Futures 42 (2010) 920–925

Contents lists available at ScienceDirect

Futures

journal homepage: www.elsevier.com/locate/futures

The transnational company after globalisation

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ARTICLE INFO

Article history:
Available online 18 August 2010

Keywords:
Multinational companies
Globalisation
Corporate finance

ABSTRACT

International capital market integration has facilitated the rise of a new kind of 'financially enhanced' transnational. The mode of operation of the financially enhanced transnational corporation is compared with that of the more traditional production-orientated multinational company. The paper discusses the breakdown of globalisation into a new regionalisation in the international financial system, and the spreading macroeconomic crisis in the major industrialised economies. It argues that new financing constraints will freeze the current structure of international business. The crisis reveals finance as the key enabler and feature of international business.

1. Introduction

The inflation of capital markets in the world's main financial centres, and the growing integration of capital markets since the 1980s have given rise to a new kind of transnational company. This is the 'financially enhanced' transnational, whose rapid growth has less to do with the dynamism of their productive and commercial activities, and more to do with the ability of companies to expand their balance sheets rapidly in inflating capital markets. When those balance sheets expand across the borders of sovereign states, multinational companies may extend cross-border activities through financial transactions, rather than decisions about how and where to produce abroad.

The circumstances in the financial markets that have fed this rapid growth have now come to an end, with the largest capital markets in the U.S. depressed by the financial crisis and the refinancing needs of the banking sector, a new international regionalism emerging out of the concentration of global foreign currency reserves in Asia, and the proliferation of bilateral swap arrangements between central banks in particular regions. This will leave the 'financially enhanced' transnational company still in a dominant position in international trade and production, but weakened by the increased illiquidity of its balance sheet.

The paper is structured as follows. The first section explores the distinctive mode of operation of the 'financially enhanced' transnational and its dependence on capital market inflation and international capital market integration. The second section examines the consequences for the 'financially enhanced' transnational of the current financial crisis. The third section outlines a key factor that will influence the progress of transnational companies in future, namely the emergence of a new regionalism in the international financial system. A final section remarks on some conclusions that may be drawn from this analysis for international business.

2. The 'financially enhanced' transnational

This section argues that the key factors in the evolution of transnational companies in recent years have not been the commercial dynamism of the advanced industrial countries or the emerging markets of Brazil, Russia, India and East Asia, but

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0016-3287/$ – see front matter © 2010 Published by Elsevier Ltd.
doi:10.1016/j.futures.2010.08.025

changes in the capital markets. For readers with a historical perspective, this should come as no surprise. After all, changes in capital financing and banking have always played a crucial part in the evolution of international business: The emergence of capital markets in North America and Europe, following legislation to facilitate the routine establishment of companies with limited liability in the 1860s, played a key part in the transition from the first generation of multinational companies to the second [1].

The first generation of multinational companies, dating back to the late middle ages, had been established as trading companies by sovereign princes as a way of promoting trade, but also of generating income for the Crown. Commercial legislation in the second half of the nineteenth century that facilitated the setting up of joint stock companies incubated a new generation of multinational companies that now were able to engage in production as well as trade. As capital controls were eased following the break-up of the Bretton Woods system at the start of the 1970s, this gave rise to the main *problématique* of late twentieth century international business theory, namely the management 'choice' of whether to produce at home or abroad, and the consequences of such strategies (see [2]).

However, the facilitation of foreign direct investment by multinational companies was by no means the most important outcome of the lifting of capital controls. This aspect of globalisation combined with a new key trend that emerged at the end of the 1970s, namely the inflation of capital markets by the systematic inauguration of funded pension schemes. The shift from old-style pay-as-you-go pension schemes, in which those currently in employment paid the pensions of those currently retired, to schemes in which contributions were invested in various financial and other asset markets, to generate a return out of which future pensions would be paid, resulted in major inflows into capital markets ([3], Part 2). The impact on securities prices was not equal: bonds and other instruments with fixed maturity (repayment) values obviously had little scope to inflate, unless the bonds had a long time to maturity. The inflationary impact in capital markets was therefore concentrated on equity values, which have no assured repayment in the future. This process I have elsewhere called 'capital market inflation' ([3], Part 1). Its symptom was the boom in equity markets that gathered pace in the 1980s and continued through into the 21st century. Its chief areas of concentration were the United States and the United Kingdom. This was not, as many proponents of capital market inflation argued at the time (see for example [4]), because of the inherent superiority of those countries' capital markets. Rather, the boom in the equity markets in those countries occurred because they had the largest shift towards funded pension schemes.

