INTERNATIONAL FINANCIAL MANAGEMENT

2ND ASIA-PACIFIC EDITION

JEFF MADURA
ARIFUL HOQUE
CHANDRASEKHAR KRISHNAMURTI

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Guide to the text

As you read this text you will find a number of features in every chapter to enhance your study of International Financial Management and help you understand how the theory is applied in the real world.

PART-OPENING FEATURES

Part openers introduce each of the chapters within the part and provide an overview of how the chapters in the text relate to each other.

CHAPTER-OPENING FEATURES

Identify the key concepts that the chapter will cover with the **Learning objectives** at the start of each chapter.

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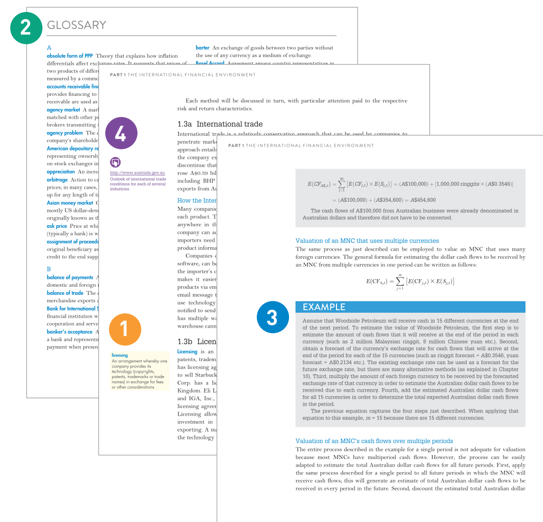

1. When you see **Key terms** marked in bold, study the **Definitions** nearby to learn important terms for *International Financial Management.*
2. See the **Glossary** at the back of the book for a full list of key terms and definitions.
3. Analyse practical applications of concepts through the **Example boxes.**
4. Explore online material by following **weblink** margin icons throughout the text.

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END-OF-CHAPTER FEATURES

At the end of each chapter you will find several tools to help you to review, practise and extend your knowledge of the key learning outcomes.

Summary

LO1.1 The main goal of an MNC is to maximise shareholder wealth. When managers are tempted to serve their own interests instead of those of shareholders, an agency problem exists. Multinational corporations tend to experience greater agency problems than do domestic companies because managers of foreign

LO1.4 The valuation model of an MNC shows that MNC's value is favourably affected when its expected foreign cash inflows increase, the currencies denominating those cash inflows increase, or the MNC's required rate of retu decreases. Conversely, the MNC's value is a affected when its expected foreign cash inflo

A list of bullet points **summarises** the chapter's key concepts and issues.

Point counter-point

Should an MNC reduce its ethical standards to compete internationally?

Who is correct? Use the Internet to learn more about this issue. Which argument do you support? Offer your own opinion on this issue.

Point Yes. When an Australia-based MNC competes countries, it may encounter some business norms ther are not allowed in Australia. For example, when comp for a government contract, companies might provide to the government officials who will make the decisio

The **Point counter-point debate** offers different views on an argument related to the chapter.

Self-test

Answers are provided in Appendix A, available on the companion website at https://login.cengagebrain.com.

1 What are typical reasons why MNCs expand internationally?

2 Explain why unfavourable economic or politica conditions affect the MNC's cash flows, require of return, and valuation.

3 Identify the more obvious risks faced by MNCs expand internationally.

Questions and applications

1 **Agency problems of MNCs**
   a Explain the agency problem of MNCs.
   b Why might agency costs be larger for an MNC than for a purely domestic company?

2 **Comparative advantage**
   a Explain how the theory of comparative advantage relates to the need for international business.
   b Explain how the product cycle theory relates to the

5 **International opportunities due to the Intern**
   a What factors cause some companies to becc more internationalised than others?
   b Offer your opinion on why the Internet may in more international business.

6 **Impact of exchange rate movements** Globe International of Melbourne has several Asian subsidiaries that remit earnings to it each year.

Test your knowledge and consolidate your learning through the **Self-tests** and **Questions and applications**.

Case study: Aussie Blades, Pty Ltd

Decision to expand internationally

Aussie Blades, Pty Ltd is an Australia-based company that has been incorporated in Australia for three years. It is a relatively small company, with total assets of only A$200 million. The company produces a single type of product: rollerblades. Due to the booming rollerblade market in Australia at the time of the company's establishment, Aussie Blades has been quite successful. For example, in its first year of operation, it reported a net income of A$3.5 million. Recently, however, the demand for Aussie Blades'

reduce costs here, why not import some parts from overseas and/or expand the company's sales to fore countries? Similar strategies have proved successful numerous companies that have expanded into Asia recent years to increase their profit margins. The C initial focus is on Thailand. Thailand has recently experienced weak economic conditions, and Aussie Blades could purchase components there at a low co Holt is aware that many of Aussie Blades' competit have begun importing production components from

Analyse in-depth running **Case studies** that present issues in context, encouraging you to integrate and apply the concepts discussed in the chapter to the workplace.

