# INTERNATIONAL BUSINESS MANAGEMENT

# 国际商务管理

Songhua Hu, PH. D.
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# Preface

In the twenty-first century, the pace of globalization is accelerating, and international business takes on increasingly greater significance. Foreign trade, foreign direct investments, and global operations appear to be common phenomena in nearly every industry. The global leverage has become a critical source of competitive advantages for enterprises, large and small.

This book focuses on the working knowledge of effective management of international business. In addition to explaining fundamental principles of conducting cross-border commercial activities, it introduces the latest theory and leading-edge practices such as double diamond model, strategic trade theory, six sigma program, synchronous manufacturing, and enterprise resource planning. To ensure relevance and practicability, the book presents tools of conceptual analysis, rules of game, and applications of techniques in the context of real cases, instructive examples, and revealing scenarios. Insights are provided on how to tackle a wide variety of practical issues such as entry mode decisions, foreign direct investments, global expansion strategies, global supply chain management, international acquisitions, managing foreign exchange risks, trade term selections, trade settlement mechanics, and transfer pricing methods.

Global perspectives are integrated with managerial implications throughout this book. International dimension is not only an integral part of its structure, concepts, and analysis, but also its case materials. There are worldwide case examples about actual experiences of established multinationals, including Japan-based Matsushita, China-based Haier, Hong Kong-based Li & Fung, Singapore-based Fletronics, America-based Aflac, Kodak, and Procter & Gamble, and Switzerland-based Nestlé. The importance of both global thinking and international management skills is also demonstrated by the cases about small and medium-size enterprises that participate in the world markets. For example, it is described that Yufo, a small manufacturer in China, encountered international settlement problems with its exports. Case examples like those are selectively diverse to shed lights on various key factors for success in challenging international environments.

This book is written based on my decade-long experiences of teaching B.A. and M.B.A. courses in International Business, International Trade Practice, and Strategic Management. at universities in China and the U. S. I would like to thank Hang Fangjin for contributing the opening case in Chapter 5, Liang Jiawen for researching case examples for Chapter 9, and Chen Shengwei for drafting the last section of Chapter 10.

Research for this book is partially funded by Lingnan college and Guangdong Natural Science Foundation. Their financial support is sincerely appreciated. It is my hope that this book can help students develop the passion, skills, and knowledge necessary to thrive in today's global marketplace.

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# *Chapter 1*
# Challenges of International Business Management

## Opening Case Galanz: A Workshop of the World

20 or even 15 years ago, microwave ovens were so rare in China that many Chinese did not know what they were. It was hard to imagine that a home-grown company, located in a county of Guangdong, could compete with foreign multinationals of electric appliances, and would become the world's largest manufacturer of the microwave ovens. Like a fairytale, Guangdong Galanz Enterprise Co. , Ltd. transformed itself from a feather and wool maker into the undisputed leader in microwave oven market worldwide in less than a decade. Galanz started to manufacture microwave ovens as late as 1993, and by 2001 its microwave ovens held 70 percent of China's market share, and over 30 percent of global market share.

Galanz originated from a small factory making feather dusters and washing duck-downs in 1978. As its duck-related-business flurished in the 1980's, the company made a range of products for exports including rabbit fur, down garments and duvets. In the early 1990's, its export business was dealt a fatal blow by newly imposed international trade rules limiting China's textile exports. The company had to find a new way out. At the time, a home appliance industry was burgeoning in Guangdong, and factories producing rice cookers and electric fans were springing up like mushrooms. Galanz took its own route by chance. At a Shanghai duty free store, Mr. Liang, the company's CEO, came upon microwave ovens, bought one out of curiosity, and brought it home. The product aroused the interest of the company's management. After serious discussions, the company decided to produce microwave ovens. To launch the program, engineers were recruited from Shanghai, and technical teams were sent to Europe and Japan for training. In 1992, a production line, along with the technology, was purchased from Toshiba for US$5 million. In 1993, Galanz made a pilot-run of 10,000 microwave ovens. The products were shipped to a Shanghai Department Store to test the market. The sales were beyond expectations. All of the products were sold out at a high price of 1, 800 yuan within a week. The gross profit margin was 100 percent. Given the success, Galanz began to expand production. As its sales grew, Galanz boosted its output to 100, 000 units of microwave ovens in 1994. By 1995, Galanz became the biggest domestic maker of microwave ovens as its output reached 250, 000 units, accounting for a quarter of China's market share.