The effect of capital market inflation was an equity boom for companies, leading to the over-capitalisation of the largest companies. An over-capitalised company has more capital than it requires to conduct its non-financial business. The excess capital may be held as liquid assets, or used to conduct merger and takeover activity [5]. In the past, over-capitalisation was considered contrary to shareholders' interests because it involved 'watering down' the profits of a company, i.e., distributing a given profit generated from commercial activity over a greater amount of shares, or reducing earnings-per-share. But with anti-inflationary fervour maintaining high short-term interest rates, over-capitalisation virtually paid for itself because of returns on liquid assets. Additional profits could be generated from buying and selling companies.

In the 1980s, therefore, there emerged a new type of multinational company, the financially enhanced and, this time, genuinely transnational company: previous multinational companies had their ownership concentrated in one country; the new transnational, through its operations in capital markets around the world, has its ownership dispersed around those markets. The financial enhancement came in two forms. The first was through over-capitalisation, which improves the financial stability of a company by allowing it to hold more liquid assets without having to save these up out of its retained profits. The second financial enhancement was through access to capital markets around the world, as capital controls in Europe and North America, and then emerging markets (with the significant exception India and China) were eased. Companies could now raise additional capital in many other countries. Transnational companies like Siemens have their shares quoted in markets in the key countries in which they operate. Their ownership is, in theory at least, truly global, if we overlook the fact that in most markets only locally incorporated companies may have their shares listed. More importantly, relatively minor companies from developing countries could turn themselves into transnational companies simply through their ability to raise capital in the more open capital markets.

The promotion of emerging market companies such as Cimex and Mittal to transnational status did not, however, mean that the perfect capital market, that state of entrepreneurial democracy in which capital is available to anyone with a sound business idea, had arrived or was imminent. The opening up of capital markets usually meant allowing foreign residents to hold shares listed on a given market, rather than allowing foreign companies to raise capital in that market. This eased in a new kind of foreign direct investment. The old kind, dating back to the 19th century, involved the export of capital equipment, in which a company buys and installs such equipment in a foreign country. Increasingly, since the 1980s, foreign direct investment has been of the financial kind, in which no equipment crosses borders, but ownership of companies crosses borders. With the growing trend to privatisation, more and more state companies were sold to foreign companies, and holding companies divesting themselves of subsidiaries sold them to foreign purchasers.

The financially enhanced transnational company is distinctive because it grows by means of international mergers and acquisitions, rather than by means of expanding production abroad. Its strategic management is less concerned with decisions to set up production plants in foreign parts, but more and more with buying and selling companies in foreign parts: a lucrative business as long as capital market inflation allowed subsidiaries to be sold at a profit. It also means that, for a given volume of foreign direct investment there was now less actual investment in fixed capital and infrastructure [6]. In other words, the apparently more efficient capital market was in fact becoming less efficient at delivering productive investment: more financial transactions accompanied a given amount of such investment.

The general effect of capital market inflation on banks has been to make them less stable. The ease with which new securities may be issued, and high prices in securities markets, has made it much easier for governments and large corporations to finance themselves by issuing long-term securities, and even company paper, rather than borrowing from banks. This in turn has deprived banks of their largest and most reliable borrowers. Banks have responded to this by expanding their activities in financial markets, including the hitherto thriving derivatives markets, and increasing their lending to small and medium-sized enterprises and households. These have provided generous, but rather less reliable, fee and interest income to replace that lost from their larger corporate and government customers, who can satisfy their borrowing needs now in inflated securities markets.