Small business dilemma

Developing a multinational sporting goods corporation

In every chapter of this text, some of the key concepts are illustrated with an application to a small sporting goods company that conducts international business. These 'Small business dilemma' features allow students to recognise the dilemmas and possible decisions that companies (such as this sporting goods company) may face in a global environment. For this chapter, the application is on the

therefore had already established a business relatior with these stores. Logan did not believe that he cou compete with this company in the Australian marke

Rather than pursue a different business, Logan d to implement his idea on a global basis. While Aust Rules football obviously has not been a traditional s foreign countries, it has become more popular in so foreign countries in recent years. Furthermore, the expansion of cable and streaming networks in foreig

The **Small business dilemmas** show a real world example (with questions) of a small business utilising the concepts discussed in the chapter.

Internet/Excel exercises

The website address of the Australian Trade and Investment Commission is https://www.austrade.gov.au.

1 Use this website to assess recent trends in foreign direct investment (FDI) abroad by Australian companies. Compare the FDI in Malaysia with the FDI in Singapore. Offer a possible reason for tl difference.

2 Based on recent trends in FDI, are Australia-ba MNCs pursuing opportunities in Asia? In East Europe? In Latin America?

Direct students to online information and data to use in analysis with the **Internet/Excel exercises**.

Online articles with real-world examples

Find a recent article online that describes an actual international finance application or a real-world example of a specific MNC's actions that reinforces one or more of the concepts covered in this chapter.

If your class has an online component, your lecturer may ask you to post your summary there and provide the web link of the article so that other students can access it. If your class is live, your lecturer may ask you to summarise your application in class. Your lecturer may

search terms (and include the current year as a sear to ensure that the online articles are recent):

1 company AND repatriated foreign earnings
2 Pty Ltd AND repatriated foreign earnings
3 company AND currency effects
4 Pty Ltd AND currency effects
5 company AND country risk
6 Pty Ltd AND country risk
7 foreign direct investment

Apply chapter concepts to a specific situation in an MNC with the **Online articles with real-world examples**.

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END-OF-PART FEATURES

PART 1 INTEGRATIVE PROBLEM: THE INTERNATIONAL FINANCIAL ENVIRONMENT

Perth Framing specialises in the production of small, fancy picture frames, which are exported from Australia to the United Kingdom. Perth Framing invoices the exports in pounds and converts the pounds to Australian dollars when they are received. The British demand for these frames is changing prices between the two countries, while capital flows will adjust to interest rate differentials. Perth Framing believes that the value of the pound is very sensitive to changing international capital flows and is moderately sensitive to changing international trade flows.

Analyse the **Integrative problem** that presents an issue in context, encouraging you to utilise the principles discussed in the chapter in the workplace.

MIDTERM SELF-EXAM

MIDTERM REVIEW

You have just completed all the chapters focused on the macro- and market-related concepts. Here is a brief summary of some of the key points in those chapters. Chapter 1 explains the role of financial managers to focus on maximising the value of the MNC and how that goal

Challenge yourself with the **Midterm self-exam** and test your knowledge of concepts learned throughout the first half of the book.

FINAL SELF-EXAM

FINAL REVIEW

This self-exam focuses on the managerial chapters (Chapters 10 to 21). Here is a brief summary of some of the key points in those chapters:

1 Chapter 10 describes various methods that are used to forecast exchange rates.

Attempt the **Final self-exam** to test your comprehension of the topics learned throughout the text.

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Guide to the online resources

FOR THE INSTRUCTOR

Your #1 resource for your course. This tailored collection of teaching tools includes downloadable PowerPoint lecture slides, Instructor's Manual and a Test Bank with customisable questions for quizzes and assessments.
Log in or request an account to access instructor resources at au.cengage.com/instructor/account for Australia or nz.cengage.com/instructor/account for New Zealand.

INSTRUCTOR'S MANUAL

The **Instructor's manual** includes:

- A lecture outline
- A chapter theme
- Topics to stimulate class discussion
- Point-counter-point answers
- Answers to end-of-chapter questions
- Solutions to continuing case problems (Aussie Blades, Pty Ltd)
- Answers to supplemental cases (Appendix B)
- Small business dilemma.

POWERPOINT™ PRESENTATIONS

Use the chapter-by-chapter **PowerPoint** slides to enhance your lecture presentations and handouts by reinforcing the key principles of your subject.

WORD-BASED TEST BANK

This bank of questions has been developed in conjunction with the text for creating quizzes, tests and exams for your students. Deliver these though your LMS and in your classroom.

ARTWORK FROM THE TEXT

Add the digital files of **graphs** and **flowcharts** into your course management system, use them in student handouts, or copy them into your lecture presentations.

Online appendices

The appendices include:
Appendix A: Answers to self-test questions
Appendix B: Supplemental cases
Appendix C: Using Excel to conduct analysis
Appendix D: International investing project
Appendix E: Discussion in the boardroom.