The growing business of microwave ovens attracted many new producers, large and small. Competition was intensified. To speed up its growth, Galanz chose a low price strategy to increase sales volume, and achieve greater economies of scale. It was reasoned that the cost advantage arising from scale economies would enable the company to further lower its price, and gain more market share. Since 1996, Galanz cut its price by 40 percent each year. By 2001, the lowest price of a Galanz oven fell to the bottom of 300 yuan. Under the attacks of Galanz's massive price cuts, global giants such as Matsushita, LG Group, and Sam sung Electronic Co. , Ltd. lost a substantial portion of their previously dominated markets, and many domestic microwave oven factories did not survive savage price competition, and closed down their factories. As a result, Galanz earned a nickname of "price butcher" by the media. However, the competitive strategy worked well for Galanz, and it captured an increasingly larger share of domestic market, 34% in 1996, 47% in 1997, 61% in 1998, 67% in 1999, 76% in 2000, and 70% in 2001.

One source of Galanz' competitiveness is its Original Equipment Manufacturing (OEM) business. For Galanz, OEM is not only a fast track to international market, but also an effective strategy to build its competitive edge. By making contracted products for the multinational corporations, Galanz upgraded its manufacturing capability by acquiring production lines and the technology at a relatively low cost. For example, at the beginning, Galanz produced microwave ovens with imported parts such as transformers. The imported price of a transformer from Japan would be US$23, and over US$30 from Europe. To persuade Europeans to contract out their manufacturing, Mr. Yu, the vice president of Galanz pledged, "If your production line is moved to our factory, we can manufacture the transformers for you, and sell to you at US$8 per unit." He added, "As for the excess production capacity, we can use for our own market." It was a too good offer to be refused for the European company. Apart from low labor cost, another reason for the production efficiency of Galanz is that at Galanz, workers take three shifts, and the factory operates 24 hours a day, but in Europe, there is only one shift for 7 hours a day. Thus it may be possible for Galanz to "make the same number of things in a day that it would take Europeans a week to make." After Galanz made OEM products for Europeans, Japanese manufacturers were worried. Then Galanz offered a Japanese firm the price of US$5 per transformer on OEM terms. The Japanese firm was happy to accept the deal, and provided its production lines and technology to Galanz. With Japanese new production lines, Galanz improved its manufacturing efficiency further, and it was able to produce transformers with commeasurable quality at a variable cost of US$4 per unit. When overheads and other fixed costs were factored in, Galanz could still make profits, though the margin was razor-thin. By contrast, the Japanese firm could charge a high price on the product, and take in fat earnings due to its well-honed brand.

Through OEM contracts, Galanz now makes products for about 250 foreign companies around the world. In effect, Galanz becomes a partner with well-known multinationals like GE, Wal-Mart, Home Depot, Target, Best Buy, Carrefour, Auchan, Tesco, Kingfisher, and Karstadt-Neckermann. According to the company's recent estimate, 40% of its microwave ovens are sold under its own brand and 60% as OEM products. In 2003, Galanz sold 16 million microwave ovens, 70 percent of which for export. The company's microwave ovens accounted for about 35%, 60%, 70%, 60%, 70% and 30% share of European, Latin American, African, Southeast Asian, Chinese and world total markets respectively. In 2004, its microwave ovens amounted to 40% of global market share. All this shows that Galanz is truly a "factory for the world." In spite of such an achievement, a Galanz executive said, "We are just coolies."