However, international capital market integration has also offered new opportunities to banks. If even modestly proportioned but ambitious industrial and commercial companies may expand into transnational companies by expanding their balance sheets, raising capital and buying companies abroad, similarly small banks could also do the same. Multinational banking, whose modern history goes back to the era of the gold standard before the First World War, has experienced a revival from the 1960s with rise of the Euro-markets in which the leaders were New York banks, such as Citibank and J.P. Morgan. With the abolition of exchange controls in Europe, they were joined by European banks such as Spain's Santander, and Austria's Creditanstalt (see [7]). Such multinational banks conduct deposit-taking and lending in many countries. But their most dynamic business has come to them thanks to the activity of the new financially enhanced transnational companies. The issuance of capital obligations in different countries and the application of the proceeds of such new issuance to buying and selling financial assets in various countries, has resulted in a much more rapid turnover of larger foreign currency transactions and payments. These are conducted through transnational banks. A notable peculiarity of this development has been the way in which the U.S. Glass-Steagall Act, separating investment banking from commercial banking, gave European banks, which could conduct business more freely across all markets, a competitive advantage [8].

3. The impact of crisis

The rise of the financially enhanced transnational corporation and the financially enhanced transnational bank however, does not mean that the older generation of multinational corporations has not survived. They did, most notably in the motor-car industry of the United States, dominated by General Motors, Ford, and Chrysler and the conservative technological demands of the North American car market. The fate of these car manufacturers vividly illustrates the flaws in the business model of the older generation of multinational companies: Devotion to internationally integrated production left them with excess capacity as non-coincident business cycles made markets diverge around the world. For example, the post-unification industrial stagnation in Germany, from the mid-1990s onwards, reinforced international integration by keeping research, design and motor plants in that country, while encouraging the distribution of assembly plants in more dynamic economies, especially emerging markets, which then succumbed to crises in those markets.

The crisis of the U.S. motor-car corporations at the beginning of 2009 vividly illustrates the financial consequences of their failure to embark on financial enhancement. Without over-capitalisation they quickly ran out of liquid assets or reserves from which to defray the deficits in their income and expenditure flows, while internationally integrated production left them less able to raise liquidity through the sale of subsidiaries.

A major factor in the financial crisis now affecting large parts of the world was the growing indebtedness of companies, after years of equity boom. Increasing indebtedness came not as a result of higher investment, as Minsky and Fisher had argued in their theories of financial crisis and deflation, but because of need to refinance balance sheets [9,10]. Thanks to over-capitalisation many financially enhanced transnational corporations could have avoided rising indebtedness. Moreover, such corporations were usually too large to attract the attentions of the private equity funds that flourished after the collapse of the new technology boom at the end of the last century. Such funds specialise in indebting companies. But the diversified ownership of transnational corporations, and the limited financing capacity of the funds has prevented equity funds from making really serious money by taking over really large corporations, indebting them, and forcing them to repay their debts through 'sweating' asset and disposals.

Nevertheless, firms that were vulnerable to rising indebtedness and, in particular among them small and medium-sized firms, dominate employment (and hence wage income) and fixed capital investment in most capitalist economies. The result of that rising indebtedness has been a growing disinclination to invest in production. The exception has been China, where the industrial policy of the Communist government rather than market forces, has sustained a remarkable economic boom. Elsewhere, the reluctance of non-financial investors has given rise to economic stagnation, most notably perhaps in central Europe.

Financially enhanced transnational corporations therefore entered the present period of crisis and instability in remarkably good financial condition. Certainly by comparison with banks in general, and banks operating mutlinationally, and multinational companies operating the more traditional model of international production, multinational corporations that have expanded by operating across financial markets have strong balance sheets whose solvency is reinforced by holdings of liquid assets.

The difficulty for multinational companies is that these margins of liquidity will now drain away as households in the largest capitalist economies raise their saving rates, and as reduced buying makes securities markets less liquid. Fiscal deficits, which would normally increase the net income of the corporate sector, will be increasingly directed towards refinancing banking systems, which does not increase the net income of businesses. This is because the refinancing of banks is being done by credit transfers between banks and governments, without any additional expenditure arising in the real economy. By contrast, traditional Keynesian deficit financing, directed towards pubic works or income support, does increase economic activity and business income. Reserves, built up from capital gains on assets such as palatial headquarters buildings, will be reduced as asset prices fall. Falling fixed capital investment in the financially advanced countries, and in China, whose investment has powered the recent industrial and commodity booms of many countries, will further cut the net income of the business sector. International businesses, although in a strong position in many markets, will not be able to avoid the consequences of the contraction of those markets. Postponing new investment projects will only further squeeze new income for other businesses.