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PREFACE

Businesses evolve into multinational corporations (MNCs) so that they can capitalise on international opportunities. Their financial managers must be able to assess the international environment, recognise opportunities, implement strategies, assess exposure to risk, and manage that risk. The MNCs most capable of responding to changes in the international financial environment will be rewarded. The same can be said for the students today who may become the future managers of MNCs.

INTENDED MARKET

International Financial Management (second Australian edition) presumes an understanding of basic corporate finance. It is suitable for both undergraduate and master's level courses in international financial management. For master's courses, the instructor may adopt more challenging questions, problems and cases in each chapter, along with special projects.

ORGANISATION OF THE TEXT

International Financial Management (second Australian edition) is written in a manner that helps students understand the issues facing the modern corporate manager. Since managers of MNCs will need to understand the environment before they can manage their company, a background on the international environment is first provided, and then the text builds on the managerial aspects from a corporate perspective. This text replaces the Madura US edition and is suitable for use in Australia, New Zealand and elsewhere in the Asia-Pacific region. Examples and institutional details therefore reflect the Asia-Pacific/Australia/New Zealand context.

The first two parts of the text establish the necessary macroeconomic framework. Part 1 (chapters 1 to 4) introduces the major markets and environment that facilitate international business. Part 2 (chapters 5 to 8) describes relationships between exchange rates and economic variables and explains the forces that influence these relationships. Furthermore, the market for foreign exchange derivatives and the essential features of derivative products are discussed.

The rest of the text develops a microeconomic framework with a focus on the managerial aspects of international financial management. Part 3 (chapters 9 to 13) explains the measurement and management of exchange rate risk. Part 4 (chapters 14 to 18) describes the management of long-term assets and liabilities, including motives for foreign direct investment, multinational capital budgeting, country risk analysis and capital structure decisions. Part 5 (chapters 19 and 20) concentrates on international banking and trade financing. The basic features of international banking, their role in trade financing, other forms of short-term financing and recent developments are explained. Further recent innovations in fintech (financial technology), such as peer-to-peer lending and cryptocurrencies, are also discussed.

Each chapter is self-contained so that lecturers can use classroom time to focus on the more comprehensive topics while relying on the text to cover other concepts. The management of long-term assets (chapters 14 to 16 on foreign direct investment, multinational capital budgeting, multinational restructuring and country risk analysis) is covered before the management of

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long-term liabilities (Chapter 18 on debt financing) because the financing decisions depend on the investment decisions. Nevertheless, these concepts are explained with an emphasis on how the management of long-term assets and long-term liabilities is integrated. For example, multinational capital budgeting analysis demonstrates how the feasibility of a foreign project may depend on the financing mix. Some lecturers may prefer to teach the chapters on managing long-term liabilities prior to teaching the chapters on managing long-term assets.

The strategic aspects, such as motives for foreign direct investment, are covered before the operational aspects, such as short-term financing or investment. For lecturers who prefer to cover the MNC's management of short-term assets and liabilities before the management of long-term assets and liabilities, the parts can be rearranged because they are self-contained.

Lecturers may limit their coverage of chapters in some sections where they believe the text concepts are covered by other courses or do not need additional attention beyond what is in the text. For example, they may give less attention to the chapters in Part 2 (chapters 5 to 8) if their students are taking a course in international economics. If lecturers focus on the main principles, they may limit their coverage of chapters 9, 10, 16 and 18. In addition, they may give less attention to chapters 19 and 20 if they believe that the text description does not require elaboration.

APPROACH OF THE TEXT

International Financial Management (second Australian edition) focuses on management decisions that maximise the value of the company. The text offers a variety of methods to reinforce key concepts so that lecturers can select the methods and features that best fit their teaching styles.

- *Part-opening diagram.* A diagram is provided at the beginning of each part to illustrate how the key concepts covered in that part are related.
- *Objectives.* A bulleted list at the beginning of each chapter identifies the key concepts in that chapter.
- *Definitions.* Definitions of key terms are provided in the margin to facilitate the understanding of students.
- *Examples.* The key concepts are thoroughly described in the chapter and supported by examples. Besides US examples, the text now includes a large number of examples from Australia and the broader Asia-Pacific region.
- *International credit crisis.* Coverage of the international credit crisis is provided in each chapter where applicable; this coverage focuses on European countries that have experienced problems in making their debt payments and on the exposure of their banks to credit problems. We have now added a section on Brexit and its impact.
- *Term paper on the international credit crisis.* Suggested assignments for a term paper on the international credit crisis are provided at the end of Chapter 1.
- *Web links.* Websites that offer useful related information regarding key concepts are provided in each chapter.
- *Summary.* A bulleted list at the end of each chapter summarises the key concepts. This list corresponds to the list of objectives at the beginning of the chapter.
- *Point/counter-point.* A controversial issue is introduced, along with opposing arguments, and students are asked to determine which argument is correct and to explain why.

