-interest loans.

-With the Marshall Plan, the United States was already lending to Europe nations to help them rebuild, therefore the bank turned its attention to "development" and began lending money to third-world nations.

-It lends money under two schemes. Money is first raised through bond sales in the international capital market and borrowers pay's a market rate of interest which is lower

than commercial bank's rate. The second scheme is overseen by the International Development Association, where wealthy nations subscribed to fund IDA loans that only goes to the poorest countries.

### **9) What is the fixed exchange rate system, what were its origins and why did it collapse?**

- System of fixed exchange rate were established in 1944 at Bretton Woods. Representatives from 44 countries met to design a new international monetary system.
- After the collapse of the gold standard and the Great Depression, they were determined to build an enduring economic order that would facilitate postwar economic growth. The consensus was that fixed exchange rates were desirable.
- Under the agreement, all countries were to fix the value of their currency in terms of gold but were not required to exchange their currencies for gold. Only the dollar remained convertible into gold (35\$/ounce). A fixed exchange rate regime puts in place mechanism for controlling inflation and imposing economic discipline on countries.
- The collapse of the system can be traced back to the US macroeconomic policy package of 1965-1968. To finance the Vietnam war and the welfare programs, President Johnson backed an increase in government spending that was not financed by an increase in taxes.
- It came from an increase of money supply, which led to a rise in price inflation during that time period. The rise in government spending had stimulated the economy therefore people spent more, especially on imports, deteriorating the trade balance. Increase in inflation and worsening of US trade position gave rise to speculation in the foreign exchange market.
- For the first time in 1971, US was importing more than exporting which sets off the massive purchase of German currency, who speculators guessed it would get revalued against the dollar.
- Under Bretton Woods, any other country could change its exchange rates against all the currencies by simply fixing its dollar rate at a new level. But the key currency in the system could only be devalued if all countries agreed simultaneously to revalue against the dollar, and most countries did not want to because it would make their goods more expensive relative to the dollar.
- To offset the speculation, there was a switch to a floating system temporary and that solution became permanent. The fixed exchange rate system could only work as long as the US inflation rate remained low and US did not run a balance-of-payments deficit.

**10) By expanding globally, firms can increase their profitability and profit growth rate in ways not available to purely domestic enterprises. Identify and describe the four main profitably profit growth opportunities that global expansion can create using a company such as Unilever or GE.**

1. Expanding the market for their domestic product offerings by selling those products in international markets.

-A company can increase growth rate by selling goods and services developed at home and sell them internationally. Returns are greater if indigenous competitors in the nations a company enters lack comparable product. Expansion also relies on the core competencies. Core competence refers to skills within a firm that competitors cannot easily match or imitate, their competitive advantage. -Example: Unilever selling products in XYZ foreign country, where competitors can't match the quality of output

2. Realizing location economies by dispersing individual value creation activities to those locations around the globe where they can be performed most efficiently and effectively.

-It can lower the cost of value creation and help a firm differential its product from competitors, by creating a global web of activities performed efficiently. Transportations cost and trade barriers complicate this opportunity.

-Example of Unilever developing products in 3<sup>rd</sup> world country and developing its marketing in the US

3. Realizing greater cost economies from experience effects by serving an expanded a global market from a global location, thereby reducing costs of value creation.

-The experience curve refers to the systematic reductions in productions costs that occur over the life of a products. Economies of scale refers to the reduction in unit cost achieved by producing a large volume of a product, generally by spreading fixed costs over larger volume. Serving international markets from the same factories allows companies to utilize its productive assets more intensively which translates into higher capital productivity.

4. Earning 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.

-Skills can be created anywhere within a global network, where people have the opportunity and incentives of trying new things. Creation of skills can then help to lower costs of production, or enhance perceived value and support higher product pricing with coming from corporate center necessarily.

-Examples of XYZ company learning to manage better-in compact locations like Japan

**11) Briefly discuss the key issues that companies must consider with when deciding on their scales of entry and strategic commitments when it comes to expanding into new countries.**

-Entering a market on a large scale involves the commitment of significant resources; it also implies rapid entry.

-Not all firms have the resources necessary to enter on a large scale and some large companies prefer entering on a small scale then build slowly as they become more familiar with the market.

-The consequence of entering on a large scale are associated with the value of the resulting strategic commitments:

-A strategic commitment has a long-term impact and is difficult to reverse. A large scale entry can have an important influence on the nature of competition in a market. By entering, companies signal their commitment to the market.

**-Positive:** it will make it easier for the company to attract customers and distributors.

-It gives them reasons to believe the company will remain in the market for the long run.

-It will make foreign competitors hesitate to enter the market since not only they will have to compete with indigenous companies, they also have to deal with a large foreign institution.

**-Negative:** Fewer resources available to support expansion into other desirable markets, therefore limiting company's strategic flexibility.

-Firms must look at the implications: identify how actual and potential competitors might react to large scale entry.

-Large scale has the advantage over the small scale in:

-able to capture first-mover advantage with demand pre-emption, economies of scales and switching costs.

-Small-scale entry allows firms to learn about a foreign market while limiting its exposure to that market. It is also a way to gather information about the market before deciding to enter on a large scale and how to best enter it. With that collect of information, **small scale entry reduces the risk associated with a subsequent large scale entry. Therefore small scale entries > large scale entries**