FINANCING MNC SUBSIDIARIES IN CENTRAL AMERICA

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Abstract. This article studies the historical financial sources for MNC activity in Costa Rica, Honduras, and Nicaragua. The evidence suggests that country environment factors have dominated the sourcing policies of MNCs. The most important factors include perceived exchange risk and domestic credit conditions.

INTRODUCTION

Financing foreign subsidiaries of multinational corporations (MNCs) is complicated by the unique environmental factors that are not generally encountered in the domestic context. Common among such factors are the differences in financial norms and practices across countries, the need to cope with the home and host country regulations, and the problems of working with a multitude of currencies.

The pioneering works of Stobaugh and Robbins and Stobaugh deal with a cross section of 39 U.S.-controlled MNCs representing different sizes and industries. In-depth interviews were used to study the influence of size, percentage ownership, and technology level on financial management strategies and to discuss the alternate sources for financing foreign affiliates. Studies by Robock and Smith developed an initial conceptual framework and analyzed the influence of numerous variables on financial decision making for U.S.-based MNCs. Wooster and Thoman provided guidelines for the international finance function under floating exchange rates and rapidly changing financial/political parameters. Surveys on U.S. foreign direct investments conducted by the U.S. Department of Commerce shed light on the financial practices of U.S. affiliates.

The purpose of this study is to augment the rather scarce micro level literature on financing MNC affiliates operating in developing countries by reporting the historical financial sources for a sample of affiliates in three of the Central American Common Market nations (CACM); namely, Nicaragua, Honduras, and Costa Rica. Major financial variables and considerations that led to the choice of various alternative sources of financing are discussed, and additional evidence on some of the important conclusions reached by previous researchers is reported.

THE ENVIRONMENT

The typical financial system of a CACM country consists of the Central Bank, government development bank (INFONAC in Nicaragua, BNF in Honduras, and CODESA in Costa Rica), savings and loan institutions, insurance companies, financieras, and a commercial banking system that includes local and foreign banks. Most of the stock and bond offerings are privately placed. The secondary markets either don't exist or lack regular trading activity. The Central American Bank for Economic Integration (CABEI) is a major regional body which undertakes long-term financing of major projects.

The primary sources of short-term credit are the commercial banks, where there is no compensating balance requirement for prime customers; however, small borrowers pay higher effective interest rates through commissions, discounting, and other means. Also, the terms are generally determined by the type of business (that is, agricultural, industrial), and some banks specialize by sectors in their lending operations. Many of the local banks are tied to the various business groups and finance mainly the groups' activities. As a result, the foreign firms rely on foreign banks which provide a full range

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of services. There are no restrictions on foreign subsidiaries except in Costa Rica, where majority foreign-owned subsidiaries of firms need government approval before they can obtain credit from private banks.

The major sources for medium- and long-term funds are the development banks and financieras. With the exception of CONADI in Honduras and CODESA in Costa Rica, which do not grant loans to foreign majority-owned firms, there are no restrictions for MNCs on tapping these sources. The development loans are granted at favorable terms and include technical assistance and other benefits that further reduce their effective costs. The equity and bond financing are more expensive than in the U.S. due to the underdeveloped nature of markets, problems of placement, lack of liquidity, and higher underwriting costs. Mortgage banks, savings and loan associations, as well as insurance companies provide some medium- and long-term financing. For the period of this study, there were no major restrictions on obtaining foreign equity or debt.

An understanding of the local financial norms is very important for decisions related to financial structure at the subsidiary level. Past research indicates different financial norms and goals across countries. In Central America, the financial integration within the common market has led to similar industry and overall financial norms (leverage) across CACM countries; however, statistically significant differences were found in the financial structure of different industries in a given CACM country.

The changes in exchange rates affect profitability of the subsidiary and the parent company. As Dufey points out, no two firms operating in a country whose currency has devalued will be affected in exactly the same way. The expected changes in exchange rates are crucial for the initial investment decision, in allocating funds for further expansion, in management of working capital and cash, in hedging policies, and, above all, in financing decisions which affect profitability, translation loss, and cost of funds. In Central America, the risk of exchange rate change as perceived by decision-makers was minimal during the period of our study. In addition, the CACM countries have historically maintained stable exchange rates vis-a-vis the U.S. dollar and no significant restrictions existed for payments of interest, dividends, or capital repatriation during the period of this study.

In CACM, MNCs are exempt from income tax for up to eight years. The dividends to the parent are taxed at 15 percent in Costa Rica and Honduras. Nicaragua does not impose this tax. The interest payments for foreign and local sources are treated in the same manner for tax purposes; thus, taxation need not be an important criterion for decisions related to the choice between local and foreign sources with similar characteristics.

Despite local pressures for joint ventures, there were no major official regulations with regard to the ownership policies during the period of our study; however, the foreign direct investment regulations of the U.S. in effect at the time may have had some implications for financial policy of U.S.-based MNCs.

The multinational operations in CACM are rather limited. In addition, no centralized data bank on their financial operations exists. Even data on such global categories as value of U.S. direct investment, asset distribution, and income earned (by industry classification) are incomplete.

Hence, the sample reflects availability and willingness on the part of management to provide the necessary information under strict secrecy agreements. All firms in this sample are large and represent important industry groups in their respective countries. The quantitative information was obtained from balance sheets and income statements. Where feasible, cross-checks were made with the central bank and tax authority figures. The data inconsistencies were reconciled and qualitative aspects of financial practices were probed through personal interviews with the management. A few companies were eliminated from the initial sample due to inconsistencies, incompleteness, or lack of reliable information.

The small size and nonrandom character of the sample is a definite limitation for gen-