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- *Self-test questions.* A 'self-test' at the end of each chapter challenges students on the key concepts. The answers to these questions are provided in Appendix A, available on the textbook companion site.
- *Questions and applications.* Many of the questions and other applications at the end of each chapter test the student's knowledge of the key concepts in the chapter.
- *Case study.* Presented at the end of each chapter, the case study allows students to use the key concepts to solve problems experienced by a company called Aussie Blades, Pty Ltd (a producer of rollerblades). By working on cases related to the same MNC over a school term, students recognise how an MNC's decisions are integrated.
- *Small business dilemma.* The small business dilemma at the end of each chapter places students in a position where they must use concepts introduced in the chapter to make decisions about a small MNC called the Sports Exports Company.
- *Internet/Excel exercises.* At the end of each chapter, there are exercises that expose the students to applicable information available on various websites, enable the application of Excel to related topics, or a combination of these. For example, students learn how to obtain exchange rate information online and apply Excel to measure the value at risk.
- *Integrative problem.* An integrative problem at the end of each part integrates the key concepts of chapters within that part.
- *Supplemental cases.* Supplemental cases allow students to apply chapter concepts to a specific situation of an MNC. All supplemental cases are located in Appendix B, available on the textbook companion site.
- *Running your own MNC.* This project allows each student to create a small international business and apply key concepts from each chapter to run the business throughout the school term. The project is available on the textbook companion site.
- *International investing project.* Located in Appendix D, available on the textbook companion site, this project allows students to simulate investing in stocks of MNCs and foreign companies and requires them to assess how the values of these stocks change during the school term in response to international economic conditions.
- *Discussion in the boardroom.* Located in Appendix E, available on the textbook companion site, this project allows students to play the role of managers or board members of a small MNC that they created and to make decisions about that company.
- The variety of end-of-chapter and end-of-part exercises and cases offer many opportunities for students to engage in teamwork, decision-making and communication.

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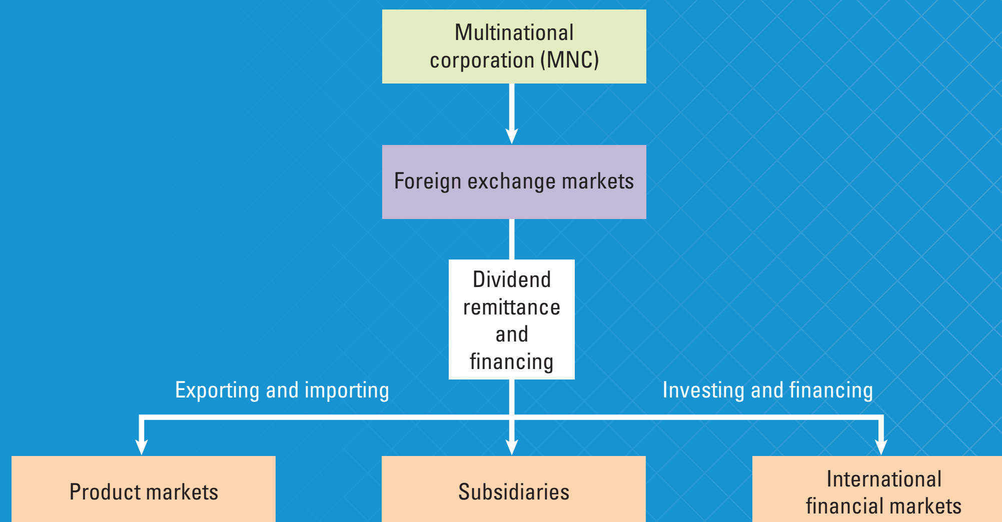
PART 1

THE INTERNATIONAL FINANCIAL ENVIRONMENT

Part 1 (Chapters 1 to 4) provides an overview of the multinational corporation (MNC) and the environment in which it operates. Chapter 1 explains the goals of the MNC, along with the motives and risks of international business. Chapter 2 describes the international flow of funds between countries. Chapter 3 describes the international financial markets and how these markets facilitate ongoing operations. Chapter 4 explains exchange rate systems and how central banks intervene in exchange rate movements.



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1 MULTINATIONAL FINANCIAL MANAGEMENT: AN OVERVIEW

LEARNING OBJECTIVES

The specific objectives of this chapter are to:

- LO1 identify the management goal and organisational structure of the MNC
- LO2 describe the key theories that justify international business
- LO3 explain the common methods used to conduct international business
- LO4 provide a model for valuing the MNC
- LO5 describe the global financial crisis (GFC) and its impact on the foreign exchange (FX) market and MNCs' FX risk management
- LO6 explain the impact of coronavirus disease 2019 (COVID-19) on the MNC
- LO7 discuss how chapters are organised in this textbook.

multinational corporations (MNCs) Companies that engage in some form of international business.

Multinational corporations (MNCs) are defined as companies that engage in some form of international business. Their managers conduct international financial management, which involves international investing and financing decisions that are intended to maximise the value of the MNC. The goal of these managers is to maximise their company's value, which is the same goal pursued by managers employed by strictly domestic companies.