**Discussion Questions:**

1. Which mode of entry did Galanz use to expand into international market? How important was this strategy to its growth?
2. Would you recommend Galanz' business model to other firms? Why or Why not?

## 1.1 Significance of International Business

It's the time of a new millennium. Economic isolationism has become a thing of the past. There is no turning back, but to face the tide of global economic integration. There are no other options, but to participate in the world market. Owing to the rapid advances in telecommunication technologies and the falling barriers to international trade and investment in the last several decades, there has been a rising trend toward an integration of national economies. This trend is commonly known as globalization. Global production and international consumerism are powerful forces for building growing interdependence among national economies. In their quest for natural resources, low-cost production factors, technical know-how or new markets, multinational enterprises (MNEs) disperse production and other operational activities to locations worldwide. As transnational businesses expand, there is acceleration in the international flow of information, goods, services, capital and people, making national borders less relevant. In the meantime, consumer preferences among different countries are converging due to flourishing international travel, Internet communication, satellite TV, global marketing and other cross-cultural activities. As customer tastes are becoming less heterogeneous, distinctions between national markets fade gradually, and world markets are increasingly more integrated.

On November 11, 2001, China joined the World Trade Organization (WTO). Since then, China's protective tariff and non-tariff barriers have been gradually reduced, and will be further cut down in the months to come. China's enterprises can no longer ignore foreign competitors, and foreign markets. The tide of globalization has not only brought forward enormous transnational markets, and business opportunities, but also intensifying competition and great threats to domestic industries. China's enterprises must be rejuvenated in order to withstand the merciless test of global competition. We all have a stake in this match of international competitiveness. We must hone our competitive skills in order to prosper in this changing era. The study of international business management is to help us become more successful participants in the world market.

International business management is an exciting subject because it is a cross-cultural study of both the science and the art of conducting transnational economic activities. International business encompasses foreign trade, overseas investment, and cross-border operations. Theoretically, it is not meant to be a "zero-sum game," where one must win at the expense of others. It is supposed to be a set of value-added activities that benefit all parties involved. Even on a high conceptual level, substantial gains from international business will go to better players, and thus it is possible that poor players may actually feel worse off because of their insignificant share of the benefits from global commerce. In reality, international business can be a cruel game where naïve players may "lose their shirts" due to misconception, deception or fraud. Undeniably, to play international business games successfully, one must know well the rules of the game, and master the playing skills, or "the tricks of trade."

The trend of globalization is irreversible. Our country is turning into the manufacturing center of the world. International business is becoming increasingly important for Chinese economy. Consider the following facts:

China's foreign trade has surged in recent years. In 2003, China's foreign trade reached US$850 billion. In 2004, it soared to US$1.15 trillion, a 35.7% increase over the previous year, and the trade surplus amounted to US$31.8 billion. Now China is the third largest trading nation in the world, next to the U.S. and Germany. It's a dramatic change because China was only ranked 10th and 7th largest trading country in 1997 and 2000 respectively.

China is one of the largest host countries of foreign direct investment (FDI) in the world. From 2001 to 2004, FDI made in China amounted to US$46 billion, US$44.8 billion, US$53.5 billion and US$60 billion respectively. China was the world's largest recipient of FDI in 2002, and the second largest recipient of FDI, second only to the U.S. in both 2001 and 2003, and the third largest recipient of FDI after the U.S. and the United Kingdom in 2004.

The value of imports and exports by foreign-related enterprises accounts for a substantial portion of China's foreign trade in the last two decades. Most of it is related to the trade of processing incoming materials. In 2004, the trade of processing incoming materials amounted to US$600 billion, accounting for 58% of China's foreign trade.

In the last decade, an increasing number of Chinese companies have expanded into international markets. So far, over 8,000 Chinese companies have made foreign direct investment in 160 countries and regions.

Obviously, international business plays a critical role in the development of our industries, the improvement in the standard of living, and economic prosperity of China.