In this situation even businesses that manage to avoid substantial falls in sales, because of their size and the scale of their international operations, will be inclined to hold on to liquid assets rather than investing. But firms can only do this at the expense of other firms' sales revenue. So, while some international business is in a better position to ride out the current recession than most smaller businesses, it will also contribute more than most towards deepening that recession by withholding more expenditure than most. Lakshmi Mittal may save money by cutting the capital expenditure of his international steel company Arcelor Mittal. But the suppliers of his capital equipment will lose that revenue, and those capital equipment manufacturers also use prodigious amounts of steel in their production. In any case, the rationale for investment is weak when a fall in global steel demand of 37% and more is expected [11].

4. The end of globalisation

The second factor affecting the prospects of multinational corporations is the regionalisation of international finance, arising out of governments' attempts to rescue their ailing banking sectors. As a consequence many countries will now adopt or strengthen controls on foreign capital inflows and outflows in order to stabilize their financial systems. In the past foreign capital controls would have brought disapproval from the multilateral agencies charged with policing the international financial system, the International Monetary Fund, the World Bank, the OECD, and behind them the United States, disapproval reinforced by the threat of exclusion from IMF-led financing. But this was because past crises were international banking crises that these agencies hoped to resolve by refinancing bank debt through the capital markets.

Not only has the international climate of opinion towards capital controls changed. As before, the financing capability of the IMF is limited by comparison with the financing requirements for alleviating the crisis. The IMF is therefore acting as a lead agency to facilitate other sources of finance. However, since the other sources have been frozen up by the crisis, an important element in the additional financing have been central bank swap facilities that have been extended by the U.S. Federal Reserve to central banks in Mexico, Brazil, and South Korea. In Europe, the European Central Bank has extended such facilities to central banks in Hungary, the Czech Republic and other new member states. In the case of Iceland, such facilities are being provided by Scandinavian central banks. Such assistance is being targeted on particular favoured countries in difficulty. But much of the banking systems in the beneficiary countries, in many cases, for example in Mexico, most of that system, is foreign-owned. This will result in a more benign view being taken by the banking authorities and the central banks of capital controls. Capital controls would be necessary to prevent multinational banks from drawing down central bank assistance in a country benefitting from such swap facilities in order to assist bank subsidiaries in another less favoured country.

Reinforcing this informal policy of protecting domestic banking, is the policy of requiring banks to increase their capital ratios, while at the same time urging them to increase lending. This squeezes banks in between weak capital markets, preventing banks from obtaining instant additional capital, and a widespread revulsion against debt, leading to 'deleveraging' (debt repayment) in the most financially advanced (and hence indebted) countries. Banks now have a real incentive to reduce their cross-border lending because, for any given type of borrower, this requires more capital than a similar domestic borrower if only because of exchange rate risk. The withdrawal of lending by foreign banks has been a factor in the crisis affecting most notably those transition economies in Eastern Europe, such as Latvia, whose banking systems had been virtually taken over by foreign banks.

The increased preference for domestic lending imposes a new credit constraint on the operations of financially enhanced transnational corporations. Where previously they could maintain the liquidity of their operations fairly easily by buying and selling subsidiaries around the world, these balance sheet operations are reduced if borrowing is limited. Even the sale of a subsidiary on favourable terms may be frustrated if the purchaser cannot borrow enough money.

Worse, most multinationals, and especially those that are financially enhanced, have their stocks quoted on more than one major stock exchange. This means that selling pressure frustrated by falling prices in one market, is transmitted to other markets. Stockholders unable to sell a sufficient amount of stock in one market, because of the effect that this may have on prices, will distribute their selling across more than one market. Frustrated selling pressure will also frustrate the issue of new stock. The resulting inability to raise finance simultaneously in a number of countries will act as an informal capital control.

Among the informal financial regions that are emerging, one will stand out for its financial stability. This is East Asia, whose total foreign currency reserves exceed those of the rest of the world put together, thanks in large part to the recent record trade deficits of the United States. Here the risks are much more political than financial, for example political crisis in China as growth slows down, or disputes between the dominant powers of the region, China and Japan. But even financial stability is no guarantee of economic stability. The regional economy is peculiarly dependent upon the U.S. export market, and this is now contracting. And even if that market were not contracting, the recent history of Japan demonstrates how business may fail to respond to clear export opportunities if company balance sheets are loaded with excess debt [12].