Initially, companies may merely attempt to export products to a certain country or import supplies from a foreign manufacturer. Over time, however, many of these companies recognise additional foreign opportunities and eventually establish subsidiaries in foreign countries. Dow Chemical, IBM, Nike and many other companies have more than half of their assets in foreign countries. BHP is an Anglo-Australian multinational mining and petroleum company with a number of mines and other facilities worldwide. Rio Tinto, an Australian global mining and metal company, has operations on six continents. Some businesses, such as ExxonMobil, Fortune Brands and Colgate-Palmolive, commonly generate more than half of their sales in foreign countries.

International financial management is important even to companies that have no international business. The reason is that these companies must recognise how their

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foreign competitors will be influenced by movements in exchange rates, foreign interest rates, labour costs and inflation. Such economic characteristics can affect the foreign competitors' costs of production and pricing policies.

This chapter provides background on the goals, motives and valuation of a multinational corporation.

LO1.1 MANAGING THE MNC

The commonly accepted goal of an MNC is to maximise shareholder wealth. Managers employed by the MNC are expected to make decisions that will maximise the stock price and thereby serve the shareholders' interests. Some publicly traded MNCs may have additional goals, such as satisfying their respective governments, creditors or employees. However, these MNCs now place greater emphasis on satisfying shareholders; that way, the company can more easily obtain funds from them to support its operations. Even in developing countries (for example, Bulgaria and Vietnam) that have recently encouraged the development of business enterprises, managers of companies must serve shareholder interests in order to secure their funding. There would be little demand for the stock of a company that announced that the proceeds would be used to overpay managers or invest in unprofitable projects.

The focus of this text is on MNCs whose parents wholly own any foreign subsidiaries, which means that, say, the Australian or US parent is the sole owner of the subsidiaries. This is the most common form of ownership of Australia- and US-based MNCs, and it gives financial managers throughout the company the single goal of maximising the entire MNC's value (rather than the value of any particular subsidiary). The concepts in this text also apply generally to MNCs based in countries other than Australia or the United States.

1.1a How business disciplines are used to manage the MNC

Various business disciplines are integrated to manage the MNC in a manner that maximises shareholder wealth. Management is used to develop strategies that will motivate and guide employees who work in an MNC and to organise resources so that they can efficiently produce products or services. Marketing is used to increase consumer awareness about the products and to monitor changes in consumer preferences. Accounting and information systems are used to record financial information about the revenue and expenses of the MNC, which can be used to report financial information to investors and to evaluate the outcomes of various strategies implemented by the MNC. Finance is used to make investment and financing decisions for the MNC. Common finance decisions include:

- whether to discontinue operations in a particular country
- whether to pursue new business in a particular country
- whether to expand business in a particular country
- how to finance expansion in a particular country.

These finance decisions for each MNC are partially influenced by the other business discipline functions. The decision to pursue new business in a particular country is based on a comparison of the costs and potential benefits of expansion. The potential benefits of such new business

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depend on expected consumer interest in the products to be sold (marketing function) and the expected cost of the resources needed to pursue the new business (management function). Financial managers rely on financial data provided by the accounting and information systems functions.

1.1b Agency problems

Managers of an MNC may make decisions that conflict with the company's goal of maximising shareholder wealth. For example, a decision to establish a subsidiary in one location versus another may be based on the location's appeal to a particular manager rather than on its potential benefits to shareholders. A decision to expand a subsidiary may be motivated by a manager's desire to receive more compensation rather than to enhance the value of the MNC. This conflict of goals between a company's managers and shareholders is often referred to as the **agency problem**.

agency problem
The conflict regarding goals between a company's shareholders and its managers.

The costs of ensuring that managers maximise shareholder wealth (referred to as *agency costs*) are normally larger for MNCs than for purely domestic companies for several reasons. First, MNCs with subsidiaries scattered around the world may experience larger agency problems because monitoring the managers of distant subsidiaries in foreign countries is more difficult. Second, foreign subsidiary managers who are raised in different cultures may not follow uniform goals. Third, the sheer size of the larger MNCs can also create significant agency problems. This can be a challenge, especially in countries where some people may perceive that the first priority of corporations should be to serve their respective employees.

EXAMPLE

A few years ago, Bates Australia (based in Australia) established a subsidiary in Mexico so that it could expand its business there. It hired a manager in Mexico to manage the subsidiary. During the last couple of years, the sales generated by the subsidiary did not grow. Even so, the manager hired several employees to do the work that he was assigned. The managers of the parent company in Australia did not closely monitor the subsidiary because it was so far away and because they trusted the manager there. Now they realise that there is an agency problem. The subsidiary is experiencing losses every quarter, so its management must be more closely monitored.