## 1.2 The Role of International Business Environment

To succeed in business, an enterprise must first adapt to its external environment. As the pace of globalization accelerates, the competitive environment for enterprises is both domestic and international. International environment factors become important determinants of enterprises' performance. Business operations are affected by the world price fluctuations of raw materials or products, the emergence of import substitutes, the inroads of foreign competitors, and changes in trade policy of foreign countries. A simple model can illustrate the relationship between impact of external environments and the operational size of an enterprise. Let R denote impact of international environment factors, and D operational scale of an enterprise.

In the short-run, curve AB in Figure 1. 1 shows that the impact of the environmental factors and the firm's operational scale are positively related. Point A shows that the enterprise at its birth is affected by international environment factors. Point K indicates that at the start of international operations, the firm is subject to an increasingly greater influence of global environmental factors.

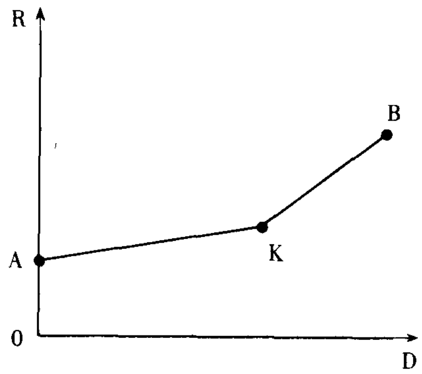


**Figure 1. 1 Short-Run Environmental Impact Model**

In the long-run, the impacts of environmental factors on the firm become more complicated, and can be illustrated by the graph in figure 1. 2. The shape of curve A – B shows the trend of increasing impacts of international environmental factors. Points h, i, g, f, and w indicate that at the different stages of the firm's operations, effects of environmental factors may vary significantly. At point i and f, the impacts of environmental factors are reduced due to the effectiveness of risk management by the company. At point w, the maximum level of output has been reached for the firm's economies of scale in its current business form. Output level beyond point w will result in diseconomies of scale. At point w, the firm cannot sustain its growth unless it restructures and reorganizes.

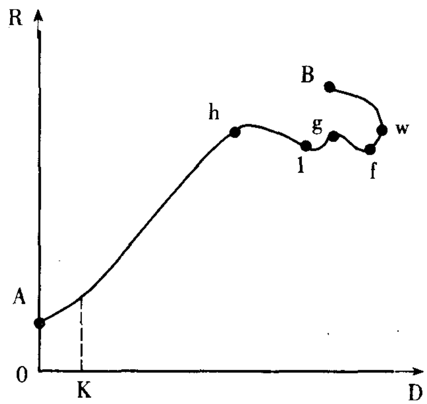


**Figure 1. 2 Long-Run Environmental Impact Model**

**Business Brief: Guideline on "Special Payments"**

According to a recent report by the U. S. Securities & Exchange Commission, a practical distinction can be recognized between payments made to government officials to procure special and unjustified favors and those made to persuade low-level government officials to perform functions that they are obliged to perform as part of their governmental responsibilities but which they may refuse or delay unless compensated.

## 1. 3 The Decision-making Function of International Managers

A firm becomes a multinational enterprise (MNE) when it has production activities in at least one foreign country. The managerial decisions of the MNE must take into account of a large number of environmental factors, including economic, political, legal, cultural, technological, and geographic variables. These variables must be incorporated into the business decision-making function.

A general function for the decision-making of the MNE can be written as:

DM = F (RS, EC, PL, SC, T, G, ⋯, N)

where DM stands for decision-making, RS for internal resources and skills of the MNE, EC for economic and competitive factors, PL for political and legal factors, SC for social and cultural factors, T for technology, G for geographic factors, and N for other factors. Main decision issues for international managers are concerned with global expansion strategies, foreign direct investment, international trade, and global operation management.

Both internal and external environmental factors place constraints that limit what the MNEs can do. Take legal factors for example, there are a wide variety of laws and regulations, ranging from the minimum wage, to foreign exchange control and local content regulations. The laws and regulations vary from region to region, and from country to country. The minimum wage law requires the companies to pay wages above a certain level. Foreign exchange control restricts the flow of currency, and imposes financial limits on the firms to gain access to foreign currency. The local content regulations require the multinational corporations to purchase certain percentage of components from local companies.