5. Conclusion

Capital controls will tend to freeze the present hierarchy of multinational companies, if only because competitors, or potential competitors will find it more difficult to finance mergers and acquisitions in a declining capital market. It is a staple of business school research that most mergers and acquisitions do not improve the financial results of the companies being combined in this way [13]. In fact profits were rarely the motivation for business takeovers. In recent years the rationale for mergers and acquisitions has been provided by capital market inflation, which made buying companies for resale at a higher price in an inflating market a profitable business proposition. This possibility no longer exists because of the reduced liquidity in the main stock markets of the world.

The prospects for the financially enhanced transnational business, that made money from restructuring its balance sheets in different countries, are not good. With a less liquid balance sheet, and little to offer in the way of economic efficiency to its subsidiaries, the financially enhanced transnational faces a future of trying to make money in the old way out of production, rather than balance sheet operations. But the prospects for the more traditional transnational are, if anything, even worse. The financially enhanced transnational can survive because of its size and because its production units in different countries can operate autonomously. Internationally integrated production renders the whole transnational vulnerable to the problems in its weakest market. This is very apparent in the fate of *maquiladora* production (assembly plants exporting to foreign markets). In Mexico, which pioneered this kind of production, gross domestic product has fallen by nearly 10 per cent since 2008, in large part because of the difficulties of this kind of multinational operation [14].

It is important too not to overlook the consequences of the crisis for the way in which the business of transnational corporations is understood and discussed. Inflating asset markets dominated by investment bankers earning *pro rata* fees for balance sheet restructuring has provided a very congenial ambience for international business theories that can provide some managerial rationale for such restructuring. Declining asset markets will be correspondingly uncongenial to such theories. Falling profits will reduce the supply of successful companies providing case studies of the ‘excellence’ attributed to alleged ‘competitiveness’, ‘capability’, ‘internal advantage’, ‘synergy’, ‘competences’, ‘culture’ or some other mystical source. Furthermore, financial austerity will make it much more difficult to secure financial backing for management strategies driven by speculative theoretical projections. The present crisis reveals, perhaps too vividly, the financial asset inflation behind much of the financial success of international business and the most common means by which international business could emerge and thrive. For those researching the problems of international business, the only effective approach to understanding the subject, the crisis provides an unrivalled opportunity to uncover the true constraints that determine the character and dynamics of cross-border capitalism.

For the management of international business the future is not so much bleak, as boring. A generation of business managers has been conditioned by a continuous diet of financial market news and ‘statsbabble’ (the stream of data shorn of context and significance) masquerading as vital information for the decisions of everyday life, without which they are supposed to suffer from ‘informational asymmetries’ and other ailments of post-modernity. This conditioning has resulted in a business leadership that regards balance sheet restructuring as the final solution to all business problems. But the age of the corporate ‘supermen’ (women do not play power games like this), who could construct and reconstruct large balance sheets incorporating assets and liabilities in different countries, and claim as their achievement the financial benefits accruing to their companies from conveniently inflating asset markets, is now over. Those markets are not inflating any more; it is much more difficult to turn over financial capital in less liquid markets; and banks will not provide foreign credits so easily. The business of producing and selling real goods and services is constrained by stagnant demand in the main markets of the world. Success in that business requires much more mundane and long-term commitment to excellence in production and sales, from which the leadership of the key decision-makers of today’s transnational companies are usually far removed, geographically and organisationally. Japan showed us the way: At the end of the 1980s its industrial corporations started making more profits from financial engineering than from production. But this was the prelude to the 1990s when those corporations succumbed to losses on both accounts.

For the foreseeable future the successful transnational corporation must use its financial resources to support production and sales, rather than asset management, reducing the finance director to the ancillary function he held through the middle part of the twentieth century. The Crash of 2007–2009 destroyed the mystique that finance acquired through its apparent ability to generate more profits without more production and sales. The romance of finance is history again.

Acknowledgement

I am grateful for the generous encouragement and advice of the editors, Victoria Chick, Noemi-Levy-Orlik and Grazia Ietto-Gillies, none of whom are responsible for any remaining errors in this paper.

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