Parent control of agency problems

The parent corporation of an MNC may be able to prevent most agency problems with proper governance. The parent should clearly communicate the goals for each subsidiary to ensure that all of them focus on maximising the value of the MNC and not of their respective subsidiaries. The parent can oversee subsidiary decisions to check whether each subsidiary's managers are satisfying the MNC's goals. The parent can also implement compensation plans that reward those managers who satisfy the MNC's goals. A common incentive is to provide managers with the MNC's stock (or options to buy that stock at a fixed price) as part of their compensation; thus, the subsidiary managers benefit directly from a higher stock price when they make decisions that enhance the MNC's value.

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EXAMPLE

When Bates Australia (from the previous example) recognised the agency problems with its Mexico subsidiary, it created incentives for the manager of the subsidiary that were aligned with the parent's goal of maximising shareholder wealth. Specifically, it set up a compensation system whereby the manager's annual bonus was based on the subsidiary's earnings.

Corporate control of agency problems

In the example of Bates Australia, the agency problems occurred because the subsidiary's management goals were not focused on maximising shareholder wealth. In some cases, agency problems can occur because the goals of the entire management of the MNC are not focused on maximising shareholder wealth. Various forms of corporate control can help prevent these agency problems and thus induce managers to make decisions that satisfy the MNC's shareholders. If these managers make poor decisions that reduce the MNC's value, then another company might acquire it at a lower price and hence would probably remove the weak managers. Moreover, institutional investors (for example, mutual and pension funds) with large holdings of an MNC's stock have some influence over management because they will complain to the board of directors if managers are making poor decisions. Institutional investors may seek to enact changes, including the removal of high-level managers or even board members, in a poorly performing MNC. Such investors may also band together to demand changes in an MNC, since they know that the company would not want to lose all of its major shareholders.

How SOX improved corporate governance of MNCs

One limitation of the corporate control process is that investors rely on reports by the company's own managers for information. If managers are serving themselves rather than the investors, they may exaggerate their performance. There are many well-known examples (such as Enron and WorldCom) in which large MNCs were able to alter their financial reporting and hide problems from investors.

Enacted in 2002, the Sarbanes-Oxley Act (SOX) ensures a more transparent process for managers to report on the productivity and financial condition of their company. It requires companies to implement an internal reporting process that can be easily monitored by executives and the board of directors. Some of the common methods used by MNCs to improve their internal control process are:

- establishing a centralised database of information
- ensuring that all data are reported consistently among subsidiaries
- implementing a system that automatically checks data for unusual discrepancies relative to norms
- speeding the process by which all departments and subsidiaries access needed data
- making executives more accountable for financial statements by personally verifying their accuracy.

These systems make it easier for a company's board members to monitor the financial reporting process. In this way, SOX reduced the likelihood that managers of a company can manipulate the reporting process and therefore improved the accuracy of financial information for existing and prospective investors.

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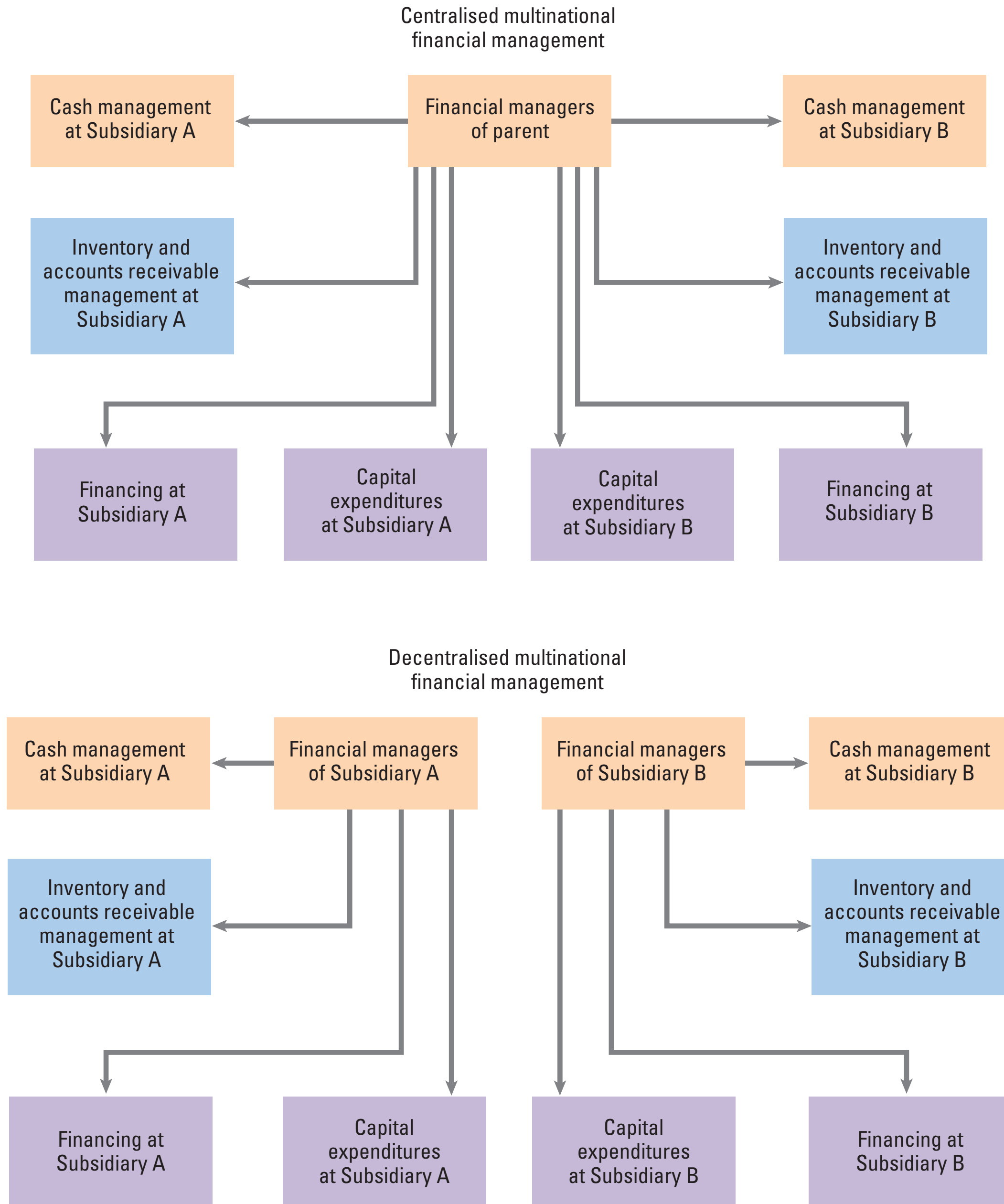
1.1c Management structure of an MNC