An important dimension of international business is the challenge of dealing with cultural differences. Culture is a set of common perceptions, a conventional pattern of behavior, and a traditional life style of a society. It is a value system composed of shared interests, ideas, aesthetics, attitudes, customs, common languages, laws, religions, education, and social institutions. National differences in these cultural elements require different business practices. For example, in Muslim nations, the laws of Islam prohibit usury that is the act of charging interest for loans. It means that credit card companies will violate the local laws if interest is charged on card users. To avoid such violations, the companies collect charges in the name of management fees instead of interest. Another interesting thing is that Muslims are not allowed to consume pork because it is not halal while Hindus consider cows so sacred that they do not eat beef. To adapt to the environments with religious restrictions, German company Haribo substitutes the pork-based substance with other compounds in its products for Islamic consumers, and McDonald's does not serve beef in India where there are over 600 million Hindus.

Multinationals may take a cautious approach when entering a new market with a unique culture. Take Wal-Mart for instance, it may set up "sample stores" first in a foreign market. That is, at the beginning, it opens 1 or 2 supermarkets in an area to "test the water," learning local consumption pattern, and absorbing the indigenous culture. After establishing a workable operation system, it then builds its network of chain stores. This approach is exemplified by its entry into China's markets. In 1996, it set up 2 sample stores in Shenzhen, a special economic zone in China. After a long period of 2 years, it then set up a third one. Though such a strategy reduced the risk of operating in an unfamiliar market, Wal-Mart missed a good opportunity to establish a dominant position in China.

Dutch researcher Geert Hofstede explained culture by examining four dimensions of value systems: power distance, uncertainty avoidance, individualism, and masculinity. Power distance is the level of acceptance of human inequalities by a society. In countries with high power distance, employees respect and obey their superiors simply because of hierarchical authority. In countries with low power distance, employees may openly question decisions of their superiors. Uncertainty avoidance refers to the level of people's anxiety over ambiguous situations in a society. In a culture with high uncertainty avoidance, rules and procedures are formal and strict, people want more security and career stability, and there is low job mobility. Individualism is the tendency of people to make decisions based on their own interest. In a society with high individualism, an emphasis is placed on independent initiative and personal achievement, and people have stronger desire for innovation and autonomy. Masculinity refers to the degree of prevalence of masculine values: decisiveness, assertiveness, competitiveness, and concern with material possessions. By contrast, femininity is associated with women's orientations: "caring for others and the quality of life." In highly masculine societies, men are expected to be wage earners, women stay at home to raise a family, and stress tends to be high in the workplace.

Adapting products to cross-cultural differences is critical for successful operations in foreign markets. Take Procter & Gamble (P&G) for example. It is a world-renowned leading producer in packaged goods such as Tide detergent, Crest toothpaste, and Pampers disposable diapers. In 1977 it introduced Pampers in Japan. The product was characterized by American style: thick and bulky. It was suitable for American mothers to leave diapers on their babies for longer periods. P&G was unaware of the habit of Japanese women who change their babies' diapers twice as often as the average American mothers. Japanese companies seized the opportunity, and introduced thinner, leak-resistant diapers, tailor-made for Japanese mothers. It didn't take long for Japanese companies to take away P&G's diaper sales. Pampers' market share declined from 90% in 1977 to 7% in 1985. Learning from the defeat, P&G developed an improved diaper with one-third thickness of the original product. It proved to be an effective countermove. By 1990, the new diaper took about one-third of the Japanese market.

Multinational environments are intricately dynamic and complex. International business management in such a setting is inevitably challenging even for the best minds. However, a body of valuable knowledge has been developed through the remarkable endeavors of thinkers and practitioners in this rapidly growing field. Acquiring that wealth of knowledge is essential