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Multinational cash management and conglomerate discounts in the euro zone

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Abstract

We discuss the impact of liberalisation, deregulation and the introduction of a single currency on cash management within multinationals in the euro zone. The developments in the euro zone reduce financial market imperfections in transferring cash and diminish the need for separate local cash holdings. This facilitates the centralisation of cash management and headquarters' financial control. Increased financial power of multinational headquarters, moreover, offers opportunities for disintermediation. By exploiting these options multinationals in the euro zone can start to reap additional benefits of internal financing and conglomerate discounts of euro zone multinationals may diminish.

Keywords: Liberalisation; Deregulation; Single currency; Euro zone; MNEs; Conglomerate discounts; Cash management; Headquarters' control; Centralisation; Disintermediation

1. Introduction

Formerly, European financial markets were characterised by the existence of market imperfections. This was especially the case for the short-term financial markets. Since the revival of the European Common Market, as initiated by the White Paper of 1985[1], a number of these imperfections have gradually disappeared. This process

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[1] *Completing the Internal Market,* White paper from the Commission to the European Council, 1985.

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is fuelled once more by the introduction of the euro in the period 1999–2002. Most of the literature on these changes focuses on the consequences for macro-economic and monetary policy and development, but much less attention is given to the impact of these changes for non-financial euro zone[2] multinationals. We discuss in this paper the consequences of the changing financial market circumstances for these companies. In particular we will concentrate on the consequences for cash management within multinational euro zone firms[3].

Cash management is a topic that is addressed mainly by practitioners and by scholars who study cash management practices or conduct financial modelling, but it can also be approached from a theoretical perspective. In this respect two distinct approaches can be distinguished. Firstly, cash management can be considered as a stand-alone topic within the management of short-term assets and the question is addressed how much cash is needed in comparison to other liquid assets. It is the main approach in textbooks on short-term financial management (e.g. Hill & Sartoris, 1995; Maness & Zietlow, 1998). Secondly, cash management theories can start with the perfect markets assumptions of Modigliani and Miller (Modigliani & Miller, 1958; Miller & Modigliani, 1961). The theory then suggests that companies need no cash at all unless market imperfections urge companies to hold it (Van Horne, 2002). Transaction costs involved in frequently attracting additional debt and/or equity — e.g. if cash funds are needed to pay suppliers or employees — are high. Therefore it may be worthwhile to hold cash funds, even if these funds do not generate any return. Also bankruptcy costs come to the fore as a reason for cash holdings. If creditors are not paid in time, they may force the company into bankruptcy and the shareholders and managers try to avoid the concomitant costs.

In this paper we follow the latter approach. The developments within the euro zone have reduced market imperfections and we evaluate how these have affected cash management in multinationals. We add the context of a multinational, because major developments in the financial markets of the euro zone have their impact across countries and do not only affect local companies. Moreover, multinationals are more complex than single-country companies and it is usual to find a corporate headquarters and local subsidiaries. Managers of local subsidiaries can be considered to be the agents of the board members at the multinational headquarters, while the board members in their turn are agents of the shareholders. In particular the agency relationships between local and headquarters managers is important here because the control of cash is a determinant in exercising power. Managers of local subsidiaries

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[2] The euro zone is often considered to be the group of 12 countries within the European Community that introduces the euro as a single currency. These are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal and Spain. Moreover, smaller countries like Andorra, Monaco and Vatican City will also be using the euro and we include them in the euro zone. However, other countries or regions like Serbia and Kosovo that will switch from German marks to euros are not considered by us to be part of the euro zone.

[3] We mainly address here multinationals that operate completely within the euro zone, but other multinationals may also be affected, like for example US based multinationals with subsidiaries within the euro zone.