The magnitude of agency costs can vary with the MNC's management style. A centralised management style, as illustrated in the top section of **Exhibit 1.1**, can reduce agency costs because it allows managers of the parent to control foreign subsidiaries and thus reduces the power of subsidiary managers. However, the parent's managers may make poor decisions for the subsidiary if they are less informed than the subsidiary's managers about its setting and financial characteristics.

Exhibit 1.1 Management styles of MNCs



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Alternatively, an MNC can use a decentralised management style, as illustrated in the bottom section of Exhibit 1.1. This style is more likely to result in higher agency costs because subsidiary managers may make decisions that fail to maximise the value of the entire MNC. Yet this management style gives more control to those managers who are closer to the subsidiary's operations and environment. To the extent that subsidiary managers recognise the goal of maximising the value of the overall MNC and are compensated in accordance with that goal, the decentralised management style may be more effective.

Given the clear trade-offs between centralised and decentralised management styles, some MNCs attempt to achieve the advantages of both. That is, they allow subsidiary managers to make the key decisions about their respective operations while the parent's management monitors those decisions to ensure they are in the MNC's best interests.

How the Internet facilitates management control

The Internet is making it easier for the parent to monitor the actions and performance of its foreign subsidiaries.

EXAMPLE

Recall the example of Bates Australia, which has a subsidiary in Mexico. The Internet allows the foreign subsidiary to email updated information in a standardised format that reduces language problems, and also to send images of financial reports and product designs. The parent can then easily track the inventory, sales, expenses and earnings of each subsidiary on a weekly or monthly basis. Thus, using the Internet can reduce agency costs due to international aspects of an MNC's business.

LO1.2 WHY COMPANIES PURSUE INTERNATIONAL BUSINESS

Three commonly held theories that explain why companies become motivated to expand their business internationally are (1) the theory of comparative advantage, (2) the imperfect markets theory, and (3) the product cycle theory. These theories overlap to some extent and can complement each other in developing a rationale for the evolution of international business.

1.2a Theory of comparative advantage

Multinational business has generally increased over time. Part of this growth is due to companies' increased realisation that specialisation by countries can increase production efficiency. Some countries, such as Australia, Japan and the United States, have a technology advantage, whereas others, such as Bangladesh, China and Malaysia, have an advantage in the cost of basic labour. Because these advantages cannot be easily transported, countries tend to use their advantages to specialise in the production of goods that can be made with relative efficiency. This explains why countries such as Japan and the United States are large producers of computer components while countries such as Bangladesh, China and Thailand are large producers of agricultural goods and garments. Multinational corporations like BHP, Rio Tinto, Oracle, Intel and IBM have grown substantially in foreign countries because of their technology advantage.

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A country that specialises in some products may not produce other products, so trade between countries is essential. This is the argument made by the classical theory of comparative advantage. **Comparative advantages** allow companies to penetrate foreign markets. Many of the Virgin Islands, for example, specialise in tourism and rely completely on international trade for most products. Although these islands could produce some goods, it is more efficient for them to specialise in tourism. That is, the islands are better off using some revenues earned from tourism to import products than attempting to produce all the products they need.

comparative advantage Theory suggesting that specialisation by countries can increase worldwide production.

1.2b Imperfect markets theory

If each country's markets were closed to all other countries, then there would be no international business. At the other extreme, if markets were perfect and so the factors of production (such as labour) were easily transferable, then labour and other resources would flow wherever they were in demand. Such unrestricted mobility of factors would create equality in both costs and returns and thus would remove the comparative cost advantage, which is the rationale for international trade and investment. However, the real world suffers from **imperfect market** conditions where factors of production are somewhat immobile. There are costs and often restrictions related to the transfer of labour and other resources used for production. There may also be restrictions on transferring funds and other resources among countries. Because markets for the various resources used in production are 'imperfect', MNCs such as Gap and Nike often capitalise on a foreign country's particular resources. Imperfect markets provide an incentive for companies to seek out foreign opportunities.

imperfect market The condition where, due to the costs of transferring labour and other resources used for production, companies may attempt to use foreign factors of production when they are less costly than local factors.

1.2c Product cycle theory

One of the more popular explanations as to why companies evolve into MNCs is the **product cycle theory**. According to this theory, companies become established in the home market as a result of some perceived advantage over existing competitors, such as a need by the market for at least one more supplier of the product. Because information about markets and competition is more readily available at home, a company is likely to establish itself first in its home country. Foreign demand for the company's product will initially be accommodated by exporting. As time passes, the company may feel the only way to retain its advantage over competition in foreign countries is to produce the product in foreign markets, thereby reducing its transportation costs. The competition in those foreign markets may increase as other producers become more familiar with the company's product. The company may develop strategies to prolong the foreign demand for its product. One frequently used approach is to differentiate the product so that competitors cannot duplicate it exactly. These phases of the product cycle are illustrated in Exhibit 1.2. For instance, 3M Co. uses one new product to enter a foreign market, after which it expands the product line there.

product cycle theory Suggests that a company initially establishes itself locally and expands into foreign markets in response to foreign demand for its product; over time, the MNC will grow in foreign markets, but at some point, its foreign business may decline unless it can differentiate its product from competitors.

There is, of course, more to the product cycle theory than summarised here. This discussion merely suggests that, as a company matures, it may recognise additional opportunities outside its home country. Whether the company's foreign business diminishes or expands over time will depend on how successful it is at maintaining some advantage over its competition. That advantage could be an edge in its production or financing approach that reduces costs, or an edge in its marketing approach that generates and maintains a strong demand for its product.

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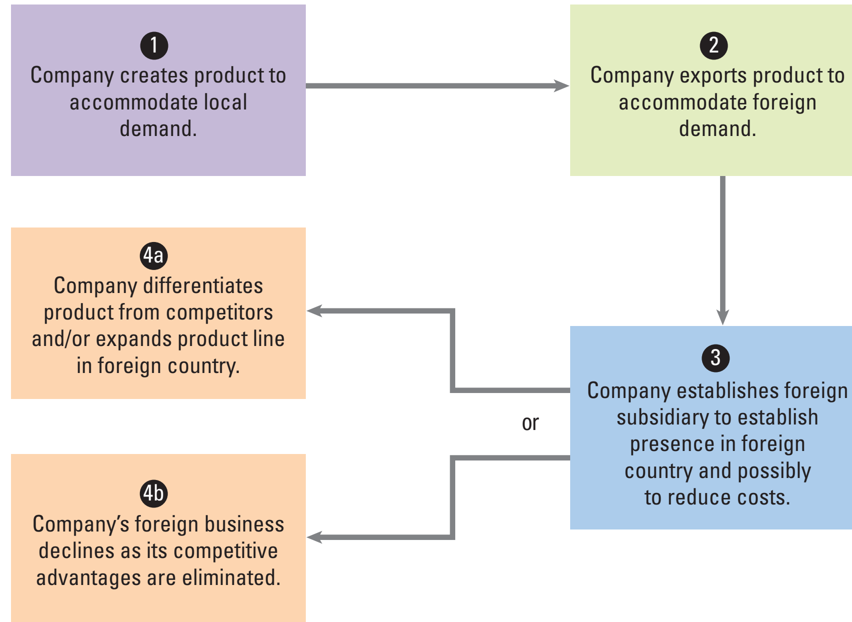
Exhibit 1.2 International product life cycle



LO1.3 HOW COMPANIES ENGAGE IN INTERNATIONAL BUSINESS

Companies use several methods to conduct international business. The most common methods are:

- international trade
- licensing
- franchising
- joint ventures
- acquisitions of existing operations
- establishment of new foreign subsidiaries.

Each method will be discussed in turn, with particular attention paid to the respective risk and return characteristics.

1.3a International trade

International trade is a relatively conservative approach that can be used by companies to penetrate markets (by exporting) or to obtain supplies at a low cost (by importing). This approach entails minimal risk because the company does not place any of its capital at risk. If the company experiences a decline in its exporting or importing, it can normally reduce or discontinue that part of its business at a low cost. Australia's top 25 goods and services exports in 2019–20 amounted to $475.24 billion, representing growth of 0.94 per cent from 2018–19. Many large Australian MNCs, including BHP, Rio Tinto and Alcoa, contribute to increased goods and services exports from Australia.

http://www.austrade.gov.au

Outlook of international trade conditions for each of several industries.

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